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Regulation in an age of austerity:

Reframing international regulatory principles¹

INTRODUCTION AND BACKGROUND.

OECD's 1997 Regulatory Recommendations.

In 1995 OECD issued a set of principles and policy recommendations on improving the quality of government regulation. The Recommendations were endorsed by Ministers in 1997.² They were the first-ever international statement of regulatory principles and helped to establish a broad international consensus on how to approach the regulation of markets.³ The consensus was not confined to the 30 member countries of OECD itself. Through OECD's outreach programme the principles extended to emerging markets in Asia and Latin America, and both the IMF and World Bank have incorporated them in their own work on governance for a still wider set of countries.⁴ Within Europe, the European Commission has promulgated and pursued its own programme on governance that has deepened the application of OECD regulatory principles in EU policy making itself.⁵

OECD's original set of recommendations were framed in the context of a perceived need for 'regulatory reform'. This agenda had three main roots. First, there were the market-oriented reforms of the Reagan/ Thatcher era. These stressed privatisation as a means to improve the performance of the economy and of government. Since privatisation did not necessarily produce a competitive market because of the market dominance of previously state-owned incumbents,

¹ The author wishes to acknowledge a helpful set of comments from Professor George W. Jones, Emeritus Professor, LSE as well as comments from Martin Lodge (Reader in Political Science and Public Policy, LSE) and Professor Danny Quah (Centre for Global Governance, LSE).

² The headline recommendations are shown in Annex A.

³ Steven K Vogel (1996) distinguishes between three levels of analysis – the overall pattern where ideas shape the direction of change; specific national settings where countries may respond in different ways; and specific sector settings where national patterns may give way to significant sectoral variations (Vogel 1996:256-259). The OECD recommendations can be seen as influential at the first level of ideas that help set the direction of change.

⁴ The APEC-OECD cooperative initiative on regulatory reform was agreed in 2000 and a voluntary checklist of good practice agreed in 2005. Both IBRD & IMF launched governance programmes in 1997 that include a focus on improved regulatory systems.

⁵ The European Commission launched its initiative with its White Paper on European Governance. July 2001.

regulation was seen as a necessary corollary to promote competition. Secondly, there was a theoretical base in economic literature that saw regulation as liable to ‘capture’ by politically powerful businesses and thus to be minimised.⁶ ‘Regulatory reform’ was often equated with ‘deregulation’ and seen more generally as an agenda to reduce unnecessary government involvement in the marketplace. Regulatory ‘reform’ was identified with regulatory ‘relief’.⁷ Thirdly, there was a shift in public administration theory and practice associated with the ‘new public management’ which suggested that governments should distinguish between ‘steering’ and ‘rowing’ or between the strategic objectives of policy and the carrying out of policy operationally.⁸ One important means to achieve this distinction was through the setting up of independent agencies with operational responsibilities at arm’s length from politics and central government departments.⁹

The assumptions underlying the agenda encountered some well considered criticisms (outlined later). Therefore, as the influence of this initial impetus waned, and to reflect changing circumstances and thinking, OECD updated its Principles and Recommendations in 2005.

The need for a fresh review.

OECD’s 2005 statement of regulatory principles and recommendations covered regulatory management, competition and market openness. It was able to take into account some of the commentary on earlier regulatory reform efforts. While the Principles themselves remained unchanged from 1997 the subordinate recommendations were expanded. However, the main themes continued the regulatory reform thrust of the earlier recommendations.¹⁰ Indeed, the 2005 statement declared that the 1997 Recommendations ‘have stood the test of time’.¹¹ It proved to be an ill-timed judgement. The international financial crisis of 2008 represented not simply a massive market failure but also a huge failure of regulation. As a result the earlier consensus on how to approach regulation has frayed. The OECD has noted reform ‘fatigue’.

⁶ The key statements in the literature on the economics of regulation are Stigler (1971) and Peltzman (1989).

⁷ Rose-Ackerman (1992).

⁸ Osborne & Gaebler (1992).

⁹ See Vibert (2007) and Levi-Faure (2008).

¹⁰ A guide to their content is given in Annex B.

¹¹ OECD Guiding Principles 2005 p2.

It is now recognised, both by theorists and practitioners, that regulatory approaches need a more thorough review. OECD has therefore begun a review process.

OECD's new review aims to expand the coverage of the earlier Recommendations with a proposal for a new instrument that will contain Recommendations on regulatory governance and how they can be best integrated into more traditional management practices.¹² The new Recommendations are being drafted and discussed over the course of 2011 with the aim of securing the approval of Ministers in Spring 2012.¹³ This paper takes into account the work now underway.

Scope of paper.

Against this background the aim of this paper is to look at the different elements that need to be considered in reframing international regulatory principles.¹⁴ To do so the paper first compares the original regulatory reform agenda of the 1990s (labelled below as the 'better regulation' agenda) with three different approaches provided by 'responsive', 'smart' and 'performance-based' regulation. The purpose of this review is to try to ensure that any revisions are securely grounded on approaches that are recognised in regulatory theory and practice and are not simply plucked from the air or simply reflect the biases of officialdom.

Secondly, the review and discussion select for particular attention those aspects of the different approaches that are especially relevant to the current economic environment facing OECD countries and to the key lessons to be drawn from recent regulatory failures. There is a danger for any international organisation with a large membership that it will not be able to change its policies fast enough or far enough in response to changed circumstances. OECD benefits from a cohesive membership. Nevertheless it has to operate through a consensus of all its members that limits how far and fast it can respond.

¹² OECD Recommendations are not legally binding but common practice accords all OECD recommendations great moral force and an expectation that member countries will do their utmost to fully implement them.

¹³ The draft new Recommendations were issued for public consultation on May 25 2011. See OECD GOV/RPC(2011)3/REV 1. (and Annex C).

¹⁴ The term 'framing' or 'frame' is used in this paper in the sense of defining a context and giving selective attention (Lindenberg :2001) rather than in the more formal sense of a framework that identifies a unit of analysis and provides a frame for theories and models (Ostrom 1999).

Salient features of the current environment are:

- The period of fiscal ‘austerity’ now applicable through much of the OECD area. In theory regulation provides an alternative to taxation and spending policies as a way through which governments can achieve strategic objectives.¹⁵
- The need to achieve a much better link between the focus of regulation on businesses or individuals (a micro focus) and the effects of regulation at the sector or economy-wide level (a macro focus). In the financial crisis it became apparent that a micro focus may miss the link.
- The need to give greater attention to what is termed in later discussion the ‘survival’ goals of regulation. They are about the robustness of systems of provision including the stability of the financial sector, security of supply in energy and the security and continuity of provision in sectors such as water or communications. They are taken for granted until they are missed.
- The need to respond to other aspects of recent regulatory failures including notably those that flowed from the culture of compliance and weaknesses in the procedures for evidence-based policy making. Improved links with international regulatory regimes can be seen as part of a strategy to reduce the occurrence of future failures.

The findings.

The challenges listed above and the lessons to be learnt from recent regulatory failures call for far reaching changes in regulatory principles. The main elements in the revisions needed to international principles suggested in this paper are:

- Incorporation of key elements of broadly defined ‘performance-based’ regulation that focus on issues of ‘substitutability’, ‘choice architecture’ and the ‘constitutive’ tasks of regulation into a ‘whole of government’ approach;¹⁶

¹⁵ ‘The attraction of regulation as an instrument of government policy is that it provides mechanisms for indicating government commitments and priorities without having costs in public expenditure, since most of the costs are compliance costs borne by the regulatees or passed on to consumers’. Baldwin, Scott & Hood (1998:7).

- A statement on compliance policies that tilts more towards the use of law and sanction;
- A recasting of the recommendations on impact assessment in evidence- based procedures;
- A broadening of the scope of the 1997 and 2005 recommendation referring to the relation between regulation and international rules on trade and investment.

According to the analysis of this paper the new OECD Recommendations will advance regulatory approaches in a number of areas and help to maintain OECD's leadership role in recommending international regulatory principles. However, the analysis does indeed suggest that what is now under consideration by OECD does not go far enough. Thus the paper concludes that OECD will need to carry out further revisions to its Recommendations in due course including to the new instrument itself.

Organisation of discussion.

The paper looks first at a typology of different approaches to updating regulatory principles as a way of taking stock of recent regulatory thinking and the background to it. Secondly, it looks at greater depth into the alternative approaches identified in the typology in order to clarify further their distinctive features as well as their overlaps. Thirdly, it selects for further discussion those key issues associated with the different approaches that seem particularly pertinent to the present context for regulatory effort. For example, there is a critical relationship between performance based regulation and performance measuring. Finally, drawing on the preceding discussion, it identifies the main building blocks for an updated set of Recommendations and how they compare with OECD's proposed new instrument.

¹⁶ See Annex D - Glossary of terms - for a selection of definitions used in this paper.

I. TAKING STOCK – A TYPOLOGY.

Definitions.

