

INTOSAI WORKING GROUP ON THE AUDIT OF PRIVATISATION

Alternatives to state-imposed regulation

Note by the United Kingdom National Audit Office

- 1 The INTOSAI Working Group on the Audit of Privatisation have examined a series of issues around the audit of economic regulation, which covers a vast range of businesses, affecting the vital interests of all citizens, and frequently accompanies the privatisation of monopolistic or dominant enterprises. In October 2001 XVII INCOSAI adopted guidelines on the audit of economic regulation (available on the Working Group's website at <http://www.nao.gov.uk/intosai/wgap/menuugu.htm>). These guidelines define economic regulation as "the exercise by the state, either directly or indirectly, of control and influence over suppliers, whether publicly or privately owned, of service to consumers".
- 2 Alongside discussions of this form of regulation, the Working Group have also debated alternatives to state-imposed regulation. At the eighth meeting of the Working Group in Budapest, Dr Ilan (SAI of Israel) presented a paper (available on the Working Group's website at <http://www.nao.gov.uk/intosai/wgap/8thmeeting/8thisrael.htm>) on circumstances in which the use of market forces and the judicial system might enable the objectives of regulation to be achieved without executive enforcement by the state. Other examples noted included casinos in the UK, where the SAI had identified grounds for reducing regulation by the state, relying more on businesses to self regulate under the pressure of reputational risk.
- 3 The attached paper by Simon Banner, regulatory economist at the UK National Audit Office, seeks to develop this discussion by examining a series of alternatives to state-imposed regulation, in particular various forms of self-

regulation and co-regulation, against the background of the objectives which society is seeking to achieve and how the behaviour of businesses might be influenced and changed in order to achieve these objectives. The paper examines the strategies available to policy makers, and the advantages and disadvantages of various types of regulatory methods ranging from state imposition to incentive based systems eg subsidies, taxation.

Points for Consideration

- Does the paper encapsulate the principal types of alternatives to state-imposed regulation?
- Are the main advantages and disadvantages suggested for each alternative reasonably comprehensive?
- It is not for the SAI to question the choice of particular regulatory regimes: that is a matter for policy makers. But the SAI will need to examine how effectively the chosen regime is working; would it therefore be valuable for the Working Group to seek to develop audit advice, based on their experiences, to help SAIs when considering these various alternatives to state - imposed regulation?

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Alternatives to state-imposed regulation

Discussion paper

Simon Banner, Regulatory Economist, United Kingdom National Audit Office

Introduction

1. Markets do not always produce the optimal outcome from society's point of view. Even where markets work well, policy makers may seek to address problems for some sections of society, or the environment. The representatives of society seek ways of changing private behaviour in order to address these problems. Often, the state imposes rules and regulations in order to achieve changes in behaviour. An alternative is to allow businesses to regulate themselves (self-regulation), or to rely on other pressures (e.g. market forces) in order to achieve the effect desired by policy makers.
2. This paper looks at how policy makers seek the most appropriate strategy for different circumstances, with the aim of improving the quality of regulatory and deregulatory decision making. It refers to themes raised in Dr Akiva Ilan's paper on "Privatising Regulation" presented at the eighth meeting of the INTOSAI Working Group on the Audit of Privatisation, Budapest June 2001. Dr Ilan set out ways in which regulation can be "privatised", through for example the creation of independent public agencies and the involvement of courts of law. He also highlighted the need for Supreme Audit Institutions (SAIs) to be alert to forms of regulation other than direct regulation. The INTOSAI guidelines on the audit of economic regulation offer guidance to SAIs on the principles involved in auditing regulatory bodies.

Rationale for regulation

3. In theory, the interaction of supply and demand in a market economy results in an outcome that provides society with the most efficient allocation of resources. In each market, the valuation that consumers place on another unit of the product (the price they pay) is the same as the cost of producing that extra unit, so it would not be beneficial for society for any more or less output of the product. So markets allocate resources to individuals according to the values they place on them.
4. But markets can produce too much or too little of goods and services from society's point of view, for

a number of reasons:

- the abuse of monopoly power may result in goods and services being under-produced, and inefficiently, with consumers paying higher prices than they would in a competitive market;
- externalities may cause goods and services regarded as beneficial (such as public transport) to be under-produced, because producers do not capture all the benefits of supply¹; while harmful outputs such as pollution are over-produced, because the polluter does not bear all of the costs of pollution;
- asymmetric information between buyer and seller may result in better quality goods and services being under-supplied, because buyers are unable to ascertain the characteristics of goods prior to purchase; and
- some goods and services (defence, policing) may not be produced in markets at all, because of the free-rider problem - both payers and non-payers enjoy the benefits of services, so there is no incentive to pay.

