

# **APEC Regulatory Reform Symposium**

**Organised by: Ministry of Commerce, New Zealand**  
**Hosted by: Government of Malaysia**  
**On behalf of: The APEC Committee on Trade & Investment**

**5-6 September 1998**

**Kuantan, Malaysia**

## **OCCUPATIONAL REGULATION**

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This paper draws heavily on a paper prepared by David Parker, Blair Comley and Vishal Beri of The Treasury, Australia for the APEC Workshop on Competition Policy and Deregulation, Quebec, Canada May 18-19 1997.

# **OCCUPATIONAL REGULATION**

## **SYNOPSIS**

Regulation is an important part of the legal and institutional fabric of a country. However, governments have become increasingly concerned that inappropriate regulation may lead to adverse growth, efficiency and distributional outcomes. This paper considers possible rationales for occupational regulation and addresses the general question: "What are the appropriate objectives of regulation, and how can we design regulations to best achieve these objectives, without producing unintended consequences?" Finally, the paper concludes with a set of principles to guide the design of quality regulations.

## **INTRODUCTION**

One of the issues that needs to be addressed in reform of occupational regulation (irrespective of whether the direction of reform is for more or less regulation) is the appropriate level of regulation. Formal legal structures which codify, create and limit rights can be general to an economy or they can be specific to particular trade sectors. Occupational regulation is usually sector specific and typically has evolved as a way of codifying previous practices and custom where the pace of change or scope of transactions demand it. The appropriateness of general or specific regulation will depend upon the objective of the regulation and whether the "problem" that is addressed is isolated or systemic.

The regulation applying to any occupation can be a quite complex as it usually involves many layers and different institutional structures. Specifically, there is the general law, sector specific law and general custom and practice. There may be general or sector specific regulators and professional bodies may also undertake self regulatory functions. There is also the issue of the inter-relationship between these different layers and institutions.

The general trend in addressing these issues has been to find new ways to regulate occupations that avoid unjustified restrictions on competition and encourage best practice and innovation. The challenge is to do so in ways that promote important social goals.

## **THE RATIONALE FOR OCCUPATIONAL REGULATION**

This section discusses some rationales for regulation and some desirable properties of regulation.

Law, custom and practice all set the environment in which market transactions take place. Regulation of market activity may be necessary where additional sets of rights, or qualifications of rights, are required to assist the market operate in a manner that is efficient and equitable for participants.

Promoting competition is often useful to encourage both an efficient and equitable operation of a particular market. Competition in the market provides a discipline that balances the interest of sellers and buyers. Insofar as equity is concerned, this can be particularly important if one group may otherwise have the ability to capture all the benefits of economic activity through limiting competition. However, unfettered market activity, and unfettered competition, does not always promote the most desirable outcomes.

The regulation of occupations generally arises out of a recognition that there may be a set of circumstances where competition and unconstrained transactions do not produce optimal outcomes. Such constraints include barriers to entry (such as qualification requirements) or regulation of transactions themselves (such as price or other content controls). Three potentially legitimate rationales are often given for regulating individual market transactions in occupational services. These are: information limitations; non-voluntary transactions; and distributional concerns.

### ***Information Limitations***

A person who is purchasing goods or services needs to make an assessment of the quality of the goods or services. The consequences of making incorrect judgments (i.e. the risk) for a relatively simple good with few characteristics is likely to be small as consumers are likely to be able to form a reasonably accurate estimate of the value of the good. The ability of consumers to form accurate judgements is most likely when consumers can assess the quality of the goods after consumption and they undertake repeat purchases.

However, professional services are significantly more difficult for consumers to assess. Five key characteristics of professional services will tend to magnify the information asymmetry and its consequences. First, services are generally not observable before they are purchased as the consumer cannot inspect a service before purchase in the same direct way as can be done with most goods. Second, professional services are by their nature complex and often require considerable skill to deliver and tailor to the consumer's needs. Therefore, it can be difficult for the consumer to assess the quality of the service before it is purchased. Third, the quality of many professional services can be difficult to assess even *after* the service has been purchased. For example, if a person hires a lawyer to undertake litigation, which is ultimately unsuccessful, it can be difficult for the consumer to know whether the legal services were poorly delivered or that the case was inherently difficult to win. Fourth, many consumers are very infrequent consumers of professional services. Therefore, they do not have repeat purchases to assess quality. Fifth, the consequences of purchasing poor professional services can be significant. For example, the service may represent a large expenditure for the consumer and a defective service (e.g. a heart by-pass operation) can risk serious and irreversible harm.