Regulation can be defined as measures consistently applied to affect the behaviour of the targets of the regulation and to steer that behaviour in particular directions.¹⁷ Regulations may emanate from private as well as public sources. The addressees may be governments themselves (as with some internationally agreed rules) or public or private agencies or associations (such as a public economic regulator or a private accountancy board).¹⁸ The targets are usually individual firms or enterprises in particular sectors (such as manufacturing or agriculture or the service sector) or, less frequently, individual persons (for example with money laundering). However, citizens are not usually the main target and often experience the effect of regulatory measures as second-round effects. For example, a regulatory requirement on energy firms to meet a proportion of their supply from renewable sources will be experienced by citizens in the form of higher household utility bills.¹⁹

A wide variety of labels are attached to measures with regulatory impact and are often used interchangeably – from regulations to rules, codes, recommendations, principles, accords, conventions, memorandums of understanding, guidelines or guidance notes. In the EU many regulations take the form of directives where the manner of implementation is left to the member state, in contrast to EU regulations that are directly applied. It is generally agreed however that labels are not a reliable guide either to the content of a measure or to degrees of flexibility in their interpretation.²⁰ Attempts to categorise measures as ‘hard’, or ‘soft’, or ‘light touch’, aim to

¹⁷ There is no single authoritative definition in use. Baldwin (1995) and Black (1997) put the stress on behavior modification. Braithwaite (2008) places the emphasis on steering: ‘Regulation is conceived as that large subset of governance that is about steering the flow of events, as opposed to providing and distributing’. (2008:1). Baldwin, Scott & Hood (1998) suggest that there are three meanings of regulation – targeted rules, state interventions more generally and all mechanisms of social control by whomsoever exercised. The first meaning corresponds to the French term ‘réglementation’ while the French term ‘régulation’ corresponds to the broadest of the definitions.

¹⁸ See Börzel (2002) for the distinction between the addressees and targets of regulation.

¹⁹ OECD’s draft Recommendations refer to ‘users’ as a term to include addressees, targets and citizens in their multiple roles as targets (sometimes) intended beneficiaries and payees. (See Draft Recommendation 2.)

²⁰ See the discussion in Shelton (2000).

provide a rough guide to degrees of interpretive flexibility but can be fundamentally misleading.²¹

Key Distinguishing features.

The different approaches:

The different approaches to regulation identified under the typology used in this section are ‘better’ regulation, ‘responsive’ regulation, ‘smart’ regulation and ‘performance based’ regulation. They are selected because they are identifiable both in the academic literature on regulation and in practice and provide an overview of current regulatory orthodoxies. The term ‘better regulation’ is used to characterise the international regulatory reform agenda of the 1990s -- a term that remains in use in the UK. The European Commission has recently adopted the mantra of ‘smart’ regulation.²² Canada’s Treasury Board refers to its system as ‘performance-based’ and a number of examples are drawn from its practice.²³ In the US the recent Executive Order updating US regulatory procedures refers both to elements of ‘smart’ regulation and to ‘performance –based’ regulation. (EO 13563 dated Jan.18,2011, Section 1).

Overlap.

These ways of framing debate about regulatory practices are not mutually exclusive and there is considerable overlap and common ground between them. For example, both the ‘smart’ regulation approach and a broadly defined ‘performance based’ approach overlap in their discussion of the ‘effectiveness’ of different regulatory and non-regulatory instruments. The common ground shared by all of these approaches is as follows:

- regulatory measures should always be preceded by some kind of impact assessment;

²¹ See for example H eritier and Lehmkuhl (2008) on ‘the shadow of hierarchy’ that may lie behind the appearance of ‘soft’ or ‘light touch’ or ‘self regulation’. See also Ayres & Braithwaite on the concept of ‘enforced self regulation’ (1992: 101).

²² Smart Regulation in the European Union: Communication from the Commission COM(2010) 543 final(8.10. 2010).

²³ ‘The Government of Canada is committed to creating a performance-based regulatory system that will protect and advance the public interest in the areas of health, safety and security, the quality of the environment, and the social and economic well-being of Canadians’. (Source: Treasury Board of Canada: Regulatory Affairs website:06/01/2011).

- the regulatory process needs to be looked at as a continuing cycle from inception through to evaluation that, in its turn, will inform future design;
- the attainment of regulatory objectives is likely to involve the use of a wide range of possible instruments;
- private actors are involved and wield authority in regulation as well as public bodies.

There is a sequential relationship in that ‘responsive’ regulation was a reaction in part to the original ‘better regulation’ agenda and ‘smart’ regulation to the ‘responsive’ regulation agenda. However, despite large areas of overlap, the differences between them are more than stylistic.

Typological distinctions.

The typology identifies three distinguishing features of these different approaches:

First, they differ in terms of what they see as the critical issue or question of public policy to be addressed in regulation. Thus, the key policy question as seen by the original ‘better’ regulation approach was ‘over regulation’, or undue government interference in markets. By contrast, the key policy issue as seen in ‘performance based’ regulation is the need to better align the choice of a regulatory approach with other possible instruments of government policy and a government’s macro objectives with its micro policies. The key policy step in responsive regulation was to move away from ideological disputes about the role of markets and to look at regulation from the pragmatic perspective that markets and regulation are not necessarily in opposition.²⁴ In the case of ‘smart’ regulation the key question to be addressed by policy change is seen to be the ineffectiveness and inefficiency of much regulation.

Secondly, the focus of attention in each is on different aspects of regulation. For example the focus of the ‘better regulation’ agenda was on ‘deregulation’ and regulatory interventions were to be justified mainly by market failure. ‘Responsive’ regulation rejects the focus on ‘deregulation’ and places it instead on the need to involve private actors as partners in regulation

²⁴ The desire to avoid ideological disputes can be seen as belonging to the ‘satisficing’ or ‘pragmatic’ tradition in policy making. (For one discussion of ‘pragmatism’ see Posner 2003).

and to steer behaviour through webs of control.²⁵ ‘Smart’ regulation looks at the interrelationship between state and private forms of control at the level of the targets of regulation. ‘Performance-based’ regulation, broadly defined, aims to evaluate a government’s ‘tool box’ in the round so as to ensure that regulation is the most appropriate tool for a government to use in meeting its policy goals.

Thirdly, each approach emphasises different regulatory strategies and techniques. For the ‘better’ regulation agenda, ‘self regulation’ was seen as the ideal and techniques such as cost/benefit or risk/benefit analysis were seen as a way to cull unnecessary interventions. On the other hand, ‘smart’ regulation emphasises the importance of integrating the use of both regulatory and economic instruments at the micro level (for example to supplement regulatory action to meet environmental objectives with such economic instruments as cap and trade systems and carbon pricing). ‘Responsive’ regulation places the emphasis on what is called the ‘pyramid’ of regulatory instruments and enforcement strategies.²⁶ In ‘Performance-based’ regulation a key element is to make sure that the objectives of regulation have been clearly specified and benchmarked.²⁷

The ‘choice architecture’ must also be got right if the behaviour of the targets of regulation at the individual(micro) level is to be consistent with a government’s broad (macro) objectives.²⁸

²⁵ See Braithwaite (2008) for a discussion of ‘webs of control’.

²⁶ ‘Responsive regulation is distinguished (from other strategies of market governance) both in what triggers a regulatory response and what the regulatory response will be’. Ayres & Braithwaite 1992:4.

²⁷ In his 1983 study Hood does not mention performance targeting or benchmarking but refers instead more generally to the use by governments of ‘active detection’ tools of which benchmarking can be seen as one variety.

²⁸ ‘A choice architect has the responsibility for organizing the context in which people make decisions’. Thaler & Sunstein (2008:3).

Before discussing each approach in greater detail this typology is summarised in table 1 below.

Approach	Critical Issue	Focus	Key strategy/technique
Better	over regulation	deregulation	cost benefit/risk benefit analysis self regulation
Responsive	‘satisficing’	delegate to private actors webs of control	enforcement pyramids
Smart	ineffectiveness inefficiencies	inter-relationship state/private	integrate reg/ec. instruments
Performance -based	align micro/macro goals	whole of toolbox	goal setting choice architecture

Note: ‘satisficing’ in this context refers to the need to take regulatory decisions that avoid ideological disputes about the role of the market and role of government and accepts that markets and regulation go together.

The approaches distinguished above and selected for further discussion are not exhaustive. Responsive regulation arguably belongs to a family of regulatory approaches.²⁹ In addition what has been labelled above as ‘performance-based’ regulation incorporates what has been termed ‘management-based’ regulation (discussed later).³⁰

There are two further ways of looking at regulation that have their own special features and a claim to be separated. One is about the need for regulation to be based on the ‘evidence’; the other is to look at regulation through the lens of ‘risk’.

²⁹ Colin Scott identifies a family of regulatory approaches that share a scepticism about the capacity of law to exert control and that has to be seen in the context of other means of social orderings. Other approaches in the same family as responsive regulation according to Scott are ‘governmentality’ (that looks at how power is diffused in modern society) and ‘autopoiesis’ (that looks at the problems of communication between different social sub-systems including the law) . (See Scott 2004:152-160).