5. Other rationales for regulation involve social goals based on value judgements, for example:

- where provision of "essential" services is regarded as socially desirable although the provider incurs losses, for example postal services to remote locations;
- where economic agents have unequal bargaining power;
- where the interests of future generations need to be taken into account; and
- to prevent undesirable behaviour or results, such as discrimination².

Addressing the problem

6. The implications of these goals are that, even in competitive markets, there are rationales for intervention to change the behaviour of private agents (whether consumers or producers) participating in those markets. This paper looks at attempts to change the behaviour of producers, whether they are small businesses, or large publicly listed companies.

7. Any regime seeking to change behaviour (whether state-imposed regulation or otherwise) requires the following:

¹ For example, a motorist benefits when the supply of public transport increases, because congestion is reduced (other things being equal).

² Baldwin and Cave (1999) provide more examples, page 17, Table 1.

- an outline of "acceptable" and "unacceptable" behaviour, ranging from general principles to defined rules;
- means for identifying non-compliance with acceptable behaviour; and
- incentives to change behaviour, namely penalties for non-compliance, and/or rewards for compliance.

Rules and principles

8. Action to address a problem generally requires a change in behaviour. A starting point is to define what constitutes "acceptable" and "unacceptable" behaviour. This often involves the setting of standards of what is acceptable, and therefore some kind of standard is common to many types of policy strategy.

9. There are three types of standards.

Principle-based (or target) standards. These describe the objective sought in general terms, and require interpretation according to the circumstances. Such standards focus on the harm caused by a problem, rather than prescribing a particular type of process for addressing the problem. For example, a standard may call for the avoidance of harmful consequences such as the pollution that makes it impossible for a river to support fish life. Regulated bodies are free to decide how best (and most cheaply) to achieve the standards.

Performance-based (or output-based) standards. These specify the desired outcome in precise terms, but allow each regulated body to determine for itself how to achieve the outcome. The focus is on the level of risks that a process creates, rather than the actual harms done. Performance standards demand a given level of delivery, but do not specify how that delivery is to be arrived at (emission standards are an example).

Prescriptive (or specification, or design) standards. Specification standards focus on prevention by controlling the process that give rise to harm (for example specifying how much river pollution per hour a process may produce).

Monitoring

10. Without monitoring, it is impossible to assess whether the action taken has resulted in a change of behaviour, such that policy objectives are being met. Inspection by government agencies and self-certification are examples of monitoring.

Incentives

11. Regulated bodies may need incentives to change their behaviour, otherwise the problem identified may not be addressed. Incentives fall broadly into the categories of "carrot" and "stick", although regimes can combine the two. For example in the UK railways, the rail network operator makes payments to train operating companies if it causes more train delays than the performance regime benchmark, but receives money if it causes fewer delays.
12. It is more common to find regimes with penalties for not behaving in a way consistent with policy objectives, ranging from negative publicity to fines and imprisonment. Rewards for behaving in a manner consistent with policy objectives are less common, with probably the most obvious example being subsidies to produce goods and services that would not otherwise be produced in a free market.

Strategies available to policy makers

13. An important question, therefore, is – who should address the problem? The state may impose a solution to the problem, it may create regulatory agencies to address the problem, or it may leave it to others – regulated bodies themselves, or to the courts – to find solutions. Each of the three features identified above – rules or principles, monitoring and incentives – can be specified and undertaken either by the state, or by others.
14. There is a range of regimes available to policy makers that can bring about changes in behaviour.

