The achievements of regulatory policy

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Abstract: *Regulatory policy has already made a significant contribution to economic development and societal well-being. Economic growth and development have been promoted through the contribution of regulatory policy to structural reforms, liberalisation of product markets, international market openness, and a less constricted business environment. Regulatory policy has also supported the rule of law through initiatives to simplify the law and improve access to it and through improvements to appeal systems. Increasingly, it supports quality of life, social cohesion and the rule of law, through enhanced transparency which seeks out the views of the regulated and through programmes to reduce red tape for citizens.*

Regulatory policy and economic theory

Alongside political science, history and the law, the discipline of economics has been a key factor in the development of regulatory policy. Regulatory policy has both learnt from and contributes to developments in economic theory. The analytical framework which underpins the development of regulatory policy is based on a significant stream of economic analysis.[1]

The case for regulation is generally premised on the existence of significant market failure resulting from the existence of externalities, from information imperfections in market transactions, from market power resulting from economies of scale and scope in production, and from resulting income and wealth distribution effects.

- *Externalities.* Markets are highly effective institutions for allocating resources efficiently, but markets may fail to do so when important impacts are not considered in decisions by market actors. These unconsidered impacts are termed externalities (Arrow, 1969). For example, pollution can be an external harm of economic activity. Failure to consider the social and environmental harm of pollution results in an excessive level of pollution and an excessive level of the economic activity generating the pollution, compared to the levels that would be obtained in an efficient market were this external harm considered in market actors' decisions. An essential function of regulation is to internalise externalities by inducing market actors to take these impacts into account in their decisions (Laffont, 1987).

- *Asymmetric information.* Markets may be inefficient where some actors have information that others do not, skewing their transactions (Akerlof, 1970). For example, consumers may be unaware of product defects, workers may be unaware of safety risks in the workplace, investors may be unaware of the risks of default or downturn in the activities underlying the loans or securities in which they invest, and insurers may have difficulty monitoring risks taken by their insured policy holders. Excessive risk, which would not be reflected in prices paid, may result from a lack of information. In such cases, appropriate regulation can improve market outcomes by ensuring that more symmetric and full information is available to the actors to make well-informed decisions.

- *Market power.* Concentration of power to influence markets – to affect prices and supplies of goods, services, or factor inputs – can also result into market distortions. For example, a monopolist can raise prices while restricting supply to increase its profits; if competitors cannot enter the market to contest the monopoly price, consumers will be harmed. Regulation can improve market outcomes by limiting market power and ensuring that consumers are able to choose among competitive goods and services (Baumol *et al*., 1982).

- *Other public policy goals.* Regulation may be needed establish allocation of rights, opportunities and responsibilities and to correct discrimination by market actors (or governments) against citizens because of their group association, or more generally to prevent unfairness.

A key underlying assumption, in both theory and practice, is that regulation is motivated by public interest and improving social welfare. This approach has been criticised by public choice theorists who argue that there may be many advocacy groups that have strong incentives for lobbying the government to implement specific policies that would benefit them, potentially at the expense of the general public (Buchanan, 1972). This line of thinking has been refined in the concept of "regulatory capture", which posits that the regulatory process has a bias in favour of particular interests. Stigler (1971) and Peltzman (1976) argue that regulators are presumed to favour producer interests because of the concentration of regulatory benefits and diffusion of regulatory costs. Some research goes so far as to claim that regulation *always* leads to socially sub-optimal outcomes because of "inefficient bargaining between interest groups over potential utility rents" (Newbery, 1999 and see also Laffont, 1999).

Regulation is also subject to "political capture" where regulatory goals are distorted to pursue political ends (Laffont and Tirole, 1991). The state itself is not perfect, and is made up of structures and individuals who sometimes pursue personal objectives in the name of the general interest. Under political capture, regulation becomes a tool of self-interest within government or the ruling elite (Posner, 1974 and Stiglitz, 1998). More generally, North (1990) develops a line of reasoning where the process and outcomes of a regulatory regime are determined by the specific institutional context of an economy, as reflected in both the formal and informal rules of making economic transactions.

The case for regulatory reform and deregulation takes it genus from the Chicago school of economics which advocates the virtues of open markets free of state interference. Milton Friedman and Fredrick Hayek believed in the inherent self-correction of markets, and that regulation should be kept to a bare minimum, not much more than competition policy enforcement. This thinking exerted a significant influence from the 1980s onwards over government economic policy in countries such as the United Kingdom and the United States. Privatisation programmes from the 1980s onwards were (apart from raising funds for the state) driven by a desire to reduce the presence of the state in markets.

These developments had significant consequences for regulatory management. The objective of free markets encouraged the deregulation of product markets, and with the liberalisation of previously monopoly sectors, opened the way to construct market-based regulatory regimes in these sectors (Armstrong and Sappington, 2006). Autonomous economic regulatory agencies were established, at an arm's length from ministries and the political process, to manage these previously monopoly sectors leading to the so called raise of the regulatory state (Majone, 1994).

Measuring the benefits of regulatory reform and policy

A new area of focus has been exploring the relationship between various kinds of regulatory reform and economic growth. This body of evidence can be described as positive and persuasive that the quality of regulation is strongly linked to economic growth and productively. This section examines the impact of regulatory reform in a number of areas covering broad-based measures and those linked with market openness, competition, labour and product markets.

