EDITORIAL: BETTER REGULATION WITHOUT THE STATE

Keith Boyfield

There has been mounting concern about the increasing level of regulation in the UK economy over the last decade or more. Regulation has significant costs and is difficult to repeal. The government has set up various bodies to examine deregulation and better regulation. This article and the other articles in this issue look at those approaches and ask whether the state should be involved to a lesser degree in regulation. In many areas, it may be appropriate for the state to withdraw altogether, either because the private sector can spontaneously develop better regulation than the state can or because the unintended costs of state regulation are so great.

Introduction

The damaging effects on economic growth resulting from excessive regulatory oversight have attracted mounting media coverage in recent years. Nowhere has this concern been more in evidence than in the United Kingdom, where the Labour government elected in May 1997 has introduced a wide raft of new regulations and legislation aimed at delivering its manifesto pledges. In a report published last year, the then Better Regulation Task Force (BRTF) estimated that 'the cost of regulation to the UK economy is between 10–12% of GDP – or over £100 billion – similar to the annual take in income tax' (BRTF, 2005a, p. 2).

Administrative costs, or red tape as the popular press prefers to describe it, account for just under one-third of total regulatory costs in the UK. The rest – about 70% – is down to policy costs relating to the development of regulations on environmental protection, health and safety, economic regulation and much else.

Not all regulation springs originally from Whitehall. An increasing proportion is generated by the European Commission in Brussels. In value terms, HM Treasury calculates that around half of all new legislation impacting on business derives from EU law (2004 Budget, p. 60). Fifty years ago, the European Commission passed only 20 Regulations and no Directives, but by 1998 the Commission was reaching a peak of production, issuing no less than 158 Directives and 3,008 new Regulations in that year. Note that a Regulation applies throughout the EU, whereas a Directive sets out the framework, purpose and intention of an EU law: member states are then left to transpose these rules into their own legal statute books, a process that triggers considerable 'gold plating' in the UK.

In one of his first speeches as the incoming EU Trade Commissioner, Peter Mandelson argued that what the EU needs is 'less regulation, but more effective regulation'. By his own estimation, he judged regulatory costs accounted for about 4% of the EU's gross domestic product. More alarming still, Mr Mandelson conceded in his address to the CBI's annual conference in November 2004 that the cost of EU-generated red tape was roughly double the economic benefits generated by the single European market (source: 'Mandelson Comes Out Fighting on State Aid', *Financial Times*, 9 November 2004).

In the light of this soaring regulatory overload, it comes as no surprise to see that deregulation has become a popular political prize, both in the UK and EU contexts. In recent years, the UK government has exhibited a new commitment to the cause of deregulation, at least in terms of rhetoric, while the EU has adopted a Six Presidencies initiative aimed at culling the *acquis communautaire* (i.e. the accumulated EU regulatory rulebook) and employing a far more rigorous approach to new regulations. How far these initiatives will succeed has yet to be judged, but at least it is a step in the right direction.

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The urge to regulate

Why have we witnessed such an explosion in statutory regulation in Britain over the last decade? The answer may lie with the Blair administration's faith in regulation as a tool to achieve certain desired political objectives – although it should be said that the economy inherited by the Labour government was not the liberal, free-market paradise to which most IEA authors would aspire!

While in Opposition, New Labour consistently criticised the Conservative government for its attachment to free markets and its alleged lack of interest in a range of social and environmental objectives, which Labour politicians viewed as important goals of public policy. Once the Labour Party won office in May 1997, ministers lost no time in implementing a host of measures aimed at regulating economic activity in one form or another. Invariably, this was justified on the grounds of 'market failure', although in many instances the problems were more clearly associated with government failure.