State-imposed regulation

15. State-imposed regulation is defined by Baldwin and Cave as “*the exercise of influence by imposing standards backed by criminal sanctions ... The force of law is used to prohibit certain forms of conduct or to demand some positive actions or to lay down conditions for entry into a sector.*”³
16. State-imposed regulation has three main characteristics.
 - it attempts to change the behaviour of regulated bodies, by detailing how they should or should not behave, for example through legislation or through licensing;
 - it generally relies on government inspection and/or monitoring to detect non-compliance; and
 - it imposes punitive sanctions (such as fines) if the regulations are not complied with.
17. Under state-imposed regulation, the state plays a large or exclusive role in determining rules and

³ Baldwin and Cave, *Understanding Regulation*, page 35.

principles, monitoring methods and incentives for compliance. It is common for rules and principles to be set by government departments through primary or secondary legislation, and then enforced by local authorities or regulatory agencies. In some cases, Parliament creates regulatory agencies to specify what is acceptable behaviour in an industry. In the UK, the Office of Water Services (Ofwat) was created in 1989 to regulate the water and sewerage industry in England and Wales. Licensing is often used to determine and screen entry to an industry, and to regulate aspects of activity such as quality of service or customer protection thereafter.

18. Monitoring often takes the form of inspection by government-appointed agencies. Incentives are provided by the state, often laid out in Acts of Parliament. In some cases removal of a licence to operate, or criminal sanctions, may be applied to those who breach regulations.

Figure 1: Examples of state-imposed regulation in the UK

In 2000, the Department of Health introduced new regulations requiring the licensing of butchers' shops in England and Wales. In order to improve standards of food hygiene and management in butchers' shops, only licensed premises are permitted to handle and sell unwrapped raw meat and ready-to-eat food from the same premises⁴.

Ofwat controls the prices charged by water companies in England and Wales for water and sewerage services, to prevent monopoly water and sewerage suppliers from abusing their monopoly power.

Advantages

19. Claimed advantages⁵ of state-imposed regulation include the following - it offers certainty; it carries the force of law; it prescribes minimum standards of behaviour and screens entry; and it is subject to public scrutiny⁶.
20. Policy makers often prefer state-imposed regulation for high risk, high impact public issues, in particular, protection of the safety of consumers and employees. State-imposed regulation also has the potential to work when addressing well-defined problems that are stable over time.

⁴ See Appendix.

⁵ In this discussion paper, advantages and disadvantages are those suggested by theory. Baldwin and Cave offer a more comprehensive list (chapter 4).

⁶ In the UK, for example, regulatory agencies such as Ofwat are accountable to Parliament, including through the SAI's reports to the Public Accounts Committee.

Disadvantages

21. State-imposed regulation may be inflexible, and unresponsive to changes over time; complex rules can multiply over time; there may be a long delay before the regulation takes effect; enforcement is costly, and compliance costs are high. It may act as a barrier to entry into the market; it provides an incentive to meet the standard but no more (alternatively a risk of "gold-plating"); "creative compliance" (complying with the letter but not the spirit); and the risk of "regulatory capture"⁷ by the industry.
22. State-imposed regulation may be inappropriate for influencing the quality of the provision of complex services such as those provided by many of the professions. The more complex the services provided, the greater the proliferation of rules required, leading to "over-regulation, legalism, delay, intrusion on managerial freedoms, and the strangling of competition and enterprise"⁸.

Self-regulation and co-regulation

23. Self-regulation can be seen as a substitute for state-imposed regulation, and also as a self-administered form of regulation. The term self-regulation covers a wide variety of schemes⁹. Also, membership of schemes can be either voluntary or compulsory.

a) Self-regulation

24. Self-regulation generally takes the form of representatives of an industry (through a trade association for example) formulating rules and codes of conduct, with an industry solely responsible for monitoring of its members and enforcement.

⁷ Capture occurs when regulation is biased by "the pursuit of the regulated enterprises' interests rather than those of the public at large" (Baldwin and Cave, page 36).

⁸ Baldwin and Cave, page 37.

⁹ The UK National Consumer Council, quoted in the Better Regulation Task Force report (2000), identifies eight different categories - unilateral codes of conduct; customer charters; unilateral sector codes; negotiated codes; trade

Figure 2: Examples of self-regulation in the UK

The Banking Code, sponsored by the British Banks Association, is a negotiated code. Membership is voluntary, but all main banks and building societies subscribe.