These characteristics can be used to justify regulation aimed at quality assurance. Such schemes are intended to provide a guaranteed level of service quality to consumers and therefore reduce risks

associated with purchasing professional services. To some extent these schemes substitute search and information gathering by individuals with information gathering and assessment through some regulatory mechanism. These arrangements can reduce the transactions cost for consumers and help the market to function efficiently.

The focus here is on consumer protection, but that does not imply that all professional services should be regulated in the same way. Different services have different complexities and risks and, in some markets, consumers may be able to form reasonably good assessments of quality and risk through word of mouth reputation or "branding".

### ***Non-voluntary transactions***

Non-voluntary exchange may not be mutually beneficial. Concern about coercion can be used to justify laws that invalidate contracts that are entered into under duress. Generally societies have laws, customs and practices that limit the ability of individuals to coerce others. In markets for professional services there may be a case for special protection because of greater opportunity for subtle coercion. For example, professionals may have significant opportunities to misrepresent the costs and benefits of taking a particular course of action. There may also be cases where relationships of trust between the professional and the client can be abused.

### ***Distributional considerations***

Distributional considerations are often used to justify regulations which set the terms on which services are provided. These can include price caps which are intended to provide services at lower cost to low income earners.

There is a debate about whether such occupational regulation is appropriate. The key question in that context is whether distributional concerns should be addressed through direct regulation of occupations or whether there may be a better, more direct redistribution mechanism. That may depend on the stage of development of the economy but generally it is worth noting the following points. First, attempting to redistribute through such regulatory mechanisms is often not transparent. That is, it can be difficult to know whether those who the government intends to assist are actually assisted by the policy. Second, a regulatory approach to redistribution may not be well targeted. The nature of such indirect regulations is such that they cannot differentiate between income groups. Therefore, high income groups will also benefit from the regulations (funded from a cross-subsidy

from other consumers). If so, the total redistributive benefit is less than the total cost imposed on other consumers. Third, a more efficient method may be to target the distributive issue directly through the tax/transfer system. Whilst this may well be the best theoretical solution, if the redistribution would otherwise not take place, it may be best to undertake some, albeit imperfect redistribution via regulations consistent with the redistributive objectives of the government.

In summary, economists are generally sceptical about the desirability of using occupational regulation tools to achieve distributive objectives. Such regulations can lead to non-transparent outcomes, can benefit some recipients in unintended ways, and be less efficient than redistributing through the tax/transfer system.

### *Inappropriate justifications*

Regulations that have the intent of merely increasing returns to groups that are regulated are not generally considered appropriate given the arguments about distributive considerations noted above. In particular, the redistribution to regulated groups is likely to involve negative distributive consequences for relatively poor consumers.

It is not unusual that occupational regulation does indeed have that effect. For example, restrictions on entry to a profession can be expected to limit supply of the services of that profession and raise the price of the service and the incomes of those providing the service. The restriction on entry may be justified on the basis of consumer protection and, in one sense, the resulting increase in price represents the cost to the consumer of that protection, ie the consumer pays. This suggests strongly that where restrictions on entry to an occupation are justified on safety grounds, then we should be confident that the restrictions are no tighter than necessary to achieve the safety objective and that there is not some better more direct mechanism to achieve the objective. Otherwise, the consumer will be forced to overpay for the protection and the unintended effect of the regulation will be to redistribute wealth from consumers to the regulated profession. Therefore, an important objective of regulatory reform of occupations should be to ensure that regulations which have the effect of increasing the returns to occupations have some legitimate justification.

Sorting appropriate from inappropriate justifications for regulation requires that policy analysts to ask the question of what is the perceived problem that is to be addressed and why is it necessary to address this problem by regulation as opposed to a non-regulatory option. In particular, it is important that the objective of the regulation be thoroughly assessed and that the various ways in

which that objective can be achieved and the actual outcome of proposed regulations are analysed. Assessing all regulations from an economy-wide perspective, as opposed to the perspective of only those being regulated, is important if the problems identified above are to be avoided.

Using that framework, we can define good quality regulation as regulation which achieves appropriate objectives in the most efficient way. Poor quality regulation can either have inappropriate objectives or achieve appropriate objectives in an inefficient way or with unintended consequences. Compliance costs are also important in this context. Experience in a number of countries has shown that substantial compliance costs can give rise to an increased incidence of non compliance.

The following sections of the paper examine the various ways that regulation can achieve its objectives and illustrates the types of regulation which are likely to be most efficient.