³⁰ See Coglianese & Nash 2001 and 2007.

Evidence-based regulation.

The typology outlined above and discussed below does not separate ‘evidence- based’ regulation as a further category of regulatory approaches, because all of the approaches to be discussed require that those framing regulatory measures should respect the evidence base so that normative judgements about what is acceptable or appropriate or fitting have been informed by the evidence. It is one of the major components of the original ‘better regulation’ agenda that has survived intact as a principle of regulation. It underpins the use of independent or arms-length agencies to assess the evidence base and the inferences to be drawn from it. However, the procedures involved in ensuring that the evidence base is respected in regulatory policy have evolved. They are discussed later in the overall assessment of the different approaches. In addition there is a tension between the rational-choice approach of economists and the ‘social-construction’ approach of many sociologists in the way that evidence and the inferences drawn from it are treated. This tension has to be acknowledged.³¹

Risk- based regulation

The techniques of risk management have special features.³² The appeal of thinking about regulation as risk rests on three elements. First, it is alleged that many societal concerns that may call for regulatory responses are about risk.³³ Secondly, risk is what is known as a ‘boundary term’ which means that the term ‘risk’ can be deployed across widely-dispersed professional and disciplinary boundaries.³⁴ For example, risk is a concept that is common to biologists and to financial economists. Thirdly, risk provides a way of reducing different goals to a common denominator. For example, a goal to reduce harm in health (through the reduction of smoking)

³¹ Approaches that refer to the ‘social construction’ of evidence can be traced to Berger & Luckman (1966). Herbert Simon (1986) gives an account of rationality from an economist’s or psychologist’s perspective. In the procedures outlined later the difference is acknowledged in giving importance to procedures that take into account competing interpretations of the problem, the evidence and the inferences.

³² Baldwin & Black (2008) suggest that risk-based regulation can be distinguished from the ‘pyramidal’ approach of responsive regulation because it emphasizes the targeting of key risks rather than a process of responsive escalation.

³³ Beck 1992 is usually cited as the seminal text..

³⁴ For a discussion of boundary objects see Bowker & Starr (2000). Other boundary terms include the concept of ‘sustainability’ and the so-called ‘precautionary principle’..

can be expressed in terms of reducing the risk of cancer; at the same time a measure to protect the public interest (for example universal -service provision) can be presented as a measure to reduce the risk of social exclusion. For these different reasons the terminology of risk may make communication about the goals and instruments of regulation easier to understand.

Although there are important advantages in each of these features for regulatory discussion there are also disadvantages. First, a term that is in common use does not necessarily denote a common understanding of how it is to be applied. A lawyer may look at ‘risk’ as involving a duty of care; an engineer as mandating built-in redundancies, an economist as requiring the analysis of ‘fat tails’ and a statistician may want to allow for ‘black swans’. Secondly, the reduction of the different objectives of regulation to the common denominator of ‘risk’ may lead to ‘framing bias’ in the way a problem is defined and addressed and to the neglect of other important aspects of the original objective. For example, a focus on risk-weighted capital in the Basel II Accords arguably led to a neglect of other aspects of how to achieve systemic stability in the financial sector. Thirdly, recasting societal concerns into the discourse of risk may not help to resolve argument about what level of regulation is reasonable or not.³⁵ ‘Risk’ is also something that each of the approaches distinguished above aims to address among other objectives. Risk is therefore not treated separately in the discussion that follows of the main approaches to regulation identified above.

³⁵ Herbert Simon points to the importance of addressing areas of policy concern in the terms in which the concerns are framed. ‘Problem solving requires continual translation between the state and process descriptions of the *same* complex reality’. (Simon 1969: 112.). (italics added).

II. THE DIFFERENT APPROACHES.

Better regulation.

The agenda

The background to the ‘better regulation’ agenda outlined earlier meant that regulation was seen largely against the ideal of a ‘free’ market. Excessive interference by governments in the market, or ‘over regulation’, was seen as the key issue to address. Regulatory interventions were not seen as justified unless market ‘failures’ could be identified, and even then the possibility of ‘government failure’ had to be assessed. Economic tests of regulatory proposals had to pass a positive appraisal of benefits exceeding costs (or benefits exceeding risks in health and safety). The ideal was for those whose behaviour was the source of concern to regulate themselves. In cases where government regulation was justified, the preference was for enforcement through ‘soft’ instruments and a ‘light touch’ rather than through ‘hard’ measures. ‘Agencification’ provided a form of protection against excessive government interference. These, arms-length agencies had a duty to promote competitive markets together with clearly defined ‘public-interest’ obligations (such as ensuring universal service).³⁶

The critique

Four key criticisms emerged. First, the approach seemed over-ideological in its treatment of the market. In particular a wide gap opened between the rhetoric of deregulation and the reality of a constantly changing form of regulation.³⁷ Instead, the idea of a regulatory ‘space’ has developed that sees regulation as a technique for social ordering that attempts to get away from ‘artificial’ distinctions between public power and private contract.³⁸ There are different ways of formulating the idea of a regulatory space. It can be seen simply as an ‘analytic construct’; or

³⁶ Dewatripont & Tirole(1994) suggest in the context of banking regulation that the role of the regulator can be defined according to a ‘representation hypothesis’ where the regulator represents the missing depositors and engages in ‘intervention activities that depositors are unable or unwilling to do for themselves’. (1994:6). This ‘representation hypothesis’ can be extended to regulators in other sectors who represent the missing or passive consumer interest or the missing competitors.

³⁷ ‘What we have witnessed has been reregulation, not deregulation’, Vogel, Steven K (1998:3). See also Rose-Ackerman ‘Despite its strong language, the Reagan administration did not actually do very much’, (1992:9).

³⁸ See Hancher & Moran (1989). Sunstein argues that government regulation, ‘Can fit quite comfortably with a system that provides a presumptive right to freedom of contract and private ordering – while at the same time providing reasons to reject private ordering in identifiable areas.’ (1990:3).

conversely, as a practical response to social ‘complexity’ that calls for relations between groups to be more or less formally negotiated to sustain social and economic trust.³⁹ A law and economics approach suggests that the regulatory space provides a form of social coordination that avoids the ‘costs’ of political contestation and mobilisation involved in passing major new legislation, while at the same time, regulatory procedures can aggregate and act in advance of disputes that would otherwise await individual court rulings arising from particular cases.⁴⁰

An ideological approach to regulation ignored a strong tradition in the theory and practice of public administration that emphasised the virtues of avoiding deep and divisive issues (reflected in the literature on ‘muddling through’ and ‘satisficing’).⁴¹ A need was seen to try to express the relationship between regulation and markets in a different way.

Secondly and related, by positing a sharp distinction between the state and the private sector, the better regulation approach appeared to ignore a movement both by theorists and practitioners towards looking at public policy as ‘governance’ rather than government. The governance perspective included private actors with authority and looked at networks rather than at the hierarchical structures of traditional government.⁴² In particular, the way in which, in the original better regulation agenda, different private actors relate to regulation was seriously under examined and under specified. For example, the different ways in which private authority links to public authority and may rely on borrowed (public) authority is not easily encapsulated by doctrines of self- regulation.⁴³ Even more fundamental, ‘markets’ themselves can be seen as constructions, to be constituted with varying degrees of government involvement and with a variety of governance arrangements.⁴⁴

³⁹ Hancher & Moran (1989) adopt the first; Clarke (2000) the sociological approach.

⁴⁰ See for example Rose Ackerman 1992.

⁴¹ See Lindblom (1959) for muddling through and March & Olsen (1989) for satisficing.

⁴² The origins of the voluminous literature on governance are discussed in Wright (1978). Castells (1996) is cited as a key text in the development of network concepts. For a recent overview see Bevir (2010).

⁴³ See Tamm Hallström (2004) for a study of borrowed authority. Omarova (2011) notes that, ‘A ‘pure’ form of self-regulation without any government presence or intervention is not realistic and is not commonly encountered in practice’. (2011:445) and lists over ten ways of describing various forms and typologies of ‘self regulation’. (2011:424).

⁴⁴ See for example Eisner 2010. The sense in which economists may see markets as ‘constructed’ is paralleled by the distinction made between law that is ‘constitutive’ and law that is about ‘sanctions’. Shearing states, ‘For the

Thirdly, the distinctions in the ‘new public management’ between steering and rowing were not as clear in practice as they had promised. At the one end of ‘steering’ there was a major gap in the analysis about the nature of the policy-making process itself.⁴⁵ At the other end of ‘rowing’ there was a major gap about the nature of how to achieve compliance.⁴⁶ When governments look at their ‘tool box’ of policy instruments (fiscal policy, monetary policy and regulatory policy), the distinction between steering and rowing also seems to break down.⁴⁷

Finally, the attempt to characterise regulatory relationships between the regulator and the target of regulation in the economist’s concept of ‘capture’ seemed over-simplified. Socio-legal analysis in particular emphasised a much more fluid relationship based on reciprocity rather than on an adversarial (win/lose) relationship. The socio-legal analysis supported the deployment in practice of a wide range of regulatory instruments and compliance strategies.⁴⁸

Responsive regulation.