The National Federation of Builders, a trade association underpinned by a unilateral code of practice, whose membership is voluntary.

b) Co-regulation

25. Co-regulation is an intermediate step between state-imposed regulation and self-regulation (it is also known as *enforced self-regulation*). Industry develops and administers its own arrangements, but government provides legislative backing to enable the arrangements to be enforced. For example, trade association codes of practice in the UK are approved by the Director General of Fair Trading, under the Fair Trading Act 1973.

Figure 3: Examples of co-regulation in the UK

The Broadcasting Standards Commission (BSC), a non-departmental public and statutory body set up under the Broadcasting Act 1986, and underpinned by a recognised code. Membership is compulsory for all UK broadcasting authorities.

The General Medical Council professional conduct standards - a statutory body under the Medical Act 1983 and the Professional Performance Act 1995, underpinned by a recognised code. Membership is compulsory by statute.

The regulation of the UK accounting profession was re-organised in 2001 to provide additional safeguards to the system of self-regulation. The profession is now monitored by an eight-member Review Board, chaired by Sir John Bourn, the Comptroller and Auditor General, and has a majority of members from backgrounds outside the accountancy profession.

26. Under self- and co-regulation schemes, rules and principles may be determined by the industry itself, rather than imposed by the state. Monitoring arrangements also tend to be undertaken by the industry itself. The provision of incentives is what distinguishes between self-regulation and co-regulation – under the latter, the state provides incentives for compliance.

association codes approved by the Office of Fair Trading; recognised codes; official codes and guidance; and legal codes.

Advantages

27. These include engendering a degree of ownership of regulation within the industry; lower government administration costs, because schemes are developed and often administered by business; and lower compliance costs for business. Rulemaking should be better informed (because industry members know more about the industry than government officials); and rules may be tailored to specific needs, and thus better targeted than state-imposed regulation.

Disadvantages

28. Rules may be self-serving; there is potential for creation of restrictions on competition (e.g. barriers to entry); "rogue" businesses participating and not complying with minimum standards; ineffective sanctions for non-compliance; and rulemaking may be closed to the public or consumers (unaccountable).

29. There are also potential risks associated with self- and co-regulation arising from the way governments implement such schemes¹⁰. These include:

- the risk of "regulatory creep" as government increases its involvement in schemes that start out as self-regulation;
- pitching standards too high, imposing unnecessarily heavy compliance burdens on business;
- confusion about the status and enforceability of self- and co-regulation arrangements, and some businesses ignoring schemes where they regard full compliance as impractical;
- schemes which aim to shift compliance costs from government to industry, because industry has to develop and administer schemes.

Alternative policy instruments

30. There are other policy instruments which may be available to policy makers.

Financial incentive-based schemes

31. Financial incentive schemes tend to employ rules rewarding firms and individuals who behave as policy makers wish, and penalising contrary behaviour. Taxes and subsidies can be used to influence the behaviour of businesses and individuals. For example, subsidies may encourage the production of

goods and services judged beneficial by policy makers, when these goods and services would be under-produced (or not produced at all) by markets, because of the existence of externalities. And taxes may be used to reduce the over-production of goods regarded as harmful to society, including pollution.

32. Regulators can provide incentives in other ways. In their last reviews of price controls, the UK regulators of electricity and gas (Ofgem) and water (Ofwat) introduced schemes allowing higher price increases to companies whose service performance is high relative to other companies in the industry.
33. Schemes involving taxes or subsidies involve the state in the setting of rules and principles (which can be very detailed), monitoring arrangements (to avoid fraud) and the provision of incentives (since government finance departments must budget for such arrangements).

Advantages

34. Incentive schemes tend to be rule-based, reducing the extent of regulatory discretion and the risk of regulatory capture; they avoid "micro-management", minimising information collecting burdens and leaving managers free to manage. And they offer the possibility of reducing harmful behaviour such as pollution to zero, because (say) the polluter benefits from every unit of pollution reduction¹¹.

Disadvantages

35. Rules can be complex (for example taxation rules), and may run counter to flexibility for dealing with problems; and they may be contentious. Taxes can be avoided or evaded, and the use of taxes and subsidies can introduce inefficiencies to the economy; incentive schemes may mistakenly assume rational behaviour, and predicting the effects of incentives may be difficult.