## **FORMS OF OCCUPATIONAL REGULATION**

The introduction foreshadowed the complex issue of the level at which regulation should be imposed and structure of regulatory institutions. Before addressing those issues this part of the paper briefly sets out the various types of sector specific occupational regulations that are commonly imposed by governments. Many occupations have some form of specific regulation in Australia. For the most part this is a responsibility of State Governments, given that the Commonwealth Government generally does not have specific constitutional power to regulate occupations.

Occupational regulations can deal with entry barriers, transactions, and redress mechanisms and can vary in the degree of restrictiveness.

### ***Entry Barriers***

Many occupations have barriers to entry. These barriers can take a variety of forms.

**Registration** requires practitioners to register to be able to provide a particular service. Requirements for registration can include appropriate educational qualifications and/or membership of professional bodies. In addition, candidates for registration may need to pass probity tests or satisfy the criteria to be a “fit and proper” person. Registration schemes can be run by government agencies or by selfregulating industry bodies. In Australia registration schemes apply to regulate entry into a range of occupations such as law, accounting and health services.

**Licensing** is similar to registration in the sense that the grant of a licence to practice an occupation is often dependent on formal qualifications, approved training periods, or general probity tests. However, licensing can restrict entry into an occupation and place restrictions on the range of activities that an individual can carry out. Licences can be issued by government agencies or by industry licensing boards. In Australia licences to practise have been traditionally associated with many occupations, including construction and manufacturing, engineering trades and agricultural industries as well lawyers, accountants and other service professionals. For most occupations the license to practise has been valid only within the jurisdiction in which the license was granted. An additional license has been required to practise in another State or Territory.

**Negative licensing** is an approach where individuals are generally entitled to practise but can be prohibited from practising if they have committed some form of offence deemed serious enough to warrant exclusion from the industry. Negative licensing imposes lower barriers to entry than licensing.

Whilst not strictly restricting market entry, other forms of occupational regulation such as certification and information regulations are also aimed at ensuring that acceptable standards of conduct in practice are maintained.

**Certification** or accreditation is usually administered by a certification body responsible for keeping a 'list' of those practitioners who have reached a certain level of competency or meet other standards. These schemes are usually non-legislative and fostered by industry bodies. However, whereas certification indicates the achievement of a certain level of expertise or competency, a non-certified practitioner may also be able to provide similar services. For example, certified practising accountants (CPA) are distinguished from those accountants who have not completed the additional study required to become a CPA.

**Accreditation** operates in a similar way. For example, under an Agricultural and Veterinary Chemicals Accreditation Scheme administered in some jurisdictions, manufacturers, distributors and retailers who are not accredited with necessary training in the appropriate handling and storage of chemicals can be prevented from trading in chemicals.

### ***Transaction Content Regulation***



**Information regulations** are designed to directly address information asymmetries. They may require government warnings, or may require a practitioner to provide specific guidance to a potential consumer. They are generally considered to be the least intrusive form of regulation.

**Transaction regulations** may also deal with price and other forms of regulation. In this context occupational regulation is part of the broader mosaic of regulation. For example, building codes and legal procedures provide a range of regulations to ensure quality standards.

### ***Performance Based Regulation***

It is commonly stated that performance based regulation focussed on outputs is generally to be preferred to prescriptive regulations which control inputs. This is because input controls tend to be more restrictive of innovation and competition. For example, it is usually better in environmental regulation to specify permissible levels of emissions rather than specify a particular technology (ie an input) that must be used in a production process. The idea is that the performance based regulation allows firms to discover the best, or invent a better, means to achieve the emissions target which may may not necessarily be the technology chosen by the regulator.

In the case of occupational regulation, entry barriers are more in the nature of input controls than performance based criteria. To the extent that this is justified, it should be because performance based criteria would not provide adequate protection to consumers due to a significant risk that unqualified persons would not be able to systematically provide services that would reach reasonable performance criteria and that the risk to consumers of sub standard service was very high.

## **SECTOR SPECIFIC AND GENERAL REGULATION**

The justification for specific occupational regulation is that there may be individual issues that need a tailored solution, or the consequences of inappropriate behaviour are so serious that there needs to be more stringent safeguards than would normally be required. However, the various approaches to regulation are not necessarily mutually exclusive. Rather, the approach adopted is usually a combination of the approaches described above and reliance on general law. Also, some laws provide for some professional associations to set standards for entry into the occupation, to make rules for the conduct of practitioners and set other consumer safeguards. Safeguards usually extend to redress mechanisms should inappropriate behaviour be detected. Aggrieved consumers can then access accelerated dispute settlement procedures in addition to access to general legal processes.