Responsive regulation can be seen as a reaction to each of these perceived shortcomings. First, it deliberately tries to avoid the market ideology of regulation in favour of a more ‘pragmatic’ approach to societal goals that sees the way in which markets go together with regulation as the critical issue.⁴⁹ Secondly, it equally deliberately tries to avoid the opposition between state and private authority in favour of taking up the idea of network governance, ‘webs of control’ and by pointing to the potential for private actors, such as public-interest groups, to engage in the

constitutive conception, regulation is very clearly a productive enterprise. It does not simply restrain a market, it is what constitutes a market’. Shearing 1993: 74.

⁴⁵ The interconnectedness between the formation of policy and operational experience is discussed in Barberis (1998).

⁴⁶ The major contribution to filling this gap has come from socio-legal studies looking at what has been termed ‘natural’ decision making. (See Hawkins 1984 and Manning 1986).

⁴⁷ When the tools of government are viewed as ‘resources’ then a clear link is established between those who row (and who may or may not be given the resources) and those who steer (who decide on resource allocation). Hood also notes that the tools of government can be used in a general way or for particular applications directed to individuals or organizations. (Hood 1983: 17).

⁴⁸ The pioneering study in the importance of reciprocity was that by Gresham Sykes (1958). For a recent study in a totally different context see Downer (2009). See also Hutter 1997.

⁴⁹ Braithwaite (2008) has advanced the term of ‘regulatory capitalism’ as a way of pointing out that markets and regulation go together.

framing, monitoring and compliance of regulatory objectives.⁵⁰ Thirdly, it sidesteps the distinction between steering and rowing by focussing on the many instruments of regulation from education to criminal prosecution. Finally, it evades the confines of regulatory ‘capture’ to discuss the many types of enforcement strategies available for regulators.

The most distinctive feature of the responsive regulatory approach is in its analysis of what ‘responsiveness’ entails both in the choice of instruments and the choice of enforcement strategies.⁵¹ It chooses the metaphor or visual image of ‘pyramids’ to discuss both the range of regulatory instruments available and the range of possible enforcement strategies. It emphasises that regulators have a variety of instruments to choose from, ranging from education and persuasion at one end to the possibility of bringing civil or criminal charges at the other. It illuminates the choices regulators face in deciding which instrument to use through the concept of the enforcement pyramid. Under this approach regulators will have a first preference for persuasion (at the base of the pyramid) while legal sanction will be the choice of ‘last resort’ (at the top of the pyramid). The use of the pyramid metaphor does not provide a complete mapping of compliance issues.⁵² (Nor does it claim to). Nevertheless there are many empirical studies in the socio-legal literature that provide support for this view of how regulators and inspectors actually work.⁵³

Smart regulation.

Smart regulation shares many of the criticisms of the better regulation agenda included in responsive regulation. It too follows in a pragmatic tradition of public policy and avoids both the market rhetoric of deregulation and the assumption that the role of the state is necessarily in opposition to the role of the private sector. Instead it suggests ways in which private forms of control can be aligned with the public interest and the self interest of the private sector harnessed for regulatory goals.

⁵⁰ ‘If we learn to pull the right strand at the right time we might find that the entire fabric of the web of controls tightens to become quite strong’. Braithwaite (2008:201).

⁵¹ Braithwaite states, ‘The basic idea of responsive regulation is that regulators should be responsive to the conduct of those they seek to regulate in deciding whether a more or less interventionist response is needed’. (2008:88).

⁵² Baldwin & Black (2008) offer a critique and suggest among other points that the compliance model has to be linked to performance-based concepts of regulation.

⁵³ For law as a last resort see Hawkins 2002.

The critical issue identified in the smart regulation approach is what it sees as the inefficiencies and ineffectiveness of much regulation.⁵⁴ Where it differs from the responsive regulation agenda is in doubting that a wide variety of regulatory instruments and enforcement strategies alone will provide for effective regulation. Instead, appropriate and efficient strategies will usually involve a mix of instruments including tax and other instruments of an economic nature such as tradable certificates alongside regulatory instruments.

The focus of smart regulation is on the private-sector targets of regulation and to make sure they face a consistent set of behavioural incentives from both regulatory and economic instruments. The efficacy of the policy mix is to be assessed at the micro level of the targets of the policy action. For example if the target is to encourage farm businesses to farm in environmentally-sensitive ways, the policy mix would involve the subsidy and income-support regime being assessed alongside regulatory measures so that the two do not work against each other in the incentives they offer.

The message about the need to look at the efficacy of the policy mix can be interpreted in broader terms about the need for regulators to check whether or not a programme is ‘fit for purpose’ in all its elements taken together. (as taken up by the European Commission).⁵⁵

The concern of the ‘smart’ regulation approach with the effectiveness of the mix of regulatory and economic instruments overlaps with a similar concern in what is described below as ‘performance-based’ regulation. However, there are important differences in the perspectives on effectiveness. The differences flow from the use of more ‘generic’ ways of classifying the instruments in the tool box under the performance-based approach. These generic classifications refer, for example, to a resources-based typology or to a ‘survival/ effects’ typology. This placement of the instruments of regulation in a generic typology allows questions about the choice of instruments, or the ‘tool box’, to be seen in a sector or economy-wide context rather than one that focuses mainly on the level of the individual or individual firm.

⁵⁴ ‘Most existing approaches to regulation are seriously suboptimal’. Gunningham & Grabosky (1998:4)

⁵⁵ Under its smart regulation approach the European Commission undertakes to carry out ‘fitness checks’ to ‘assess if the regulatory framework for a policy area is ‘fit for purpose’ and, if not, what should be changed’. Commission Communication 2010:4.

Performance-based regulation.

Performance-based regulation can be defined narrowly to refer to an approach that sets outcome objectives and performance standards for the targets of regulation.⁵⁶ It can be defined broadly to include the need for government to be clear about its policy objectives as well as the link between its macro objectives and micro policies and where, in the pursuit of its objectives, regulation as a tool of government finds its place.⁵⁷ It brings together two, hitherto disconnected streams of government activity, performance measuring developed in the context of financial management and regulation. Goal setting and being clear about goals and intended outcomes are the common elements of both the narrow and broad definitions. So too is a focus on all the options in the ‘tool box’. In the discussion below the narrow and broad definitions are treated together.

The components.

The performance-based approach has three main components.

First, there is the view (under the narrow definition) that the operating and management responsibility for meeting regulatory objectives can be left in large part to companies and their employees.⁵⁸ This leaves regulators with the important task of needing to evaluate and measure the actual performance of managers in living up to the goals of regulation.⁵⁹ The advantages claimed for what is sometimes referred to as a ‘management-based’ system of regulation arising from within a company or organisation include: locating decision making closer to those with relevant information, the encouragement of a search strategy as to how to achieve goals and the

⁵⁶ Peter May (2010) uses this narrow definition. It is also reflected in EO 13563 that states, ‘Each agency must....to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt’. (EO dated Jan 18, 2011 section 1 para.b).

⁵⁷ Carter, Klein & Day (1992) trace the use of performance measuring to the 1960s and to this broader central government context.

⁵⁸ Hutter (2001) traces this view in the UK to the Robens Committee report of 1972 on ‘Health and Safety at Work’.

⁵⁹ Hutter notes, ‘the regulatory agency is cast into the role of overseer of the company’s own efforts to regulate’. (2001: 305). Carter, Klein & Day refer to performance measuring as ‘an instrument of hands-off control’. (1992:42).

stimulation of goal-setting that might be broader than an external agency might require or envisage.⁶⁰

This perspective on the targets of regulation is reinforced by the experience of regulatory agencies in dealing with their own resource limitations of money and staff. These limitations provide agencies with their own incentives to delegate functions and to set performance-based expectations while leaving the target to decide on how to meet those expectations.⁶¹

Under this approach, viewed either from the side of businesses that are the target of regulation or from the side of regulatory bodies faced with resource constraints, regulation shifts from a prescription of actions to be undertaken by the target to the use of performance targets as a way of establishing goals and monitoring outcomes. When goals are not met, or outcomes are unsatisfactory, the focus of an agency's external review is on management systems rather than on operating detail.⁶²

The second component of 'performance-based regulation' looks beyond the limited resources that may be available to an individual regulatory agency to assess more broadly the resource position of the government as a whole. This broader approach looks at the choice of regulatory instruments against the complete tool box of instruments available to governments including fiscal and monetary policy.⁶³

The key assertion in this second component of performance-based regulation is that over a range of government policy objectives different instruments are 'substitutable' or can be

⁶⁰ See Coglianese & Nash (2001) for a discussion. Coglianese & Nash 2006 see management based strategies as part of a tool kit that includes direct government expenditures, information disclosure programs and voluntary programs (2006:8).

