BRIEFING PAPER

Reforming the Regulators

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Background

The size and number of market regulatory agencies in the UK has increased dramatically since 1997. This may be attributable to both the 1997-2010 Labour government's view of market mechanisms as needing top-down 'guidance' to operate effectively, and also to their belief in engineering markets to bring about socially optimal results. This report will argue that the current regulatory system is bloated, ineffectual, and counterproductive to the goal of increasing competition in the marketplace.

Over the past decade, the role of market regulators has grown far beyond their initial purpose, which was to create competitive markets with the aim of seeing regulators eventually wound-up. The regulator's role was to act as a proxy for the pressures of a fully competitive market in newly privatized industries until competition emerged naturally. The Labour government believed that regulation should also help to deliver social and environmental objectives, in addition to the purely economic role marked out by previous Conservative governments.

This wider role was spelt out in the Utilities Act 2000 and successive related acts. For example, the enhanced and detailed regulatory role to be fulfilled by Ofcom was spelt out in the Office of Communications Act 2002, which added a further 135 duties on top of the 128 duties laid down for the five regulatory bodies Ofcom replaced, many of which went beyond Oftel's original competition-focused remit.

Furthermore, the regulatory sector in the UK has experienced a dramatic gain in both budget and staff over the past decade. The Financial Services Authority's (FSA's) budget increased by a third between 2000/1 and 2003/4, and its staff size has ballooned in recent years, with the number of total staff on payroll increasing from 537 in 2000/1 to 2,333 in 2009/10. This is reflective of the wider surge that has taken place across the regulatory sector.

There is little doubt that this has taken its toll on businesses. The British Chambers of Commerce's 'Burdens Barometer' estimates that the total net cost of major regulations approved since 1998 is £88.3bn.[1] Moreover, the government's own Better Regulation Task Force (subsequently renamed the Better Regulation Commission) estimated in 2005 that the annual cost of regulation to the British economy was an astonishing 10–12 per cent of GDP.[2] That's roughly the same as the income tax burden.

The 'consumer agenda' espoused by the Labour government also led to the creation of a number of consumer councils, such as Energywatch, in order to put pressure on the regulators and give consumers a louder voice in the regulatory process. Other consumer protection agencies like Postwatch, WaterVoice, and the London Transport Users Committee were all intended to protect consumer interests by shadowing various market regulators. This reflected Labour's distrust of market mechanisms and reliance on quangos as quick fixes for long-term problems. In some cases, notably Postwatch, staffing and running costs exceeded those of the regulator they were mirroring.

Some industries have had to deal with a multiplicity of regulators, with the structures of regulation changing rapidly over the past decade. The back of a BT telephone bill from July 2004 can illustrate this. This referred complainants to BT itself, but also to Ofcom, the Office of Telecommunications Ombudsman (Otelo – approved by Ofcom), the Independent Committee for the Supervision of Standards of Telephone Information Services (ICSTIS – industry funded), and the British

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Approvals Board for Telecommunications (BABT). ICSTIS and BABT were abolished by 2010, but for premium rate service complaints PhonepayPlus was given regulatory responsibility as a co-regulatory agency. The consumer may consider this shifting multitude of advocacy agencies to be more confusion than protection.

Indeed, most of the consumers in whose name these bodies were created had little interest in or knowledge of the agencies. Furthermore, there was a systemic inefficiency in the running of these agencies. The National Audit Office (NAO) examined Energywatch and Postwatch and concluded that both 'could be more proactive in seeking to reduce costs.'[3] Both were guilty of massive waste and over-budget spending. Even more damningly, it is clear from the NAO report that these bodies did not understand consumers' needs, nor what the then Department of Trade and Industry expected them to achieve. They did not know what they were supposed to be doing, how to do it, or what it should cost.

Regulation: A failed experiment

Looking back over the past decade, Professor George Yarrow, an eminent Oxford academic, has observed that 'UK environmental policy suffers from the ad hockery, volatility and incoherence typical of politicised decision making.'[4] He adds: 'The effects of this have been particularly severe in the electricity sector, which has borne the brunt of the policy weaknesses. [What was once] the poster child of world liberalisation is now closer to being a basket case.'[5] Britain's experiment in regulation, with a multitude of regulators being used to try to fine-tune the economy and achieve social goals, has manifestly failed.

It is questionable whether any government should devolve its responsibilities to unelected quangos, as this removes powers from elected representatives and distances the citizenry from the decision-making process. Furthermore, the pro-consumer agenda has proved hard to define in legal language. Ministers provided the utilities with hardly any guidance on how to fund their social and environmental objectives. For instance, how far should prices climb in order to address the needs of those who cannot afford essential heating? And how high should prices go in order to deal with specific environmental problems? The energy expert Professor Dieter Helm, a Fellow of New College, Oxford, commented that the Utilities Act 2000 was one of the 'worst examples of poor drafting in recent times.'[6] It showed a woeful ignorance about how utilities operate in the real world – ignorance that resulted in misguided policies and wasteful spending.