The utilities sector, comprising water, gas, electricity and telecoms, was a key part of the UK economy that attracted government ministers' attention. Shortly after assuming office, Labour imposed a so-called 'windfall' tax on a group of utilities, a move that was justified on the grounds that they had earned super-profits under the previous administration due to lax regulation. In total, the Windfall Tax levy raised just over £5 billion. Approximately £2.2 billion was paid by electricity utilities, with a further £1.65 billion coming from water companies. An additional £1.45 billion was contributed by BAA plc, Railtrack plc, BT plc and Centrica plc. The money raised was channelled into public expenditure programmes favoured by the Chancellor of the Exchequer, Gordon Brown, notably the 'Welfare to Work' initiative aimed at young people, the long-term unemployed, lone parents and the disabled (1997 Pre-Budget Report, para. 4.21).

Politically, it is worth noting that the Windfall Tax was strongly supported by trade unions, many of whom drew their membership from the industries privatised by the Conservatives, notably the energy utilities, water, telecoms and rail.

The next item on New Labour's agenda was to introduce an assortment of initiatives in order to regulate individual sectors of the economy, such as utilities, financial services and rail. The Utilities Bill is a good illustration of this legislation. Originally, the Bill dealt with the regulation of water, gas, electricity and telecommunications. In the second reading debate in the House of Commons, Stephen Byers, the Secretary of State for Trade and Industry, claimed that the government had 'inherited a fundamentally flawed system of utility regulation'. This new Bill, he promised, would put 'consumers first and provides a basis for effective competition and a stable framework of regulation for the future'. In reviewing the utilities sector, Byers asserted that competition was lacking, consumer representation was inadequate and regulation was over-personalised.

Following an intense period of lobbying by industry groups, the government drastically amended the Bill so that it only dealt with regulatory reforms in the gas and electricity markets. In retrospect, the Bill can be seen as a shambles. Dieter Helm, a leading energy economist and a Fellow of New College, Oxford, has observed that the Utilities Act was one of the 'worst examples of poor drafting in recent times', and one, furthermore, that showed a woeful ignorance about how utilities operate in the real world (Helm, 2003, p. 292).

New Labour's enthusiasm for regulation in the utilities sector was mirrored by new legislation in several other key areas of the UK economy, notably with the Financial Services and Markets Act that re-engineered the Financial Services Authority (FSA); the Strategic Rail Authority (SRA) and Office of Passenger Rail Franchising (ORR) in the transport sector; Ofgem, a combined energy regulator; Ofcom, a new super-regulatory agency in the communications and broadcasting fields; and a revamped Office of Fair Trading (OFT) and Competition Commission, an anti-trust body that replaced the former Monopolies and Mergers Commission. All these entities were given substantially higher budgets, which they deployed to recruit larger numbers of staff, many of whom were handsomely remunerated. This has given rise to a new *apparatchik* class, the like of which we have not seen previously in the UK.

This urge to regulate was underpinned by a commitment to establish a whole new raft of statutory consumer watchdogs. Since Labour was elected to office, we have seen the creation of many such entities, including EnergyWatch, PostWatch and the Rail Passengers Council. These bodies have substantial budgets and staff. Indeed, PostWatch has a far larger budget and a much bigger payroll than Postcomm, the regulatory agency established to oversee postal services. Again, the government justified the creation of these bodies on the grounds that there was market failure in the sectors concerned. Consequently, it was claimed, consumers required an official voice to speak for their interests. The fact that this implied a weakness in the common law protecting consumer interests was largely ignored by ministers.

The better regulation initiative

New Labour's enthusiasm for new regulatory bodies and regimes soon began to trigger a backlash from business and commerce. Owners and managers became increasingly alarmed at the soaring amount of time they had to spend on regulatory matters; they

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also had to foot the bill for many of the new regulatory agencies.

This was seen across the UK economy and vividly demonstrated in the financial services sector, which was overwhelmed with forms and surveys from the FSA, and from the clutch of regulatory agencies created or enlarged in the utilities, transport, agriculture and environmental sectors.

When it came into office, New Labour renamed what had been known as the Deregulation Taskforce, an advisory group based within the Cabinet Office, the Better Regulation Task Force. The renaming was significant. New Labour was clearly keen on regulation and it did not share the Major administration's reluctance to have more of it.

