Regulatory Reform: Time for Action

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A growing body of experience shows that well-planned and properly implemented regulatory reform that stimulates competition in domestic and international markets can raise productivity, lower prices and expand the range of goods and services available to consumers. Yet reform does not mean complete laissez-faire: regulations will continue to be important tools for setting the rules of the game by which markets function, and for improving safety, protecting the environment, and upholding social values such as equity. Here, governments are finding new means, both regulatory and other, of providing sound social protections while allowing markets to work more efficiently.[1]

In a world that rewards flexibility, rapidity and responsiveness, government regulation can seem increasingly out of step, even irrelevant at times in the face of ever-swifter economic, technological and social change. As a consequence, long-standing national regulatory institutions and regimes are becoming obsolete, and even harmful to national prosperity and government effectiveness. Regulations that block competition also depress capital and labour productivity, raise prices, restrict consumer choice, stifle the development and diffusion of new technologies, and slow adjustment to changing market conditions. Evidence suggests that large gaps in sectoral productivity between some OECD countries can be blamed partly on differences in regulation.[2] More productive and flexible economies are necessary, not only to stimulate output and job creation but also to serve aging OECD populations. As populations age, there are proportionately fewer workers to support a growing number of retirees; productivity thus has to increase if living standards are to be maintained.[3]

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Other regulations preserve the past at the cost of the future by discouraging entrepreneurs from starting new businesses. Barriers to entry for small and medium-sized enterprises (SMEs) are a source of particular concern, since SMEs are important generators of jobs, innovators and flexible suppliers to larger firms.

As tariffs and other border measures are dismantled, national regulations are often left as the biggest impediments to an open, competitive market economy and the free flow of goods, services and technologies that benefit consumers and bring domestic firms up to international standards of performance. Maintaining an open world trading and investment system requires broad changes in regulatory style and content to promote global economic integration, avoid trade disputes and improve trust and mutual confidence across borders. And an inefficient framework of rules erodes not only the competitiveness and adaptability of regulated industries but also those of non-regulated firms that pay more for goods and services.

Superstock

Reform is not only a question of liberalising markets. It also involves a quest for better gov-

1. ***Report to Ministers on Regulatory Reform***, *OECD Publications, Paris, 1997.*

2. *See pp. 19–22.*

3. *Lans Bovenberg and Anja van den Linden, 'Pension Policies and the Aging Society',* ***The OECD Observer***, *No. 205, April/May 1997.*

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ernment. Government intervention is often called for to safeguard economic and social-policy objectives in, for example, consumer and environmental protection, health and safety, and equity, but voters in many countries feel that governments are losing credibility and effectiveness in the face of inexorable change. In some countries, pervasive government controls leave opportunities for corruption. Regulators in all policy areas today must learn to react more quickly, assess more completely the impacts of their actions and intervene only where essential, apply rules more transparently and predictably, and wield a wider range of flexible and cost-effective policy tools, such as market-based instruments and voluntary agreements.

But regulatory reform is not an end in itself. Regulation is an instrument of policy, and reform must be based on a debate about policy goals, economic and social priorities, and the roles of governments and markets in delivering to taxpayers a changing mix of goods and services (including social protections) that together maximise the quality of life. The benefits of reform must be weighed against costs and risks. Reform that is badly designed or clumsily implemented, without taking policy linkages, transition costs, and institutional incentives and capacities into account, can worsen economic performance and undermine social objectives.

Differing Priorities

From limited beginnings two decades ago, regulatory reform has spread rapidly across the OECD, though progress has been uneven across countries and sectors. Priorities in reforming regulation differ among countries. Some, such as New Zealand, the United Kingdom, and to some extent members of the European Single Market have launched far-reaching structural changes in important sectors that were traditionally highly regulated, such as transport and public utilities, by removing restrictions on competition, often beginning with privatisation, and building new efficiency-promoting regulatory regimes.

Other countries, such as Australia, Japan and Mexico, have also set broad-based reviews in motion across the entire administration to apply market principles to decades of accumulated economic and social regulations and to formalities such as government licenses and paperwork. These reviews are aimed at reducing regulation and other government controls to the minimum necessary to reach policy objectives.

Others yet, including Canada, the Netherlands, Sweden and the United States, are changing institutions and decision-making processes inside governments through the use of central supervisory bodies, regulatory-impact analysis, public consultation and improved law-drafting. These reforms are aimed at improving the capacity of government to produce higher-quality regulation in all policy areas and, over the longer term, to change the culture of administration away from old habits of control.

Effective reform is thus a varying mix of regulation, deregulation and re-regulation, supported as necessary by institutional reform. Failures of regulatory reform, such as the credit crises stemming from financial-sector reform in some countries,[4] the slow and disappointing emergence of competition in utility sectors in several, and the lack of progress in many of them in removing unnecessary and outdated regulations can have several causes. They are often rooted in a failure to implement balanced reform packages that simultaneously promote efficient markets, address links with other important policy concerns,

BACKGROUND

Defining Regulation and Regulatory Reform

The diverse set of instruments by which governments set requirements on enterprises and individuals include laws, formal and informal orders and subordinate rules issued by all strata of government, and rules issued by non-governmental or self-regulatory bodies to whom governments have delegated regulatory powers. Regulations fall into three categories.