⁶¹ Eisner identifies five main advantages with goal-setting by agencies; goals set a floor; goals can be adapted to meet the needs of specific industries; goals create incentives and flexibility for firms to go beyond minimum requirements and to look for innovative solutions; goals provide a peg for assisting firms move to higher levels of performance; goals harness market forces.(Eisner 2004:156).

⁶² Coglianese & Nash suggest that what is distinctive about management-based strategies is that 'they seek to penetrate and shape what goes on inside private-sector firms'. Coglianese & Nash 2006:3.

⁶³ Different authors define the contents of the 'tool box' in slightly different terms. Hood 1983 distinguishes between four different resources of government: its 'nodality' or centrality, its possession of money (treasure) its possession of legal or official power (authority) and ability to act directly (organisation). Daintith (1998) notes 'respect' or the recognition of legitimate authority as an important resource of government. Salamon (2002) suggests a range of dimensions including degrees of coerciveness, directness, automaticity and visibility. .Frieberg (2010) classifies the tools under the forms of power that governments may deploy including the ability to confer or withdraw benefits by authorizing forms of conduct.

combined.⁶⁴ For example, faced with constraints on its own expenditures, a government may turn to private investors to carry out investments in infrastructure or in health or education, while using regulation to determine the conditions under which they do so.⁶⁵ In an age of fiscal austerity when government spending resources are limited, this broader conception of performance-based regulation has a clear relevance.⁶⁶

The third component of what can be viewed as a performance-based approach is about what has been referred to above as ‘choice architecture’, meaning that once a government has decided on which combination of tools it can best combine in the light of its resources position there then follows a second decision about making sure that the combination is the most effective one possible in influencing the targets of regulation to behave in ways consistent with a government’s policy objectives.⁶⁷ A government needs to judge the aptness of the combination for which is the best instrument available to ‘nudge’ behaviour towards the goals and outcomes desired.⁶⁸ The language of ‘nudge’ has earlier antecedents in discussions of policy tools that ‘induce’ or ‘incentivize’ or ‘motivate’ behaviour.⁶⁹

The relationship between the choice of instrument in the tool box and decisions about the choice architecture can be seen as a decision about resources followed by more detailed decision-taking that looks at the effectiveness of particular instruments to achieve a given goal in the light of the

⁶⁴ Hood 1983: 67.

⁶⁵ For example in calling for comments on a revised set of regulatory principles, UK’s dept. BIS states ‘over the next five years, £200bn of investment in infrastructure is planned.....the Government therefore wishes to initiate a debate about how the high-level design and operation of regulatory frameworks can best achieve the desired outcomes, while minimizing uncertainty for investors’. (Source: Call for Evidence on Principles for Economic Regulation. BIS. Jan 2011 pp1-3.).

⁶⁶ Hood noted ‘cheque-book government may have something of the character of a ‘fair weather’ instrument’. Hood 1983:53.

⁶⁷ Hood (2007) notes that a focus on ‘effecting tools’ offers an alternative generic way of classifying the tools of government that he traces back to Etzioni (1964). Hood (ibid) notes the large element of ‘common ground’. Etzioni made a distinction between a ‘survival’ model of organization and an ‘effectiveness’ model which he defined as ‘A pattern of interrelations among the elements of the system which would make it most effective in the service of a given goal’. (Etzioni 1964:19).

⁶⁸ ‘A nudge is any factor that significantly alters the behaviour of Humans’. Thaler & Sunstein 2008:6.

⁶⁹ Elmore (1987) identifies ‘inducements’ as financial inducements; Schneider & Ingram (1990) define ‘incentives’ broadly to include several subtypes – inducements, charges, sanctions and force (1990:515). May (2005) looks at a ‘continuum’ of ways of effecting motivation and notes the importance of deterrence as a ‘backstop’. (2005:40). In such a continuum ‘nudge’ can be seen at one end of hidden persuasion while sanctions or outright bans can be seen at the other end.

resources available.⁷⁰ The relationship can be seen in the following hypothetical example about environmental policy:

- a. If a government is under severe fiscal constraints, a resources perspective on the tool box may rule out providing tax incentives or spending grants to encourage the purchase of fuel efficient (hybrid or electric) cars. By comparison, setting emissions standards may be more attractive because it displaces the costs of compliance to businesses themselves and to the consumer.
- b. However, from a more detailed choice architecture perspective, economic instruments (such as road-use or congestion charging) may be more effective than setting fuel-efficiency standards in encouraging people to minimise their carbon footprint. In this case the economic instruments judged effective do not involve raising government expenditure and are therefore consistent with the decision to avoid spending measures.
- c. If however, for both tax and spending reasons, the setting of emissions standards is still a preferred option (because road use charging is unpopular), such standards may be made more effective in changing consumer behaviour if they are accompanied by well- crafted requirements for information and disclosure that are seen as salient by consumers.

The example shows that the tool box looks at regulation as a resources choice while choice architecture takes the resources decision as a given and looks at the detailed effectiveness of the different options then available to steer behaviour towards the intended goals.

With resource constraints more generally , those regulatory instruments that are less costly to administer (such as those relying on information disclosure and ‘effects’ monitoring) may be preferred to those that are more burdensome on agencies or government bureaucracy (such as

⁷⁰ Hood (2007) notes that his classification of the tools of government ‘deliberately excluded all the intermediate activities and associated instruments, that form the ‘production function’ of much policy making within government’.

setting up and monitoring a cap- and-trade system). However they need to be effective in modifying behaviour which again calls for choice architecture.⁷¹

Under this more comprehensive definition of performance-based regulation the role of the regulator can be seen in what was earlier noted as ‘constitutive’ rather than ‘representational’ terms. The regulator will not simply be trying to stand in for, or to represent, missing competitors or passive investors or consumers, but will have a more far-reaching concern about whether or not the market is working in ways to achieve outcomes consistent with a government’s macro or broader societal objectives. Its decisions on choice architecture will have this wider perspective. Under this conception of its role the regulator will be mainly focussed on goals, outcomes and performance standards and will look to management-based systems to deliver those targets.⁷²

⁷¹ Thaler & Sunstein (2008) give the example in the US of the Toxic Release Inventory required under the 1986 Emergency Planning and Community Right to Know Act as an example of the effectiveness of an information - disclosure system.

⁷² According to the view that regulation is constitutive of markets: ‘Regulatory policy should be goal oriented rather than rule oriented’. Shearing 1993:75.

III. KEY ISSUES IN ASSESSMENT

The current regulatory environment.

The revision of OECD Recommendations takes place in a fiscal context in many OECD countries that calls for spending restraint and the restructuring of public spending. The regulatory environment therefore becomes a critical factor in encouraging the private funding of services and infrastructure.⁷³ The revision also takes place against the background of recent regulatory failures. In order to respond both to the new fiscal policy setting and to the lessons that need to be learnt, the analysis of regulatory approaches suggests that five issues require further discussion.

First, there is a critical reliance of performance-based regulation on goal-setting of various types. A resources perspective on the choice of regulatory tools seems necessary. However, goal setting, performance targeting and performance measuring are contested areas in regulatory policy.⁷⁴

Secondly, there is a need to look further into the competing definitions of the role of the regulator – what were referred to earlier as the ‘representation’ role as compared with the ‘constitutive’ role. The danger of the ‘constitutive’ role is that it could be seen as re-politicising the role of the regulator.

Thirdly, there is a need to look at compliance policies. Failures in a number of regulatory cases suggest that the kind of relationship established between regulator and the target regulated contributed to failure. Under any method or technique of regulation there is a basic question as to how regulators should react if the targets of regulation do not perform up to expectations or requirements.

⁷³ See for example, Sittampulam (2009).

⁷⁴ May notes that ‘A variety of claims have been made about the benefits of the performance based approach, though few of these have been substantiated’. (May 2010:3). Moynihan et al (2011) also note in a recent review of the performance literature that, ‘At a most basic level, we lack definitive evidence about whether performance regimes ultimately improve public sector capacity and outcomes’. (2011:154).

Fourthly, there is a need to look at how the evidence-base of regulatory policy is to be made more secure. All the approaches discussed above share the assumption that policy should be fully informed by the evidence. Regulation in finance, health and the environment all claim to be evidence-based. But that has not stopped failures and allegations of failure.

Fifthly, the international context of regulatory policy remains a concern – not only in the aftermath of the international financial crisis, and the stalled Doha round of trade talks, but also in the light of alleged failures in health over responses to avian and swine flu and in the environment over alleged inadequacies in IPCC procedures.

Each of these critical issues is discussed briefly below.