Lord Haskins, the CEO of Northern Foods plc and a close confidant of Prime Minister Tony Blair, was appointed the BRTF's first chairman. Haskins is refreshingly candid about the strategy he pursued. Recalling his time as chairman, he writes:

> 'I changed the name of the Task Force when I became chairman in 1997, from "Deregulation" to "Better Regulation". I did so because, although there are opportunities for deregulation, "better regulation" implies a much broader approach to the problem. Few people objected to new regulations on a national minimum wage but the challenge was to introduce measures which were effective, clear and did not impose an unreasonable burden on employers.'
>
> (BRTF, 2005a, p. 8)

Haskins claims that the BRTF has helped curb the 'tendencies of ministers and officials to use regulation as the answer to every problem'. This is probably true, although it is difficult to measure precisely how influential it has proved. Significantly, the BRTF reports back to the Prime Minister, not to Parliament, so its independence is inevitably compromised.

Lord Haskins was succeeded by Sir David Arculus, a successful businessman who had built up a broad range of commercial experience. Arculus championed a series of initiatives aimed at ensuring that statutory regulation was better designed and more effective. He said that he is 'a keen believer in the maxim "What gets measured gets done" '. In the BTRF's 2005 report he argues that 'part of the BRTF legacy is to have made the costs of regulation more visible'; he also points out that the BRTF has worked on a methodology for bringing regulatory costs under better control (BRTF, 2005a, p. 2).

In this context, the BRTF's report entitled *Regulation: Less is More* (BRTF, 2005b), represented a momentous milestone in Whitehall thinking. The report called on the government to measure and set targets for the reduction of administrative regulatory costs (i.e. red tape) on business and the voluntary sector. It also recommended a 'one in, one out' approach to new regulation, whereby ministers and officials must prioritise regulations. If new laws are to be brought forward, existing rules will need to be repealed. This may prove a useful measure but, by definition, it will do nothing to deliver a net reduction in regulation. Thirdly, the report recommended that the government adopt a programme across all departments, as well as independent regulators, to simplify existing regulations.

On vetting new regulations the BRTF has outlined 'five principles of good regulation', namely, proportionality, accountability, consistency, transparency and targeting. These are described as the basic tests of whether any regulation is fit for the purpose.

The BRTF has clearly exerted a beneficial influence. Regulatory impact assessments (RIAs) are now compulsory for all new regulatory proposals of any significance. Considerable work has been done on improving the RIA methodology and officials must now justify the merits of a regulatory proposal on cost–benefit grounds. However, as Frank Vibert explains in his contribution to this issue, RIAs are imperfect tools since neither costs, nor benefits, are always able to be measured with any confidence.

The BRTF also had a hand in the introduction of a mandatory consultation code on proposed regulations and it has insisted that all such proposals include consideration of different regulatory and non-regulatory options, including a 'do nothing' option. Whitehall departments and the major statutory regulators have now been charged with preparing simplifications plans aimed at reducing the regulatory burden on those they regulate. A Panel for Regulatory Accountability has been established to review proposed regulations likely to impose substantial costs. This Panel has also been given responsibility for holding Whitehall departments to account for their better regulation performance. In a further encouraging step, a regulatory framework developed by the BRTF requires government departments to undertake post-implementation reviews of regulations that have been passed.

Does better regulation lead to less regulation?

The British Chambers of Commerce (BCC), concerned at the mounting costs of complying with new statutory regulations, have published a series of annual barometer studies on the comparative success of regulatory impact assessments. These reports were researched and compiled by Tim Ambler, a Senior Fellow at London Business School, and Professor Francis Chittenden of the Manchester Business School. In its most recent report, David Frost, the Director General of the BCC, points out that 'the cost of complying with new regulations introduced since 1997 has now reached £38.9 billion'. He highlights the fact that 'one of the strongest complaints from

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Chamber members is the cost to their business of complying with new regulations' (Ambler *et al.*, 2005).