• Economic regulations intervene directly in market decisions such as pricing, competition, market entry or exit. Reform aims either at reducing barriers to competition and innovation, often through deregulation and use of efficiency-promoting regulatory techniques, or at improving the regulatory framework for market functioning.

• Social regulations protect non-economic values, such as health, safety, the environment and social cohesion. The economic effects of social regulations may be secondary concerns or even unexpected, but can be substantial. Reform aims to verify that regulation is necessary and justified, and to design regulatory and non-regulatory instruments that are clearer, simpler and more effective at lower cost.

• Process regulations are paperwork and administrative formalities – so-called 'red tape' – through which governments collect information and intervene in individual economic decisions. They can have substantial impacts on private-sector performance. Reform aims at streamlining and simplifying those that are necessary, and eliminating those no longer required.

'Regulatory reform' refers to changes that improve regulatory quality, that is, enhance the performance or cost-effectiveness of regulations and related government formalities. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improvement of processes for making regulations and managing reform. Deregulation is an element of regulatory reform; it refers to complete or partial elimination of regulation in a sector to improve economic performance.

4. See pp. 28–31.

5. See pp. 19–22.

*6. Sam Paltridge, 'Upwardly Mobile Telephony', **The OECD Observer**, No. 196, October/November 1995; Sam Paltridge, 'How Competition Helps the Internet', **The OECD Observer**, No. 201, August/September 1996; Sam Paltridge and Dimitri Ypsilanti, 'A Bright Outlook for Communications', **The OECD Observer**, No. 205, April/May 1997.*

Small and medium-sized companies – a vital source of innovation and employment – are disproportionately hit by red tape.

and develop political and administrative capacities for implementing and sustaining reform.

The Benefits of Reform

Experiences of the countries that have made the most progress show convincingly that winners from reform have far outweighed the losers, and that there is considerable scope for additional benefits from reform. Elimination of regulatory barriers to competition has compelled firms to become more efficient and boosted the productivity of entire industries, among them airline and road transport, electricity generation and telecommunications. Improved efficiency has meant sharply lower prices for consumers and user businesses for these services. Indeed, the effects of market liberalisation in individual sectors can be so powerful that it boosts national output as a whole.[5] As productivity improves, real wages also increase as a more efficient workforce is rewarded by higher earnings.

Reforming social and 'process' regulations (box, left) to meet public-policy objectives at lower cost is becoming the focus of efforts to raise productivity and stimulate business activity. These kinds of regulations are estimated to cost US businesses $500 billion a year (about 10% of GDP). Government-imposed administrative burdens alone are estimated to cost European businesses an annual 540 billion ECUs (3–4% of GDP), or about twice as much as the total wealth produced by the entire European farming sector. In Canada, it costs small firms 8% of their revenue to comply with government paperwork; larger firms spend 2%. Reductions in these burdens and barriers can free scarce human and financial resources for more productive activities and invigorate a new spirit of entrepreneurship.

Regulatory reform has also stimulated the creation and diffusion of new products and services, resulting in increased convenience and choice for households and businesses. In telecommunications, for instance, mobile telephones and Internet access appeared much more quickly in competitive environments than in countries with telecommunication monopolies.[6] Introduction of competition helped increase the number of subscribers to cellular phones in OECD countries from 700,000 in 1985 to 71 million by 1995. In competitive markets, the emergence of new

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Where state intervention is still considered desirable – in health care, for example – reform should make sure that regulation is effective and transparent.

financial services such as innovative mortgages has enabled more people to become home-owners.

As the world economy is integrated through trade and investment, moreover, the advantages of more efficient and innovative economies are shared by foreign producers of goods and services, as well as investors, thus allowing fuller use of economies of scale and innovative combinations of technologies. Such considerations provided the impetus behind the recent WTO Agreement on Basic Telecommunications, which is expected enormously to expand output and benefit consumers in all participating states. The European Single Market programme had, by 1993, increased EU income by 1.5%. There is therefore a shared interest in reform that should give further momentum to programmes of this sort in individual countries.

Reforms that improve government capacity to produce high-quality regulation, choose priorities more carefully and apply a broader range of policy instruments have helped satisfy social considerations, such as health, safety and environmental protection. Economic incentives as a complement to regulation, for example, can be powerful. In Sweden, a tax on sulphur content of fuel oils resulted in a reduction in sulphur content of fuel oils by almost 40% beyond the stipulated requirements.[7] In the United States, the use of more efficient emissions-trading permitted industry and regulators to agree on tougher emissions standards compared to command-and-control regulation, and still reduce costs by billions of dollars. Sometimes regulators waste considerable resources and permit unnecessary hazards by regulating tiny risks while leaving important ones untouched. A recent study in the United States, for example, found that if regulations were re-targeted at situations where lives could be saved at lowest cost, some 60,000 deaths could be avoided each year without increasing regulatory costs.[8]

Weighing the Costs

The benefits of reform have to be weighed against the costs. Transitional costs and effects on policy objectives merit careful consideration. They can include business disruptions and failures (particularly where companies have been heavily protected for many years), job losses in specific sectors (again, usually where governments have shielded them from competition), and possible impacts on safety, public services and environmental quality.