Setting goals

Setting goals, specifying objectives, desired outcomes and performance standards are key features of performance-based regulation. However, the setting of objectives and targets has a chequered background in regulatory discussion and analysis.⁷⁵ For some, it is associated with the idea of government as contract - both to those with whom a government has a direct relationship (such as health- service providers or insurers) as well as more generally with its citizens.⁷⁶ For others, goal-setting invites empty rhetoric or symbolism by governments or regulators or business management, the dangers of inconsistent policies, great difficulty in identifying measures of performance, gaming by the addressees of performance targets and the possibility of unexpected and undesirable side effects.⁷⁷

In order to respond to the controversies involved in setting goals under a performance-based approach, a basic distinction needs to be made between the different stages or layers or echelons of goal setting.⁷⁸ Each stage has its own kind of goal-setting; the goals are used differently

⁷⁵ De Bruijn (2007) provides a brief review of the pros and cons.

⁷⁶ For a discussion of contract in social services provision see for example DeHoog & Salamon (2002).

⁷⁷ However, in an empirical study of waiting times in the A& E depts. of English hospitals Kelman & Friedman looked at two of the most commonly cited dysfunctional responses to targets (effort displacement and gaming) and found, 'no evidence of these dysfunctional responses'. (Kelman & Friedman 2009).

⁷⁸ May notes that 'expectations regarding performance enter at multiple stages in performance based regulatory regimes'. (2010:4).

depending on the level at which they are set; they often fulfil more than one purpose at each level, roles change at different levels and each stage has its own kind of difficulty.⁷⁹

The first stage places the choice of regulatory instruments in the context of a government's resources and its main goals. These choices have to be made at the highest level of government. The difficulty here is that government objectives tend to be framed in general terms for communication to citizens. They are not necessarily framed in ways that acknowledge what they mean for the choice of policy instruments.⁸⁰

The second stage involves setting more detailed goals, probably at the level of a government department or a regulatory agency, that incorporate judgements about the effectiveness of different instruments and their mutual consistency.⁸¹ The difficulty here is in clarifying the 'linkage' between goals, priorities and instruments. Government departments and regulators may be reluctant to make clear the linkages and choices.⁸² The fundamental reason for this reluctance is that much regulation belongs to what has been called 'Secluded politics' where bureaucrats and regulators want to preserve their own sphere of initiative and ministers want to intervene only on the rare occasions where the issue has become a matter of broad public concern or of party politics.⁸³

At the third stage, goals are a way of judging the performance of regulatory bodies themselves (including those with a central oversight role such as OMB/OIRA in the US or the Better

⁷⁹ See the discussion in Carter, Klein & Day 1992:42-43. They also make a useful distinction between performance indicators that can be used as 'dials or tin openers'. (1992:168). De Bruijn notes that performance measures can be used to create transparency, for learning purposes, for appraisal purposes and as a basis for sanctioning. (2007:5).

⁸⁰ For example the priorities of the Government of Canada as of Jan.2011 were set under four broad categories and the only implied reference to the tool box and issues of substitutability were contained in the phrase 'We have a clear three-part plan: phasing out stimulus spending, restraining growth in other government spending, and promoting economic growth'. (Source: Government of Canada website).

⁸¹ In Canada the departmental guidelines state, 'Departments and agencies are to: set measurable objectives that address the public policy issue and its causes; establish linkages to...government priorities to ensure relevance and consistency; and develop and use performance indicators on an ongoing basis to monitor and report on progress against performance expectations. (Source: Cabinet Directive on Streamlining Regulation. April 2007. Section 4.3. See also Sect.4.4 para 1).

⁸² Pollitt's study of four functions in four European countries records the feebleness of ministries in developing performance-based strategies.(Politt 2006)

⁸³ Page defines 'secluded politics' as that area of government activity that involves specialized techniques, where it is difficult to engage the general public, where party attention is not attracted and where ministers are not usually engaged. (Page 2001).

Regulation Executive/BIS in the UK).⁸⁴ Goals set out how a regulatory body intends to implement its role and how its own performance might be measured.⁸⁵

At the fourth stage, there are goals about the outcomes that are wanted from the targets of regulation. At both the third and fourth stages there are difficulties in establishing appropriate outcome targets and performance measures.⁸⁶ The appropriate test is not whether a performance target or measure carries some dysfunctional elements with it. The correct gauge is whether or not, even including the dysfunctional element, a performance target is better than no system of measurement.⁸⁷

These different stages, or layers, or echelons, in goal-setting are illustrated in the table below.

Stage/ layer/level of detail	Focus	Addressee
Gov. Macro policy goals.	Substitutability	Whole of gov.
Micro-level consistency	Choice architecture	Gov depts/reg. agency.
Regulatory objectives	Constitutive	Reg. agency
Micro-level goals	Outcomes/standards	Business/service targets

⁸⁴ De Bruijn notes that 'who is the manager and who is the professional may...differ from echelon to echelon' (2007:5).

⁸⁵ For example Canada's Environmental Assessment Agency that manages environmental assessments for most major projects in Canada and promotes their use by other agencies responsible judges the outcome of its activities by the extent to which such assessments are taken into account in federal government programs and projects and measures its performance in relation to the number of assessments carried out each year divided by screenings, comprehensive studies and review panels.

⁸⁶ Paul Posner notes, 'goals are frequently vague and conflicted, third parties have much to say about what the goals are and how they are applied, agencies have little leverage over selecting or deselecting providers, and oversight is often deliberately constrained'. (2002:547).

⁸⁷ Kelman & Friedman note that if the net benefits of performance targets (including dysfunctional effects) outweigh the absence of any performance goals then 'it is better to manage an organization using imperfect performance measures than using none at all'. (2009:946).

The role of the regulator.

A distinction can be drawn between the representation role of the regulator where the regulator stands in for the missing consumer, or for passive investors, and the constitutive role (where the regulator actively shapes the market place and looks at the connection between the micro focus of regulation and macro policy objectives). The original regulatory reform agenda saw the role of the regulator as in representation. Each of the other approaches (responsive, smart and performance-based) imply or assume a constitutive role. The issue is how the constitutive role can be defined in ways which do not lead the regulator or central government departments to re-politicise the market.

Both the representation role and the constitutive role can be approached from a common starting point – one that is predisposed towards market oriented solutions to public policy problems. Although in the immediate aftermath of the financial crisis a common reaction was to re-emphasise the role of government, this may prove short lived. Public sector resource constraints are already working towards swinging the pendulum back to the role of markets and various forms of public/private partnerships.

The two key differences are not about the role of the market. They arise first because of differences of perspective on the role of structural as compared with behavioural incentives and secondly because of differences between a micro and macro perspective on regulation.

Structure and behaviour.

Under the representation hypothesis the role of the regulator is to focus on structural imperfections in the market – the absence of competition or the powerlessness of shareholder structures. Bad behaviour, such as predatory pricing or the pursuit of short term rewards for managers, flows as a consequence of such structural defects. The constitutive role looks at market behaviour as a prime mover of market imperfections. Behaviour drives structure, or the use made of structures. For example, the complex chain of intermediation involved in originating, distributing and funding securitized products can be seen as a reflection of short term profit driven behaviour. The difference is more than just of perspective. According to the representation hypothesis the regulator can exit once the structural defects have been remedied.

According to the constitutive role the regulator has to remain a constant presence to monitor the use and abuse of market contracting arrangements.

Macro and micro perspectives.

Under the representation hypothesis the role of the regulator is to focus on the individual firm or business – a micro perspective. The constitutive approach favours a macro economic perspective looking at the sector and economy wide implications of market behaviour. It became clear in the 2008 financial crisis that a focus on the capital adequacy of individual financial intermediaries might have encouraged the leveraging of individual intermediaries that contributed to the liquidity crisis in the sector and from there to a freeze in lending to the non financial economy beyond.

The constitutive role also takes a macro perspective in looking at the behavioural typology of regulatory instruments. The typology has two sides – an ‘effects’ side (focused on goals) and a ‘survival’ side. The idea of ‘survival’ in regulation is found in the use of such terms as ‘resilience’, or ‘robustness’ or ‘stability’ or ‘security’. The application in regulation is to such goals as maintaining the stability of the financial system as a whole so that it continues to mediate between savers and borrowers, even if some individual intermediaries fail, or to the maintenance of security of supply in energy so that the wider economy is not affected by a shortage of supply or to the security and continuity of service in communications services.

Choice architecture is critical to the constitutive role. Assessments of incentives, inducements or nudges must look beyond the individual firm to take account of the wider effects. Survival regulation has to take into account market incentives. The Basel II risk-based approach to capital adequacy that was intended to underpin system-stability (the survival objective) ignored the incentives it gave to financial intermediaries to use opaque forms of securitization.⁸⁸

Compliance

Numerous socio-legal studies in ‘natural decision making’ have demonstrated that, for good reasons, the relationship between regulators and those they regulate is, in normal circumstances,

⁸⁸ Dewatripont & Tirole observed in connection with the Basel rules long before the crisis that ‘securitization is particularly effective in raising the solvency ratio’. (1994:188).

based on reciprocity and a relation of give and take. What the financial crisis has demonstrated, as well as more recent events such as Deepwater Horizon or the Irish banking crisis, is that reciprocity can lead to an accumulation of lax practices that in the end can lead to crisis. A regulatory failure ends as an event (a crisis or disaster) but it begins as a process, meaning that while regulators may be disposed to favour the suasion end of the enforcement pyramid, experience has shown they must be much more ready to look at instruments at the sanctions end. This approach involves the more active use of their authority to fine, to prosecute, to withdraw licenses and to withhold or remove authorisations and to take orderly wind-up or business-continuity decisions.⁸⁹ Since their ‘natural’ tendency is to avoid such actions, regulatory guidelines need to provide some countervailing incentives. There is probably also a larger place than hitherto has been acknowledged for ‘comply or explain’ policies. These can be seen as providing a trigger mechanism between a suasion policy and a sanctions policy.