The above discussion illustrates that the overall regulatory structure applying to an occupation is often complex. This complexity can itself pose a challenge for the reform task because analysis of and agreement about the appropriate objectives of the regulation or the best means to achieve the objectives may not be straightforward. It has been our experience in some regulatory reform exercises that there has not been agreement among the staff of the relevant regulator as to their objectives.

The decision of whether there should be regulation will depend on the nature of the transaction which is to be regulated (ie to the seriousness of the consequences that would flow from inappropriate behaviour) and the likely effectiveness of different mechanisms. It does not necessarily follow that more serious consequences always imply that a regulatory solution should be adopted. In many cases government action will not be the most effective solution as the government may suffer from a lack of information and capacity to enforce regulations. Dispersed information held by groups and individuals that are closer to the industry may be more reliable and a better basis for action. In these situations it may be more appropriate for standards of practice, for example, to be developed and regulated by the profession rather than prescribed by government. Or, the cultural context and general mores of social behaviour may impose significant sanctions for inappropriate behaviour through loss of face and reputation within the community

Alternatively, the general legal and institutional structures which apply across the economy may be sufficient to appropriately control behaviour. This may include competition law, fair trading legislation and common law principles of contract and tort and equity. (An important issue in occupational regulation is the extent to which specific regulation should displace the general law. This is discussed further in the following section.)

The general policy principle that minimum feasible regulation targeted directly at the identified objective offers some guidance on the issue of whether general or sector specific regulation should be adopted to address particular issues. Put simply, if an issue is of general concern, such as the potential for 'misleading conduct', that would be best addressed through legislation that is generally applicable. Addressing the general issue of misleading conduct on a sector by sector basis can invite problems if all sectors are not covered. On the other hand, if there is an issue that is specific to a sector, such as the need for lawyers to observe a higher than normal standard care, then that should be addressed in some form of sector specific regulation. There is a considerable risk that departures from minimum feasible regulation will give rise to unintended consequences.

## REGULATORY FAILURE

In practice regulation does not always achieve its objective and there can be undesirable side effects. This section addresses how we should evaluate regulation and further desirable properties that should be considered when setting regulations.

Three key questions arise when considering actual regulations which are in place. First, are the regulations well targeted to address the identified problems? Second, do they have unintended consequences? Third, are other policy instruments better equipped to address the same problems? If the answer to any of these questions is "no", then it is said that there is "regulatory failure". In the broad, the rationale for regulation is to address some form of market failure. Nevertheless, policy makers need to be acutely aware of the possibility of regulatory failure. There is a risk that in addressing a market failure, regulators can substitute a "regulatory failure" which may have worse consequences than the initial market failure. Ensuring that the process of regulation setting and review follows sound principles reduces the likelihood of regulatory failure. Regulations should address a clearly stated objective, be analysed from an economy-wide perspective, be the minimum feasible regulation, and be periodically reviewed by appropriate bodies.

Even if regulations were appropriately targeted when established, it is possible that the context and application evolve over time such that regulation no longer addresses the objectives effectively. Two issues that need to be considered are "regulatory capture" and "regulatory drift". Regulatory capture occurs when a regulator takes decisions which are biased in favour of the industry that is being regulated. There is a particular risk that this can occur when professional bodies or associations representing an occupation have an operational responsibility to set standards of entry, in addition to carrying out registration, licensing or even certification functions. Professional bodies may be keen to maintain the incomes of existing practitioners and can do so by restricting the supply of practitioners through high entry standards.

For example, the 1994 Baume Report, commissioned by the Australian Commonwealth Government found that the Royal Australasian College of Surgeons and other associations of specialist surgeons exercised an exceedingly high level of control over the supply of qualified general surgeons as well as the number of surgeons in various specialities. It has been suggested that the control of supply by these medical bodies is reflected in the fees and charges surgeons are able to command. A range of other studies have made similar links between the control of supply and high costs in relation to legal and accounting services.

While entry standards may be necessary to ensure consumer protection, capture of the processes of occupational regulation may lift standards above the level which is really necessary. This may create skilled, high cost services to an extent that lower quality, lower priced services are eliminated from the market. If so, consumers who cannot afford high cost services, but may be adequately served by a less qualified practitioner, tend to be marginalised or even excluded from the market. Where this occurs, governments may feel obliged to intervene further in the market to subsidise particular consumers to allow them access to the services. In effect, this is an additional layer of regulation with the objective of counteracting the effect of the regulatory failure. However, a more direct means to address the issue is to address the prior cause of the regulatory failure.