Market-harnessing controls

36. Examples include the use of competition laws to prevent the abuse of monopoly power; regulation by contract; franchising; and tradeable permits.

General competition law

37. Some governments (for example the Government of New Zealand) rely on general competition law as a mechanism for influencing market behaviour of private firms in the telecommunications industry. By contrast, other countries have created industry-specific regulatory agencies. For example in the UK, Oftel was created in 1984, as a regulatory agency with rules specific to the telecommunications

¹⁰ Listed in the Office of Regulation Review guidance (1999), Appendix E.

¹¹ Under formal regulation, there is no incentive to reduce pollution below the specified standard.

industry (laid down by the Telecommunications Act 1984).

38. Reliance on general competition law requires the state to determine those laws. Once in place, schemes are monitored and administered by private agents and the courts. Incentives may be partly determined by the state (for example maximum fines), while the courts may have some discretion in setting penalties.

Advantages

39. Greater consistency of regulation across sectors; less intrusion in firms' internal decisions; lower government costs of administration (no sector-specific agency) and enforcement (issues are settled in the courts through private actions).

Disadvantages

40. Broad principles may not easily translate to operational issues; slow development of industry guidelines; judicially developed principles only emerge as cases happen to arise.

Regulation by contract

41. Under regulation by contract, government departments and agencies contracting with private enterprises can stipulate desired objectives as part of the contract. This allows the introduction of standards across all firms contracting with the government, while avoiding the need for state-imposed regulation. There are many examples of this in Government outsourcing.

Tradeable permit schemes

42. Tradeable permit schemes can be used to control both entry into a market and subsequent behaviour. Typically, the public agency issues a number of permits, each allowing a specified course of behaviour. Subsequent trading allocates permits to those who value them most highly, which results in efficient allocation. In the US, the Environment Protection Agency operates a tradeable permit scheme for sulphur dioxide emissions.
43. The state specifies the rules and principles of behaviour. There may be some state involvement in administering the scheme, for example if the number of permits is to be increased or decreased. Incentives are provided by price signals, through the value of permits trading in the market.

Advantages

44. Greater allocative efficiency; an upper limit on total pollution is possible; incentives to reduce harmful behaviour can operate down to zero (as with taxes); more freedom for management than under

state- imposed regulation.

Disadvantages

45. Enforcement is still required; barriers to entry may be created in markets with few firms if permits are hoarded; permits can be seen politically as "licences to pollute"; and the market dictates the price of pollution, so accountability is low.

Disclosure

46. Disclosure rules usually prohibit the supply of false or misleading information, and may also require mandatory disclosure. Disclosure regulation helps consumers to make decisions on the acceptability of the characteristics of goods and services, and the processes employed in producing them. Product labelling is an example.

47. The state is involved in setting rules and principles, where it defines the nature of the information to be disclosed. Monitoring also may require some state involvement, although some reliance may be placed on reporting of a non-complying business by consumers and competitors. And the state is involved in setting incentives, and particularly sanctions for non-compliance.

Advantages

48. Low intervention; less danger of capture; and consumers decide the issues.

Disadvantages

49. Information users may make mistakes; they may not respond in anticipated ways; information costs may be high; risks may be too great; and policing of information quality may be required.

Direct action

50. Governments can build and own facilities to meet policy objectives, then lease these out to private manufacturers. Direct action is amenable to activities where planning is important, and where small businesses may not be able or willing to invest in the necessary infrastructure. London's bus network is publicly owned, but routes are competitively tendered or franchised.

51. The state is involved in setting rules and principles (by initiating construction), and may be involved in monitoring, to ensure the stewardship of the assets while in private hands. And the state may be involved in providing incentives if services require subsidy in order to operate commercially.

Advantages

52. It allows separation of infrastructure ownership and operation; ensures acceptable level of provision.

Disadvantages

53. The fairness of subsidies and public sector involvement may be contentious; funding is costly; innovations may not be market driven.

Rights and liabilities laws

54. The government allocates rights to encourage socially desirable behaviour. If clean water rights are assigned to river users, the prospective polluter may be deterred by the potential liability to pay damages when sued by the rights holder.

55. The state sets rules and principles by allocating rights to private agents. However, the state can avoid involvement in monitoring arrangements and incentives, leaving these to be determined by private agents and the courts.