Evidence and expertise

Recent experience suggests that an important cause of regulatory failure flows from the ways in which the expert communities involved in preparing and evaluating regulations go about their work. Each of the approaches to regulation relies on two principal instruments to provide discipline on the experts and to try to ensure their work is evidence-based. The first is peer review and the second is impact assessment. Both have their limitations.⁹⁰ Evidence-based procedures need to identify more clearly the various forms of bias that affect expert groups, such as following fads, or herd behaviour, or confirmation bias.⁹¹ Regulatory guidelines need to recognise these behavioural traits and to institutionalise defences against them.

The key to improvement seems to lie in a principled set of procedures that, like peer review, are applicable throughout the regulatory cycle.⁹² The set comprises competitive evaluation (so that different viewpoints are identified and assessed), process tracing (so that key decision points are

⁸⁹ Baldwin & Black (2007) distinguish between seven main groups of enforcement tools: Pre-enforcement tools (warnings); investigative activities; continuity of business operations (licensing amendments); monetary or financial tools (fines); restorative tools (remediation orders); compliance management tools (enforceable undertakings); and performance-disclosure tools.

⁹⁰ See Lamont 2009 for a recent assessment of peer review.

⁹¹ See for example the report of the Independent Evaluation Group of IMF, ‘IMF Performance in the Run-Up to the Financial and Economic Crisis’. Washington DC.. Jan 10, 2011.

⁹² See Vibert 2011.

identified), the formal treatment of uncertainties in the analysis (so that uncertainties both in the data and in the models used to draw inferences from the data are assessed), and a focus on causal evaluation as distinct from ‘effects’ evaluation.⁹³ While a number of regulatory agencies use one or more of these practices in their work the importance of going beyond peer review and impact assessment has yet to be generally appreciated.

International cooperation

One of the merits of Canada’s performance-based system of regulation is that the international dimension of rule-making is explicitly acknowledged and has to be taken into account by Canada’s regulators in formulating their proposals.⁹⁴ This practice needs to be followed more widely. Failure to do so carries four main costs. First, regulation becomes parochial – not because of a considered evaluation of what might be justified differences in regulatory preferences but because of ignorance. Secondly, regulatory disputes arising at a later stage are likely to be more difficult to resolve. Thirdly, international bodies are less aware of changing regulatory thinking or practices among their membership, and agreements may become less resilient. Fourthly, international agreements become less easy to reach and less easy to implement.

⁹³ See Patton 2002 for the distinction.

⁹⁴ Cabinet Directive on Streamlining Regulation April 2007 Sect.4.4 paras.1& 3.. It is a curious oversight that the international rule making context is not mentioned in the Communication on Smart Regulation of the European Commission.

IV. REVISING INTERNATIONAL REGULATORY RECOMMENDATIONS

This review of different ways of reframing regulatory principles in the light of the current economic climate, the recent experience of regulatory failures and the various different approaches identified in the academic literature and in practice confirms that existing OECD regulatory Recommendations need to be updated and revised. The analysis suggests that necessary revisions should be built around three broad components. First, there is a need for a ‘whole of government’ approach to provide policy coherence across the many actors in regulation. Secondly, there is a need for revisions in certain key established regulatory management practices, notably in the approach to evidence based policy making and in the approach to compliance. Thirdly, in the light of the ‘whole of government’ approach and the required management practices there is a need to update thinking on questions of accountability.

A ‘whole of government’ approach

This paper has suggested that a ‘whole of government’ approach to regulation should contain three main elements. First, it needs to begin with recognizing the importance of a resources-based approach to the government’s tool box and the central importance of assessing ‘substitutability’. Goal setting needs to distinguish clearly between different stages, purposes and types of goal- setting as well as between the different addressees in a regulatory system, each with its different associated difficulties. Secondly, the broader constitutive role of regulation needs to be recognised alongside the representation role. A focus on competition policy remains an integral part of regulatory objectives. However wider behavioural concerns need to be recognised and sector and economy-wide objectives of regulation need acknowledgement. In recognising the constitutive role there needs to be an explicit acknowledgement of those regulatory objectives that are about ‘survival’ and focus on the resilience of a system of provision - such as security of supply in energy, or the continuity of credit flows in finance, or the integrity of communications services. Thirdly, the importance of choice architecture needs more explicit treatment. A recognition of the different incentives, inducements or nudges associated with different instruments is key to linking the micro focus of regulation with broader societal objectives and in linking the different elements of the role of the regulator.

Taken together, these components provide for a ‘whole of government’ perspective on the role of regulation in achieving societal objectives because they provide a vertical applicability to regulatory policy (from decision-taking at the top of government to decision-taking at the level of individual firms) and a horizontal applicability (a perspective that applies across the many different sectors of regulation from finance to utilities, to health and safety and to the environment).

Regulatory management.

The analysis in this paper identified two important areas where existing regulatory practices fall well short of what is needed. First, references to impact assessment have to go beyond peer review and impact assessment as currently practiced. Regulatory decision taking ultimately reflects social and political judgements that may be particular to particular societies. But it is important that such judgements are always informed by the best evidence available. Current RIA and peer review procedures do not represent best practice in the gathering and assessment of evidence. In order for the cognitive and behavioural biases of expert groups to be addressed, the principles of competitive evaluation, process tracing, the specification of uncertainties and the need for ‘causal’ evaluation as well as ‘effects’ evaluation have to become an integral part of evidence based assessments.

Secondly, the implementation practices of regulators need to be reviewed in order to focus on the way the practice of ‘reciprocity’ leads to an accumulation of dangers in a regulatory system. Revised practices need to highlight the ‘natural’ tendency of regulators to prefer suasion and education, and specifically call for regulators to be more ready to activate sanctions and to prosecute under the civil or criminal law. Techniques such as ‘comply or explain’ that can trigger a sanctions policy may have a more important place than has been generally recognised. Incentives for regulators to be tougher in their approach might include greater disclosure requirements relating to their regulatory enforcement policies and actions.

In addition to the changes needed to the way in which the evidence base of policy making is approached and to compliance policies there is also a need for a much greater vigilance about the international dimension of regulatory policy. Current statements about the need for vigilance focus on the potential impact of regulation on trade and investment policies. A much wider

perspective is required in an interconnected world. All new regulation in all sectors undertaken at the national and regional level should be reviewed in an international perspective. The aim should be to facilitate international agreements where possible, to head off bilateral disputes arising from differences in regulatory approaches that could have been avoided, to consider whether international regulatory competition is likely to be helpful or harmful, and to strengthen the institutional and procedural connections between national, regional and international rule-making bodies.

In addition to the changes in regulatory practices identified above there is also a case for a revised statement of principle on the use of boundary terms such as ‘risk’. Such a principle could set out the benefits of using such words as a way of easing communication. But it also needs to recognise that the objectives of regulation are diverse and that their translation into a common term may not do justice to, or may even distract attention from where the perceived harm or vulnerability really lies. The use of such boundary terms may not lead to a common understanding of regulatory tools or give appropriate weight to other objectives and can lead to a misdiagnosis of what is required.

Accountability: from governance to government.

Current circumstances suggest that there are important changes underway in the evolution of the regulatory ‘space’ between government, the law and market systems of ordering. At one end of the regulatory space a resources-based look at the instruments in the tool box and the choice architecture underlines the centrality of government and official regulatory bodies to key choices. At the other end of the regulatory space there seems to be a need to reaffirm the traditional legal instruments of civil and criminal law rather than the exercise of regulatory discretion relying on suasion and education. These contrasting positions both represent a shift back to the exercise of official, hierarchical, authority – a shift back from governance to government. Nevertheless within this more tightly defined space the constrained fiscal circumstances of OECD members means that regulation will be a preferred tool of government so that government can lever in the resources of the private sector. The outlook is for a larger but more tightly-bounded space.

If it is fair to represent the new regulatory environment as one which represents a return to ‘government’ then there are implications for accountability. The channels for government accountability run through the political process. It is important not to confuse the channels of democratic expression with the consultation processes necessary to give affected interests the right to express their views on particular regulatory measures. One purpose of democratic processes is to ensure that the voice of particular interests, including those of NGOs, compete with the views of the general citizenry but are not granted a privileged weight or place in debate. It is the general citizenry that ultimately pays for regulation including those regulations advocated by particular interests and NGOs.