Ambler and Chittenden note that 1,100 RIAs have been issued in the period 1998–2004. They conclude from their detailed analysis that RIA guidelines have improved but find that

> 'the objective of the RIA system, namely that the need for each regulation would be thoroughly challenged, and alternatives considered, is still not being met. As a consequence, in many cases, regulation is transferring government's administrative and social policy costs onto industry. In other words, whether intentional or not, many regulations act as a form of taxation.'
> (Ambler *et al.*, 2005)

The authors also voice their concern with regard to 'better regulation', which may mean more regulations, consequently damaging competitiveness. In support of their argument, they highlight the fact that, in the first half of 2004, the number of regulations implemented by statutory bodies increased by 46% compared with the corresponding period in 2003. Ambler and Chittenden demonstrate that the regulatory cost to business had soared by £9 billion in 2003 /04 compared with the year before.

One of the key points made by the BCC barometer series is that attempts to challenge regulatory requirements imposed by the European Commission when they are being transposed into UK law are largely worthless, since this is far too late in the process. To make any significant impact, such challenges need to be made early on when EU Regulations are being formulated in Brussels. This underlines the importance of the RIA procedure, which Frank Vibert reviews in this issue.

Ambler and Chittenden make a number of recommendations which government ministers and officials would be well advised to take further. These include the stipulation that any Minister implementing a regulation where the quantified benefits appear not to exceed the estimated costs must explain why such a regulation is justified. The business school academics also recommend the adoption of sunset clauses whenever a new regulation is implemented. In another pertinent recommendation, the authors suggest that the newly created Better Regulation Executive should publish an annual report, audited by the National Audit Office (which itself is answerable to the Public Accounts Committee of Parliament, not to government) dealing with the government's regulatory performance and compliance. The government appears to have paid some heed to this recommendation, since it announced an enhanced role for the National Audit Office in the 2005 Budget.

The British Chamber of Commerce analysis of the Better Regulation initiative also makes a further telling point. Ambler and Chittenden do not understand why Britain needs a new Better Regulation Commission as well as a Business Deregulation Team and a Panel for Regulatory Accountability. The authors suggest consolidating these various entities. They further suggest that the EU establishes an independent body to challenge new regulations that impact on business and commerce.

Tim Ambler and the current author have subsequently pointed out that, unfortunately, the BRTF's message was not always fully embraced across Whitehall. Significantly, Prime Minister Tony Blair took over as the

> 'chair of another watchdog, the Panel for Regulatory Accountability (PRA), which was strengthened in 2004 supposedly to reduce the flow and improve the quality of regulations and to ensure that regulation is used only where necessary. Since the PRA meets in secret, and attempts to discover their conclusions through the Freedom of Information Act failed, we cannot know how effective it may be.'
> (Boyfield and Ambler, 2006)

Following the publication of the Hampton Review on regulatory inspections and enforcement and the BRTF's *Regulation: Less is More* report, the UK government has sought to strengthen delivery of better regulation. It is taking forward the Hampton Report's recommendation that 31 national regulators should be consolidated into seven new agencies over the course of the next three years (*The Hampton Review*, 2005). Meanwhile, the BRTF has been renamed the Better Regulation Commission (BRC) and has been given an expanded remit and budget. However, Prime Minister Tony Blair apparently resisted attempts to make the BRC answerable to Parliament, not government, thereby reducing its perceived independence.

A complex and equivocal relationship with red tape?

Rick Haythornwaite, the new chairman of the Better Regulation Executive (BRE) has stressed that,

> 'In truth, Britain enjoys a complex and equivocal relationship with red tape. On the one hand, we publicly rail against it. But on the other, there are many who privately benefit from complex and excessive regulation. It supports an industry of regulatory consultants and can act as a convenient barrier to market entry.'
> ('Britain's Secret Shame: We Just Love Red Tape', *Financial Times*, 8 February 2006)

As evidence of this schizophrenia, Haythornwaite asked how else one could explain the City's response to the FSA's deregulatory proposal to remove the requirement for people working in wholesale banking to have certain qualifications and approvals?