Although regulators are seen as being the first line of defence against business fraud, the evidence to support this is not encouraging. The Enron and WorldCom accounting scandals in the US and the corporate governance shocks at Shell and Equitable Life in the UK all occurred in the presence of a huge volume of regulatory controls on accounting standards, financial reporting and corporate governance. The economist Elaine Sternberg has observed that: 'Regulation is typically part of the problem, not the solution. Interestingly, the worst scandals have been in industries that have traditionally been heavily regulated: energy, telecoms, defence.'[7]

One reason for this is that regulation is not as efficient as competition in exposing corporate weaknesses. Another may be that the very proximity of regulatory agencies to the companies they regulate can lead to them becoming 'captured' by industry lobbyists. Regulation can also encourage excessive risk-taking: Arguably, the regulatory failures discussed above occurred not in spite but because of the regulatory environment, as the veneer of regulatory transparency allowed improper business practices to escape scrutiny from investors for longer than they otherwise would have.

This argument also applies on a larger scale to the Financial Services Authority, which oversaw the dynamics that led to the 2008-present financial crisis. By creating the appearance that the financial sector was well regulated and overseen by so-called 'experts', government regulations contributed to a culture of excessive risk-taking and created an element of moral hazard. If a blind watchman's presence lulls people into a false sense of security, he may be worse than having no watchman at all. Our belief is that regulators are fundamentally 'blind' to the complexities of market institutions.

One of the reasons for the failure of the regulatory agencies is the nebulous accountability regime. A House of Lords Select Committee inquiry into market regulators concluded that, paradoxically, they are accountable to everyone and no one.[8] Though the original aim in their creation was to ensure that they were independent of government influence, subsequent efforts to make them more accountable to elected representatives has undermined this independence.

Sir Ian Byatt, who was adamantly independent during his time at the head of the first water regulator, has suggested: 'It is arguable that developments in regulation since 1997 have created the scope for much more detailed ministerial involvement in what are now privatised industries than was feasible for the nationalised industries.'[9] Byatt supports his argument with evidence carefully drawn from the water, electricity, telecom, rail, London Underground, and postal industries. He concludes that this trend has jeopardised the hard won advantages associated with privatisation.

Consumer protection bodies are misconceived and unnecessary. Following criticism from ourselves and other economists, some were merged into a single agency, Consumer Focus, but this has merely compounded the issue – the systemic waste and lack of purpose has continued. If they were exposed to the full pressures of the competitive market economy, utilities would use greater market research to listen to and satisfy their customers. Assuming they are operating within the law, the channels for complaint and alternative purchase options would emerge under the rigours of competition as they do in other sectors of the economy.

Reducing the regulatory burden

A great deal of regulation aimed at protecting consumers could be left to the courts, as the economist Irwin Stelzer has argued.[10] In the courts, he says, 'there are no ups and downs due to changes in political fashion.'[11] In the UK, utility customers' legal disputes could be handled by the small claims court which could draw on legislation protecting consumer rights. This legislation could be made more robust if necessary through an Act of Parliament. In larger cases, expert witnesses can throw light on a problem to provide the expertise necessary for courts to make a judgment. Abuse of market power by large firms can be dealt with by exposure to the glare of the media, allowing consumers to make up their own minds about whether or not to punish a company with their wallets by taking their custom elsewhere. To this end, the freedom of the press should be strengthened by the restriction of court gagging orders.

For a range of risks including fire, health, safety and environmental protection, insurance cover aimed at meeting certain minimum standards would provide better and more effective protection than regulation and public service inspections. Already, employers are required by statute to insure again any harm they may cause employees (this is known as Employers' Liability Insurance). Similarly, motorists must be insured for third party risks, while professionals, such as accountants, lawyers and architects must take out professional indemnity insurance. The principle of mandatory insurance need not be extended to other business sectors, such as manufacturing, hotels and restaurants, which are currently controlled by regulation, but it is likely that, in the absence of regulators, market pressures would force firms to adopt such measures.

One advantage of this may be that the goal of adequate protection for employees and the public would be achieved through ordinary market mechanisms rather than blunt regulation. Businesses running higher risks would face higher insurance costs, or their insurers would insist that they curb their exposure by, say, installing safer equipment or upgrading their staff training. Unsafe businesses would not be able to get cover and would be forced out of the market by the threat of consumer or employee litigation. Second, the adjustment would be automatic: If the nature or practices of the business change, the insurers' premiums change too, without a new regulatory rulebook having to be drawn up. Third, the insurance industry knows more than regulators about the real risks associated with any business, since they already collect claims data and have a strong commercial interest in assessing risks and adjusting premiums to match.