The shift to ‘government’ does not mean that the independence of regulators from political interference should be compromised. It remains the case that arms-length bodies are more able to mobilise and assess the evidence base for policy, less short term in their outlook, and are more likely to be trusted than government by the targets of regulation and by the public beyond. Here the avenues of accountability lie with the processes of judicial review as well as with the politicians who set their terms of reference. In a number of jurisdictions, including in international rule making, the avenues for judicial review are deficient.

OECD’s New Recommendations.

OECD’s proposed new instrument (Annex C Attached) can be assessed against the revisions to regulatory approaches discussed above. The proposed Recommendations make a significant start in updating international regulatory principles in four important areas. First, they recognise the need for a ‘whole of government’ approach to regulation and the need for greater coherence within regulatory systems. (Recs. 1 & 10). Secondly, they reinforce the ‘government’ dimension of accountability – the need for open government and access to judicial review. (Recs 2 & 8). Thirdly, they broaden references to the international dimension of regulatory policy making. (Rec. 12). Fourthly, they recognise the need for measuring the performance of regulators themselves. (Rec. 6).

At the same time the Recommendations do not go far enough in key areas in recognising the requirements of the new economic situation facing OECD members or the regulatory failures of

recent years. For example the new Recommendations fail to set out the building blocks of a ‘whole of government’ approach, including the need to link ‘micro’ judgements with ‘macro’ judgements that place the focus on ‘substitutability’, ‘choice architecture’ and the ‘constitutive’ role of regulators. They also fail to reflect the insights from cognitive and behavioural economics that must henceforward inform the approach to expert groups and evidence based regulation (Rec. 4) as well as to compliance practices (Rec.7). They fail in addition to offer the necessary cautions about the use of boundary terms such as ‘risk’ (Rec. 9). These are all areas where further updating will be required in future as lessons from past failures are more fully absorbed and as the implications of the restrictions on the use of the fiscal tools of government become more fully appreciated.

CONCLUSION.

From “better regulation” to “performance-based” regulation.

This review of different approaches to updating OECD Recommendations suggests there is no single approach that should be adopted. It does, however, suggest that a broadly defined ‘performance-based’ approach has particular relevance for current circumstances. Austerity means that governments are forced to ask whether their objectives can be reached through regulation rather than taxing and spending. Austerity requires regulators to ensure that their ‘choice architecture’ is geared to achieving consistency between broader economic goals and the behaviour of the individual targets of regulation and is resilient in the face of strain. Austerity requires that regulators use a full continuum of compliance methods, from incentives to deterrents, from nudging to sanctions. In an age of austerity, governments and regulators cannot afford not to set performance goals for the targets of regulation, however difficult targeting and measurement may be. In this new environment and against the background of the regulatory failures of recent years it needs to be recognised that old statements of regulatory principles have lost both relevance and resonance. OECD’s proposed new Instrument is an important first step in revising international regulatory principles but the analysis of this paper suggests there is much further to go.

ANNEXES.

A. OECD 1997 Policy recommendations for regulatory reform.

B OECD 2005 Summary guide to Recommendations.

C. OECD's 2011 draft Recommendation on Regulatory Policy and Governance.

D Glossary of terms.

Selected References.

Annex A. OECD 1997 Policy Recommendations for Regulatory Reform. Summary.

1. Adopt at the political level broad programmes of regulatory reform that establish clear objectives and frameworks for implementation.
2. Review regulations systematically to ensure that they continue to meet their intended objectives efficiently and effectively.
3. Ensure that regulation and regulatory processes are transparent, non-discriminatory and efficiently applied.
4. Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy.
5. Reform economic regulations in all sectors to stimulate competition, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.
6. Eliminate unnecessary regulatory barriers to trade and investment by enhancing implementation of international agreements and strengthening international principles.
7. Identify important linkages with other policy objectives and develop policies to achieve those objectives in ways that support reform.

Source: OECD.

Annex B. 2005 OECD Guiding Principles for regulatory quality and performance.

Selective guide to content of Recommendations. (1997 Principles remain unchanged).

Selected content of Principle 1: Good regulation should: (i) serve clearly identified goals....(ii) have a sound legal and empirical basis; (iii) produce benefits that justify costs....(iv) minimise costs and market distortions; (v) promote innovation through market incentives and goal-based approaches.....make effective use of ex post evaluation.

Selected content of Principle 2: Consider alternatives to regulation where appropriate and possible, including self-regulation.....use performance-based assessments of regulatory tools and institutions....integrate regulatory impact analysis into the development, review and revision of significant regulations....include risk assessment and risk management options in RIAs....

Selected content of Principle 3: ensure that firms in an industry are not subject to firm-specific benefits or costs arising from regulation.....

Selected content of Principle 4: Eliminate sectoral gaps in coverage of competition law....enforce competition law vigorously....

Selected content of Principle 5: Ensure that regulatory restrictions on competition are limited and proportionate to the public interests they serve.....Promote efficiency and the transition to effective competition where regulations continue to be needed because of potential for abuse of market power.....

Selected content of Principle 6: Better integrate the consideration of market openness principles within the design and implementation of regulation and the conduct of RIAs, taking account of the increasing role of domestic regulatory environments in determining market openness in light of advances in trade and investment liberalisation.....

Selected content of Principle 7: Apply principles of good regulation when reviewing and adapting policies in areas such as reliability, safety, health, consumer protection and energy security so that they remain effective and as efficient as possible within competitive market environments.....

Annex C. OECD's 2011 Draft Recommendation on Regulatory Policy and Governance.

(Source: OECD.)

Draft**OECD Recommendation on Regulatory Policy and Governance**

1. Commit at the highest political level to an explicit whole-of-government policy for regulatory quality, with clear objectives and frameworks for implementation to ensure that, if regulation is used, the economic, social and environmental benefits justify the costs, distributional effects are considered and that the net benefits are maximised.
2. Orient regulatory policy around the needs of users and adhere to principles of open government, including transparency and participation. This includes providing meaningful opportunities (including online) for the public to be consulted in the process of preparing draft regulatory proposals and the supporting analysis.
3. Establish institutions and mechanisms to actively pursue oversight of regulatory policy procedures and goals, support and implement regulatory policy, and foster regulatory quality.
4. Integrate Regulatory Impact Assessment (RIA) early into the policy process for the formulation of new regulatory proposals. Clearly identify policy goals and evaluate if regulation is necessary and how it can be most effective in achieving those goals.
5. Conduct systematic programme reviews of the stock of regulation against clearly defined policy goals, including consideration of costs and benefits, to ensure that regulations remain up to date, cost justified, cost effective and fit for purpose.
6. Regularly publish reports on the performance of regulatory programmes and the public authorities applying the regulations, including compliance with regulatory quality measures such as the performance of Regulatory Impact Assessment (RIA) and reviews of existing regulations.
7. Develop a consistent policy covering the role and functions of regulatory agencies in order to provide greater confidence that regulatory decisions are made on an objective, impartial and consistent basis, and avoid the risks of conflict of interest, bias or improper influence.
8. Establish systems for the review of the legality and procedural fairness of regulations, and of decisions made by bodies empowered to issue regulatory sanctions. Ensure that businesses and citizens have access to these systems at reasonable cost and receive decisions in a timely manner.
9. Apply risk assessment, risk management, and risk communication strategies to the design and implementation of regulations to ensure that regulation is targeted and effective. Regulators should assess how regulations will be given effect and should design responsive implementation and enforcement strategies.
10. Promote regulatory coherence through appropriate co-ordination mechanisms between the national and sub-national levels of government. Identify cross cutting regulatory issues at all levels of government, including the supra national level; promote coherence between regulatory approaches and avoid duplication or conflict.

11. Foster the development of regulatory management capacity at sub-national levels of government.
12. Ensure that regulatory measures contemplated in all fields take into account any international frameworks for cooperation in the same field. Regulations should be designed to take into account their possible effects on parties outside the jurisdiction where they are to be applied. Consultation should include any external interests with the aim of avoiding unnecessary international frictions.

D. Glossary of Selected Terms.

Addressee: The body (usually a govt. dept. or regulator) to whom a regulatory objective or responsibility is entrusted.

Choice architecture: The range of regulatory and economic measures available to the authorities arrayed by their capacity to alter the behaviour of the targets of regulation.

Constitutive: the role of the regulator in shaping a market.

Framing bias: when the way in which a question or problem is framed leads to the unequal treatment of data of equal information content (ie violates the invariance principle).

Instrument: the form in which a regulatory objective is conveyed.

Representation hypothesis: When the role of the regulator is limited to standing in for missing competitors or consumers or passive investors.

Reciprocity: the likelihood that regulators and their targets will develop a relationship of mutual dependence and give and take.

Substitutability: the extent to which the different powers available to a government are interchangeable.

Target: the subject of a regulatory measure.

Tool box: the resources and powers available to a government to achieve its policy objectives.

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