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In a striking insight, the chairman of the BRE suspects, 'Red tape is like an old teddy bear. We are ashamed to admit an attachment, but rather enjoy the reassurance it provides.'

Signalling a potential shift in UK policy-makers' attitudes towards regulation, Haythornwaite went on to argue in his *Financial Times* comment piece that

> 'regulation is a product of the way society perceives and responds to risk. In a sense, we get the regulation we deserve. But society's perceptions and responses are themselves influenced by what government chooses to regulate and how it goes about it. It is a cycle that needs to be broken.'

Haythornwaite used his article in the *Financial Times* to explain that he had accepted the chairmanship of the Better Regulation Commission, 'because I believe in free markets and a society based on trust – concepts that have taken a battering in recent times'. This is a theme that Stephen Sklaroff explores in his article 'Regulation in an Untrusting World', published in this issue.

Haythornwaite is at pains to emphasis that he is

> 'no starry-eyed idealist. My vision is for a smarter regulatory framework that sets proper limits but still allows business to be more productive and competitive; public services to be more effective and affordable; voluntary organisations to thrive without bureaucracy; and citizens to exercise freely their rights and responsibilities.'

If Britain is to realise this vision, Haythornwaite believes that the nature of the conversations between all sections of society about how and where government should intervene will need to change fundamentally. And this change centres on the burden of risk. Haythornwaite rightly asks, 'How do we balance the need to provide essential protections with the need to foster a healthy, resilient society where the different parts (government, business, community groups, families and individuals) share the responsibility for managing life's risks?'

The chairman of the Better Regulation Commission believes that

> 'it is neither possible nor desirable to control every risk. The law of diminishing returns suggests that the smaller a risk, the greater the cost of eradicating it. There is a point beyond which the costs to society outweigh any benefit. Regulation must control the exceptions without burdening the whole. Blanket rules represent a damaging race to the bottom.' He concludes, 'We need to have a profound discussion about the nature and purpose of regulation.'

Effective non-statutory regulation: what are the options?

This gives us our cue for this issue of *Economic Affairs*. Government-imposed regulation, implemented by statutory bodies, may not be the best way of delivering effective oversight of markets. In their article 'Pyrrhic Victory? The Unintended Consequence of the Pensions Act 2004', Alistair Byrne, Debbie Harrison, Bill Rhodes and David Blake demonstrate the perverse and often unexpected consequences of passing new legislation to address a perceived need. Drawing on a survey among industry players and professionals, the authors show how the 2004 Pensions Act has led to far-reaching implications for the occupational pensions marketplace.

The authors explain how the Act is intended to improve the governance of pension schemes and increase the security of the members' accrued benefits. Yet their research findings reveal that the Act will probably have serious and adverse unintended consequences. The most significant of these is to undermine the continued provision of occupational pensions, particularly defined benefit schemes. Sponsoring employers can no longer afford the increased burden of such provision and the latest statistics show a pronounced trend away from defined benefit schemes to money purchase schemes. In 1998, there were 5 million active members of open private sector defined benefit schemes; in 2004 there were only 1.9 million (Pensions Commission, 2005).

Apart from a clutch of major corporations, defined benefit schemes are solely a feature found in the remuneration packages offered within the public sector, whether in central government, local government or the expanding field of quangos and regulatory agencies. Without reforms, it is estimated by the Pensions Commission that around 10 million people could be at risk of under-providing for their retirement. Unless this problem is addressed, the majority of retired voters will be dependent on means-tested state benefits.

Frank Vibert, who has written widely about the use of regulatory impact assessment (RIA) techniques, reviews 'The Limits of Regulatory Reform in the EU' in his article about controlling regulatory intervention in the marketplace by the European Commission. He concludes that, 'the EU is certainly more likely to be able to legislate wisely and effectively using RIA techniques than in their absence. Unfortunately, liberals have good reason to doubt whether RIAs will be deployed as they might be.' Vibert warns that such techniques should not be viewed as a panacea, and that their effective implementation hinges on political will and a determination to achieve a single economic market within the EU. This suggests limits to the ability of government to deliver only that regulation that brings significant net benefits.