Advantages

56. Self-help; low intervention; low costs to government.

Disadvantages

57. Undesired events resulting from accidents and irrational behaviour may not be prevented; costs may deter individuals from enforcing; evidential difficulties and legal uncertainties may reduce enforcement; insurance may temper deterrence effects.

Public compensation/social insurance

58. These are insurance schemes that link premiums to performance. Typically, employees surrender their rights to sue employers for damages in relation to health and safety failings. In return, they are entitled to statutory compensation, often amounting to full payment of lost earnings plus costs. The incentive to maintain a healthy, safe environment is financial. The employer's premiums depend on their organisations' past claims experience, so the insurer of an employer operating a relatively dangerous environment would receive more claims, and would charge a higher premium to such employers.

59. In theory, the involvement of the state is minimal, as rules and principles are set by the insurer, who also administers the scheme and provides incentives. Monitoring is effectively undertaken by

employees.

60. Low intervention in management; low danger of regulatory capture; accurate accident reporting encouraged; employers made aware of full costs of activities; no need to legislate for each individual harm.

Disadvantages

61. Incidence levels may be too low to allow risk discrimination; tension between loss-spreading and the incentive to behave responsibly; inspection and scrutiny is expensive; and may operate similarly to state-imposed regulation.

Education

62. Another option for policy makers is to provide information to those whose behaviour they seek to change. An example from the UK is the Office of Fair Trading's campaign to inform businesses about cartels and the Competition Act 1998. The regulatory agency provides advice to businesses on how to complain about suspected cartels, and how to confess if they are members of a cartel. Education can be a feature of both state-imposed and self-regulatory schemes.

Choosing an appropriate policy strategy

63. For any given problem, there should be a number of regulatory and alternative options available to regulators. The example over the page demonstrates that regulators have many available options in considering how to address a hypothetical problem of a business polluting a nearby river, perhaps by dumping toxic chemicals.

Figure 4: Dealing with pollution of a river

The regulator could adopt one of several strategies:

- do nothing;
- make the dumping of noxious substances unlawful (state-imposed regulation);
- rely on trade association codes of practice (self-regulation);
- tax the polluter, or offer rewards to producers who reduce discharge levels (incentives);
- "name and shame" polluters (disclosure);
- provide for rights to clean water, enabling victims to claim damages (rights and liabilities); or
- introduce tradeable permits to pollute (market-harnessing through tradeable property rights).

Finding an appropriate solution

64. Although there are many strategies available, it is often the case that regulators choose state-imposed regulation. One theory put forward is that government can do one of three things - tax, spend and regulate, and budgetary controls on the other two make regulation the easiest option. Also, it is argued that policy makers are motivated to introduce regulations that shift the costs of addressing a given problem from government to businesses, because overall government spending is reduced as a result.

65. The UK NAO recently published a study on the use of Regulatory Impact Assessments (RIAs) by government departments, as an instrument for better quality decision making¹². We found that evidence of consideration of alternatives to regulation was limited, and only one of our 23 RIA case examples did not result in state-imposed regulation.

66. There are also reasons why it may be understandable for policy makers to tend to choose state-imposed regulation. Aversion to risk-taking may mean that innovative solutions to problems are rejected in favour of state-imposed regulation, with which policy makers may be more familiar.

¹² *Better Regulation: Making Good Use of Regulatory Impact Assessments*, HC 329, 2001-02.

Steps to identifying the appropriate strategy

67. All policy strategies have strengths and weaknesses, which make them more or less suitable to particular circumstances. Therefore it is important that policy makers clearly identify the problem or issue involved; the objective of any action taken; and the risk of the harm occurring. This means that an assessment of risk is an important part of policy making. Risk assessments focus on two aspects, the probability of the problem occurring, and the impact if the problem occurs. It should then be possible for regulators to consider a range of regulatory and non-regulatory options for dealing with the problem¹³.
68. One method of finding the right combination of strategies is the *pyramid strategy*. Ayres and Braithwaite¹⁴ suggested a hierarchy of policy strategies in the shape of a pyramid. Self-regulation is the base, favoured as the initial response to a problem. As the base of the pyramid is larger than the other parts, we should expect self-regulation to be most common. Where desired results are not achieved, co-regulation (with greater government monitoring) becomes appropriate. Only when these strategies fail should state-imposed regulation be brought forward. The apex of the pyramid is smallest, in keeping with the notion that state-imposed regulation should be a last resort.