Better use of market forces also overcomes the current problem that regulation revolves too much around officials' rulebooks and too little around reality and common sense. As the Nobel-winning economist Milton Friedman pointed out: 'By removing the organisation of economic activity from the control of political authority, the market eliminates this source of coercive power.'[12] Political influence over the economy is open to abuse, and scaling back the regulatory agencies would help to reduce this factor.

Strengthening the Office of Fair Trading

Though we believe that many regulators should be eliminated, there is still a need for a body to oversee the economy to ensure a competitive environment. We favour giving the Office of Fair Trading (OFT) a central role in monitoring markets and the promotion of competition

in the British economy. Our earlier study estimated that merging regulatory agencies into the Office of Fair Trading could save up to 80 percent of the current level of costs represented by these separate regulatory agencies (equivalent to £550m a year on 2006/7 costs).[13]

This radical option may be too difficult politically to implement in one term of parliament. However, government can make systematic progress towards it as a longer-term goal. A recommended strategy would be first to invite regulators to present plans for how their own scaling-back to a simple competition-promoting role should be organised, showing the dates and methods of reducing their scope, and ultimately showing how their duties and key staff could be incorporated into the OFT. This would mirror the Treasury's current practice of requiring ministerial departments to outline their strategies for coping with potential budgetary cuts.

Thereafter, progress in winding down superfluous regulators should be monitored through annual reports to Parliament, and not just to the Secretary of State as at present. These reports should include cost-benefit analyses overseen by an independent assessor, with assessments limited to a single, measurable goal, since multiple objectives make proper assessment difficult if not impossible.[14] The reports should highlight the success or failure that agencies have experienced in streamlining, clarifying and reducing the regulations applied to their sectors.

Arguably, such a strategy would make the OFT too dominant. Such concerns have been heard lately, following reports that HM Treasury will merge the OFT with the Competition Commission. However, we envisage relatively small units within the OFT monitoring trading standards by the utilities. These added responsibilities would not create a leviathan. Indeed, by radically cutting back the number of regulators, the British economy will become significantly less pressurized by government restrictions and experience a burst of innovation and growth.

Finally, it is an open question whether the OFT should be combined with the Competition Commission. The Commission is relatively modest in terms of headcount numbers, as its investigations are outsourced to specialists specifically recruited to undertake such enquiries. The Commission itself is little more than the nexus for those investigations, all of which have to be proposed by the OFT or one of a number of so-called super complainants. Accordingly, in terms of merger policy and utility regulation, combining oversight into the OFT would allow for a more streamlined and effective authority.

On the other hand, there is an argument to be made for maintaining diversity in competition and merger policy. The US has successfully handled antitrust regulation through two bodies – the Department of Justice and the Federal Trade Commission – and a similar model may be appropriate for the UK. It is arguable that the Competition Commission and the OFT have distinctly different roles: the former structural and macro-level, the latter dealing with micro-level trading issues. Yarrow has argued that: 'The current role of the Competition Commission seems to me to offer better guarantees of continuation of an appropriate quasi-judicial approach.'[15] In summary, we find the case for merging the CC and OFT far from clear-cut and we recommend it be the subject of public consultation.

Conclusion

As a consequence of ideologically driven 'mission creep' in the scope and role of market regulators, the UK's current regulatory system is a bureaucratic shambles. It stifles competition and causes needless bureaucratic red tape, which inhibits economic growth and hurts the British consumer. Policy-makers should fix this problem by eliminating unnecessary regulators and consumer councils and combining the necessary regulatory functions into a single Office of Fair Trading. This would enhance competition whilst maintaining the essential regulatory framework through a combination of market forces and limited government regulation.

Recommendations

1 Regulatory agencies should become formally answerable to Parliament, whether to a joint committee of the two Houses or a committee of the Commons. Its annual plan and report should be agreed with that body.

2 All offices for consumer interests for regulated industries should be abolished. Instead, consumer complaints should be dealt with through a mixture of grassroots consumer choice campaigns and, where necessary, litigation through the courts.

3 Market mechanisms, notably risk management tools and insurance, should be more widely adopted in place or regulation to improve standards. The legal system should be used to prosecute firms acting illegally.

4 Regulators should draw up strategic plans for reverting first to having only an economic, competitive market creating, role, and then their own demise. The costs of new non-economic regulation should be transferred to national or local government. Following the closure of each regulator, its remaining responsibilities should be transferred to the OFT.

5 The possibility of merging the OFT and the Competition Commission should be the subject of an Impact Assessment which is circulated for public consultation.

About the authors

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Endnotes

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10 Dr Irwin Stelzer was the founder of National Economic Research Associates and a past Director fo the Energy and Environment Policy Center at Harvard University. He is currently Director of economic policy studies at the Hudson Institute, based in Washington DC.
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