Terry Arthur and Philip Booth's article focuses on the FSA's role as the regulator of stock exchange activity. The authors, both well versed in the sphere of UK financial services, argue that many of the functions performed by the FSA, as the statutory regulator established by Parliament, could be fulfilled

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more effectively through embracing market mechanisms. Arthur and Booth suggest that private stock exchanges can deal with competitive financial markets in a far more adept manner than the FSA, which critics maintain has grown into a costly, risk-averse and unwieldy organisation (for example, Centre for Policy Studies, 2005). Arthur and Booth believe in regulation but show how it can be privately generated.

In his highly original contribution, Andrew Brown, the Director General of the Advertising Association, explains how the advertising industry, by leveraging the success of its self-regulatory system, challenged the assumption that statutory control should remain the means by which advertisements on terrestrial television and radio should be regulated. His article is of particular interest because, in his role as Chair of the Committee of Advertising Practice, he was closely involved in gaining acceptance for this bold experiment in co-regulation. Five years on from its original inception, a new co-regulatory system has been established which provides the essential flexibility to confront a changing media landscape. Most significantly, it commands business support, regulator approval and consumer confidence.

Co-regulation appears to be gaining greater acceptance among policy-makers. In this regard, it was encouraging to note that the BRTF, in one of the final papers it published, examined ways in which alternatives to classic regulation, notably EU Regulations and Directives, can sometimes be quicker, more flexible, cheaper and more effective. Eva Salamon's Task Force team used as their starting point the idea that policy-makers should systematically compare all the delivery options – regulatory and non-regulatory – at an early stage with a view to choosing the most appropriate one that may deliver policy goals in the most efficient and least burdensome manner (BRTF, 2005c).

It is worth remembering that in his classic 1859 essay *On Liberty*, John Stuart Mill warned against the dangers of creating a host of statutory bodies all intent on intervening in people's daily working and private lives. 'Every function superadded to those already exercised by the government', he observed, 'causes its influence over hopes and fears to be more widely diffused, and converts, more and more, the active and ambitious part of the public into hangers-on of the government, or of some party which aims at becoming the government' (Mill, 1971, p. 165).

Stephen Sklaroff, the Deputy Director General of ABI, which represents a UK insurance industry subject to detailed regulatory oversight, sets out some ideas on how we can best regulate in an untrusting world. He warns that,

> 'Much current regulatory custom and practice is stuck in a detailed, prescriptive rut which raises costs to businesses and consumers and reduces economic activity. The UK (either in its own right, or as part of an increasingly heavily-regulated EU) risks becoming internationally uncompetitive in some sectors. Mobile capital may move elsewhere.'

He notes that both governments and regulators have begun to realise that their regulatory zeal may have gone too far. Sklaroff suggests that the purpose of regulation should therefore be to support and enhance competition, not interfere with it. He argues in favour of adopting a principle-based and unprescriptive regulatory system. What is more, Sklaroff feels that we should be actively encouraging self-regulatory initiatives and industry-led compliance advice. Some existing UK regulators, such as Ofcom, have been adroit at this, but others still have some way to go.

In outlining a wide-ranging set of recommendations, Sklaroff puts forward a possible future approach to regulation which relies on some 'confidence-building measures'. He advocates policy-makers pick some well-defined areas of regulation where modest and achievable goals can be set. Through pursuing pilot schemes, experience may be gained which can then be applied more widely. In this context, it is encouraging to discover that the FSA is involved in just such an approach with the financial services industry. Initiatives such as these may mark a watershed in the remorseless rise of red tape.

So far, regulation has certainly proved one of the boom industries of the twenty-first century. Yet regulation is not a free good: it has significant costs and implications that are often hidden from the immediate view of both customers and the suppliers of the goods and services they buy. This issue of *Economic Affairs* offers some ideas on how we can stem the growth of unnecessary regulation and replace it with market-orientated policies that may deliver more effective, speedier and more flexible approaches to regulating markets.

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