Appropriate solutions - Better Regulation Task Force work

69. The Better Regulation Task Force was established by the UK Government in September 1997, to improve the quality of regulation. In a recent report¹⁵, the Task Force set out to assess (through the use of case studies¹⁶) the appropriateness of different solutions to different problems. The Task Force argued that alternatives to state regulation should be considered by policy makers where:
- markets are fragmented, with large numbers of small operators, because there may be too many operators for external enforcement to cover effectively;
 - the range of stakeholders is broad, because it is difficult for the state to step in between polarised positions;

¹³ These are the initial requirements for Government Departments in the UK when producing Regulatory Impact Assessments (RIA's), as specified in the Cabinet Office guidance (August 2000).

¹⁴ Baldwin and Cave, page 99.

¹⁵ Better Regulation Task Force (2000).

¹⁶ In its case studies, the Task Force looked at advertising, domestic builders and general practitioners.

- fast-changing environments are involved, because static regulations may hinder developments;
- expertise levels are high, because the state may have insufficient expertise to regulate effectively; and
- expertise is spread across a range of different groups.

70. Is state-imposed regulation more appropriate than self-regulation in areas of high risk? For example, could self-regulation be applied to the nuclear industry? The Task Force set out to identify any correlation between the degree of risk and the level of state involvement in several areas. The report did not find strong correlation between risk and state involvement. On the contrary, some areas of greatest risk - medicine, accounting and legal services - had a significant degree of self-regulation.

Appropriate solutions - Oftel's approach to self- and co-regulation

71. The UK telecommunications regulator Oftel has examined the appropriateness of different policy strategies to its four high level strategic objectives – effective competition, well informed consumers, adequately protected consumers, and prevention of anti-competitive practices¹⁷. Taking the example of well informed consumers, Oftel considers that self- and co-regulation are well suited to meeting this objective. Examples include the *Big Number* campaign, an awareness campaign on telephone numbering changes in 2000, and a website (*phonebills.org*) sharing tariff information with consumers to make choosing between suppliers easier. Oftel considers that its main role is to start consumer information initiatives, and to step back as the initiatives gain momentum, leaving self-regulation in place¹⁸. Oftel identified the coincidence of interest between industry, consumers and the regulator, as a key factor in determining whether self- or co-regulation is appropriate¹⁹. As a result, Oftel considers that self- and co-regulation also have a role in two of its other three objectives²⁰.

Ways forward

72. The approach that Oftel has adopted appears useful, where the regulator has identified objectives, and sought to identify which forms of regulation or self-regulation appear most appropriate. It would be

¹⁷ *The benefits of self and co-regulation to consumers and industry*, Oftel, July 2001.

¹⁸ Oftel (2000), paragraphs 2.10 to 2.15.

¹⁹ Oftel (2000), paragraph 2.22.

²⁰ Oftel considers that state-imposed regulation is best suited to the prevention of anti-competitive practices.

interesting to see whether other regulatory bodies have considered such an approach. The following sections set out other possible ways of improving regulatory decision making.

Following good practice

73. Several national and international bodies (including the Organisation for Economic Cooperation and Development, or OECD) have issued guidance to policy-makers on how to introduce good quality regulation, and this includes guidance on the consideration of alternatives to state-imposed regulation. For example, the OECD says²¹:

“Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects, and administrative requirements.”

74. The UK Government has made guidance available to policy makers on how to produce good RIAs²², which requires policy-makers to consider alternatives to state-imposed regulation, after identifying the issue and objectives and undertaking a risk assessment. The guidance requires regulators to consider both regulatory and non-regulatory options for addressing problems. The NAO study of Regulatory Impact Assessments found limited evidence that this was being done in a systematic way across Government. Consideration of options for action tended to be limited, and in only one case was an alternative policy instrument (using taxes and subsidies to influence behaviour) demonstrably considered²³.

Working with stakeholders

75. The licensing of butchers' shops in the UK provides an example where, even though regulation is state-imposed, government and industry can work together to address important public health issues, in development and enforcement of regulations. This resulted in regulation that was targeted on the problem identified, namely licensing of butchers' shops where the risk was present, rather than licensing of all butchers' shops regardless of risk (see Appendix).