Two factors can ameliorate the potential problems of professional regulation outlined above. First, self-regulatory actions of professional bodies should be subject to competition law or to some other means of control if a competition law is not applicable. If there is no such control the likelihood of regulatory capture is high. Second, consideration should be given to ensuring that the professional governing bodies are not dominated by those that are being regulated. For example, restrictions may be placed on the number of board members who have a pecuniary interest in the regulated industry. Of course, in setting such restrictions due account should be given to the need to have members with specialist expertise.

Another concern is that even if regulations could be said to be appropriate when adopted, they can cease to be appropriate over the passage of time. Such "regulatory drift" can result from structural change in the economy due to changing technology or consumer preferences. The required level of consumer protection may rise (if services become more complex) or fall (if consumers become more sophisticated). This suggests that it is desirable from time to time to review regulations to ensure that they remain fit for purpose.

## **REFORM OF OCCUPATIONAL REGULATION**

The previous parts of this paper have developed a number of reform principles. In this part, those themes are illustrated with a number of examples from recent experiences in Australia.

Broadly, there are two distinct elements to regulatory reform - a substantive element and a procedural element.

The reform of substantive regulation applying to a sector is often called "deregulation". But that term can be misleading, as reforms of this type are really aimed at better quality regulation. In some circumstances that can actually imply more regulation. Moreover, such substantive reform can often involve an easing of the prescriptiveness imposed by regulations, rather than a strict reduction in their number. In general, such reform should aim at maintaining necessary consumer protection mechanisms while increasing flexibility for providers of goods and services. As a first step, this usually involves an assessment of the costs and benefits associated with regulation. Where necessary, it involves the pursuit of more cost-effective forms of regulation. Thus, prescriptive type regulation could be replaced by performance-based regulation, where the quality of services provided by an occupation is regulated by standards and performance measures. Governments, industry bodies and consumer groups could participate in the development of standards and performance indicators so that the priorities of each were being met by regulation. This kind of regulatory practice enables all participants in the market to take advantage of changing circumstances and adjust their priorities accordingly, without undermining the purposes of regulation.

Governments can reform their own internal processes for making regulation, with the objective that improved processes will help to ensure that new regulation is of better quality. This could involve a range of management techniques applicable in any particular situation. This process can involve a number of measures such as: provisions in specific legislation for the periodic review of that particular Act and associated regulations; providing for the review of legislation in general to determine anti-competitive effects and avenues of reform; requiring government proposals for new regulations or amendments to existing rules to be accompanied by regulatory impact statements; and sunseting arrangements. Collectively, these are called "regulatory quality" mechanisms. Regulatory quality mechanisms can help to avoid and wind back the all too evident problems of the "regulatory inflation" that many countries have experienced over recent decades.

## CONCLUSION AND GENERAL PRINCIPLES

Occupational regulation has a legitimate underlying rationale to protect the consumer due to the complexity of the services in question. However, actual regulations may not be well targeted to address these rationales and may be captured by and confer inappropriate benefits upon those who are regulated. Governments have become more aware of potential problems with regulation and have initiated a range of review processes and ongoing accountability mechanisms to make regulation more effective.

The discussion in this paper has raised a number of questions regarding appropriate policy towards regulation. The following principles attempt to capture the answers to these questions.

1. The objective of a regulation should be clearly identified and the need for a regulatory solution should be demonstrated.
2. The merits of a regulation should be assessed from an economy-wide perspective.
  - That includes an assessment of the interests of those who the regulation is intended to benefit and those who are regulated, including the compliance costs. Where feasible, this should include consultation with affected parties.
3. Minimum feasible regulation which minimise restrictions on competition should be used to ensure that regulations are well targeted and to minimise the likelihood of unintended consequences of regulation.
  - The effects of various options (including non-regulatory options) should be analysed, including direct and secondary effects and implementation issues, to determine the net costs and benefits of the options.
  - Where possible, regulatory standards should be consistent with international standards to minimise barriers to international competition.
4. Competition law or some other controls should apply to "self regulatory" activities of professional organisations to ensure that these do not bring about unjustified restrictions on competition..

5. Jurisdictions should ensure that regulatory bodies are comprised of members that strike an appropriate balance between the need to have regulations set and administered by individuals with sufficient expertise, and the need to ensure that representatives of an occupation do not have inappropriate control over entry and conduct in a profession.
  
6. Regulations should be subject to an ongoing review process to ensure that the rationale for their existence remains relevant, and to ensure that the regulation remains the best way of addressing any underlying problem.