In some cases, the pain of reform must simply be borne, since the pain of not changing will be even worse, though deferred. Here, reform is a political choice that balances costs (often short-term and concentrated) with benefits (often longer-term and generalised). In many cases, though, governments can take steps to reduce the magnitude and duration of costs. The crucial element is design of a co-ordinated package that cuts across policy areas and instruments. The careful and transparent mapping-out of policy linkages and planning of the transition is essential, particularly where reform will have far-reaching structural effects. Such clarity will quicken the transition to truly competitive markets, and help avoid costly mistakes that may take years to correct.

Public misgivings about potential adverse effects of reform on safety, health and consumer protection must be addressed. Innovative and expanding markets can produce new risks to which governments cannot respond quickly enough. Increased road accidents in some countries were blamed on fiercer competition between new haulage firms after reform. Concerns have been voiced about the safety of air transport in competitive markets. And in the United Kingdom aggressive selling of some financial services to the detriment of consumers followed liberalisation.

Evidence from countries where reform has taken place shows nonetheless that strong com-

7. *Jean-Philippe Barde and Stephen Smith, 'Do Economic Instruments Help the Environment?',* ***The OECD Observer****, No. 204, February/March 1997.*

8. *Tammy Tends and John Graham, 'The Opportunity Costs of Haphazard Social Investments in Life-saving', in Robert Hahn (ed.),* Risks, Costs, and Lives Saved: Getting Better Results from Regulation, *Oxford University Press, New York and London, 1996.*

9. *Christopher Wagner, 'Safe Products and Global Trade',* ***The OECD Observer****, No. 202, October/November 1996.*

10. ***The OECD Jobs Study: Facts, Analysis, Strategies****, OECD Publications, Paris, 1994;* ***The OECD Jobs Study: Evidence and Explanations****, OECD Publications, Paris, 1994.*

Regulatory reform has brought wider consumer choice in its wake.

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petition is not inconsistent with a good safety record, as long it is backed up with effective health-and-safety measures. After the deregulation of airlines in the United States, in fact, fatalities per million passenger miles dropped by 75% (from 1974–76 to 1993–95). The safety record of road freight transport also improved in the United Kingdom after reform. Of course, regulators should be prepared to move quickly in response to rapid product developments, which may require that governments strengthen regulatory bodies in parallel with market liberalisation.

Consumer protection is another important concern. Consumers faced with more choices may require more information and confidence-building measures. Mutual-recognition agreements between countries can help address worries that entry of foreign products and services may lead to reduced standards of safety or consumer protection.[9]

The effect of market liberalisation on jobs is a central consideration. Heightened competition may initially result in job losses in individual sectors as businesses are forced to become more efficient. Although reform increases demand for labour in other firms and sectors, displacement can be costly for affected workers and society as a whole. Here, regulatory reform should be accompanied by active labour-market measures. The *OECD Jobs Study* set out a broad programme of action intended to enhance the ability of the labour market to adjust, as well as to increase the capacity of the economy to create knowledge and to innovate.[10]

Competition in vital services such as telecommunications, energy and public transport might conflict with equity objectives by undermining ‘universal service’. The reform of financial services in Australia, for example, was accompanied by new fees and charges on basic services, with disproportionate impacts on people with low incomes, not least the elderly. Market forces can also reduce the range and scope of services available in low-density areas, if, say, rural post offices begin to close, as happened in Finland.

Compensating measures can mitigate unacceptable distributional consequences while preserving the benefits of more dynamic and efficient markets. Most pro-competition reforms in public utilities have included measures to guarantee access to public services. All governments that have liberalised telecommunications markets, for instance, have maintained the policy principle of universal service and are developing a range of new programmes, such as transparent subsidies, to deliver and fund it. In some cases, competition in itself has also significantly benefited universal service by reducing prices and promoting diffusion of new technologies that are more readily available to consumers.

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Regulatory reform takes place in complex political, social, economic and administrative environments. The benefits can be maximised and the risks better managed through a process of careful and transparent planning and policy co-ordination that is informed by the experiences of other countries. A pragmatic view of reform, based on potential benefits and costs, is important. Different countries will legitimately choose to pursue different regulatory policies – the challenge is to ensure that regulation is used as efficiently, effectively, and transparently as possible in pursuit of the public interest. Reform, well co-ordinated and planned, is not an ideological act, nor simply a concession to stronger markets that accelerates painful structural change. Instead, it is a means of managing necessary change so as to ease disruption and develop new opportunities for economic and social progress. ■

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