Deregulation

76. The preceding discussion looked at ways in which policy makers could consider alternatives to regulation, before deciding whether to regulate or not. However, there is a considerable stock of

²¹ OECD checklist (1995), question 3.

²² UK Cabinet Office, August 2000.

²³ *Control of Pollution for Oil Stores RIA*, DETR, April 2000.

existing regulation, and policy-makers should regularly review such regulation, in order to assess whether the problem it was originally intended to address still exists.

77. It is possible to consider deregulation in terms of the constituent parts of regulatory regimes – rules and principles, monitoring, and incentives. For example, the state could move from a position where rules and principles are defined by statute or by regulatory agencies, to a self-regulatory structure where the industry itself sets the rules and principles. Monitoring procedures may be changed from comprehensive testing to a more risk-based approach. And policy makers may look for a more persuasive approach to incentives to change behaviour, away from more coercive provisions.
78. Particularly of note is experience in the UK utility industries, where sector-specific regulators are withdrawing from regulation in some areas, while attempting to target regulation where problems remain (or arise). This is less evident in the case of government departments handling general regulation.
79. A topical example of de-regulation is the decision of the energy regulator (Ofgem) to remove price controls on domestic gas supply²⁴. Price controls were introduced at privatisation to protect consumers from the abuse of monopoly power. Ofgem judges that competition has developed to the extent that suppliers to the residential gas market no longer possess monopoly power - if any firm attempted to raise price, it would lose custom to other suppliers. Competitive pressure is sufficient to protect consumers. However, although state-imposed regulation (through price controls) has gone, Ofgem still (through the Competition Act 1998) has competition law at its disposal if there is any evidence of anti-competitive behaviour by suppliers.
80. Finally, it is worth noting that badly managed (or badly co-ordinated) deregulation can have disastrous consequences for consumers²⁵. Blackouts in California in early 2001 were caused by a failure to build sufficient generation capacity to meet demand following deregulation in 1996, combined with tight supply price controls. And the electricity supply failure in Auckland in 1998 was caused largely by the supplier's failure to maintain network assets, a problem that good quality regulation would have been likely to detect and prevent.

²⁴ *Ofgem announces decision on BGT price control*, Ofgem, 26 February 2001.

²⁵ A good article on the subject by John Kay can be found at http://www.johnkay.com/articles/search.php?action=view&doc_id=224

Case study - Licensing of butchers' shops in the United Kingdom

Case-example - HACCP

Hazard Analysis Critical Control Point (HACCP) is a structured approach to ensuring final food safety through managing and controlling hazards inherent in the food handling and production process. Its advocates include the World Health Organisation, the European Commission and the UK Government's independent Advisory Committee on the Microbiological Safety of Food.

In March 2000 the UK Department of Health introduced a requirement²⁶ for all butchers' shops handling and selling unwrapped raw meat and ready-to-eat foods from the same premises. The regulation was introduced following the *E.coli* 0157 outbreak in Central Scotland in November 1996, which resulted in the deaths of 17 people, and a further 500 people were made ill as a result.

Although the regulation requires all such shops to be licensed, the licence does not specify detailed standards for shops to comply with. Instead, licensees are required to operate HACCP procedures that constitute a risk management approach to hazards on their premises. HACCP procedures are based on: analysis of potential food hazards; identification of the points where food hazards may occur; deciding which identified points are critical to ensuring food safety; effective control and monitoring procedures at critical points; verification that procedures are working; periodic review of the above; and documentation of all procedures.

The UK Government contributed £4.5m to fund the initiative, which included the development of a generic HACCP system for use in retail butchers shops, and associated training materials, both approved by the Royal Institute of Public Health and Hygiene. The initiative also provided free advice and state-imposed training for staff at premises, including how to devise an effective HACCP system, and on-site advice and support to retail butchers to reinforce training and ensure that effective HACCP arrangements are in place. The initiative was overseen by a Steering Group involving Government, professional, enforcement, industry and consumer representatives.

²⁶ The Food Safety (General Food Hygiene) (Butchers' Shops) Amendment Regulations 2000.

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