One needs to recognise, however, that it is challenging to demonstrate a positive impact of good regulatory policies on social and economic outcomes for at least six reasons. First, the number of potential factors that influence economic growth make it difficult to isolate the impact of regulatory policies. Second, the effect on economic growth might be indirect, *i.e*. go through other factors such as investment that influence economic growth. Third, causality can run both ways and it is complex to identify its direction. Not only can better regulatory policies lead to higher incomes, but also higher incomes may lead to more sophisticated regulatory policies. Fourth, good indicators that rank countries on their regulatory policy system, and thus can be used for such analysis are lacking. Fifth, any analytical method is based on assumptions (e.g. that any omitted factors are not correlated with the quality of regulatory policies). The findings of a study are then conditional on these assumptions, i.e. if the assumptions do not hold, the results may not hold. Sixth, lack of good data for a sufficiently high number of countries and years can limit the choice of methods, and affect the quality of results.

With these caveats in mind, many studies use relatively simple indicators of the regulatory environment. These studies tend to find a negative correlation between the restrictiveness of national regulations and growth rates for a number of economic indicators.

- Jacobzone *et al.* (2010) finds that improvements in the quality of regulatory management systems yield significant economic benefits (in terms of increased GDP and labour productivity in the business sector).
- Bouis *et al.* (2011) finds that regulatory barriers to entrepreneurship, explicit barriers to trade and – especially – patent rights protection appear to be fairly robust determinants of long-run cross-country differences in technology. Some other policies and institutions such as trade liberalisation are found to speed up technology convergence.
- Kox and Nordas (2009) finds that regulatory heterogeneity has a relatively large impact on trade. If all 25 OECD countries in the sample harmonised or recognised each other's regulation, service trade through commercial presence could increase by between 13 and 30% depending on the country.
- Using measures of business regulations in 135 countries, Djanko *et al.* (2006) shows that an improvement from the worst quartile of business regulation to the best results in a 2.3% increase in an annual growth.
- Kaufman *et al.* (2005) focuses more broadly on governance and computes an index of approximately 200 countries over six biannual time periods (1996 through 2004). They point to a strong observed correlation between income and governance, and argue against efforts to apply a discount to governance performance in low income countries.
- Hall and Jones (1999) finds that across 127 countries the difference in capital accumulation, productivity and output per worker are driven by differences in institutional and government policies.

The link with market openness

Effective regulatory policy and market openness support each other, opening up pathways for innovation, enhanced consumer benefits, and entrepreneurship. Foreign as well as domestic businesses are encouraged by an effective regulatory environment. The significant overlap between the themes picked up in the OECD's Regulatory Quality and Market Openness reviews underlines this. It is, for a large part, a shared agenda. Regulatory reforms helped to liberalise markets by helping to address non-tariff barriers to trade.

Based on an extensive review of the literature, Nordas *et al.* (2006) assesses to what extent the observed economic growth and deepening market openness are related. The study finds that there is no conclusive evidence that trade-related changes are linked to the long-run rate of productivity growth. There is, however, robust evidence that open economies are richer and more productive than closed economies. Nordas *et al.* (2006) identifies four possible channels through which trade and foreign direct investment affect productivity levels and growth rates: *i)* better resource allocation, *ii)* deepening specialisation, *iii)* higher return to investment in capital and R&D and *iv)* technology spillovers.

A number of other studies, covering both OECD and non-OECD countries, underscore the benefits of market openness and facilitating trade and investment.

- Dee *et al*. (2011) shows how more open markets in goods and services can contribute to creating jobs and increase incomes, especially in the face of post crisis recovery. Reducing tariffs and non-tariff barriers can help in the short run where the economic crisis has led to significant involuntary unemployment by reducing costs of imported products for consumers and by providing new market opportunities for exporters. Taking a longer term view, the report finds that lasting gains can be found from reallocation of resources across sector and from productivity growth.

- Francois and Hoekman (2010) surveys the literature on services trade, focusing on contributions that investigate the determinants of international trade and investment in services, the potential gains from greater trade, and efforts to co-operate to achieve such liberalisations thru trade agreements.

- Dee *et al.* (2003), looks at the effects of trade-openness on total factor productivity growth and finds evidence that openness has had an impact on growth over the last two decades.

- Johnson (2006) argues that FDI should have a positive effect on economic growth as a result of technology spillovers and physical capital inflows and the empirical part of the paper finds indications that FDI inflows enhance economic growth in developing economies but not in developed economies.

- Alfaro (2003) shows that the benefits of FDI vary greatly across sectors by examining the effect of foreign direct investment on growth in the primary, manufacturing, and services sectors. Based on panel data covering 47 countries and 20 years, FDI in the primary sector tend to have a negative effect on growth, investment in manufacturing a positive one while the evidence from the service sector is ambiguous.

The link with competition policy

The competition policy analyses carried out by the OECD as part of its multidisciplinary reviews of regulatory reform highlight a close and positive relationship between the objective of promoting competition policy principles, and that of promoting high-quality regulation and regulatory reform. Competition policies are stronger and more coherent, and regulatory policies are strengthened in a key part of their agenda – promoting competition and market openness – where they have supported each other to promote reform. The specific impacts of competition policy are examined in a number of studies:

- Baker (2003) finds that the benefits of antitrust enforcement to consumers and social welfare, particularly in deterring the harms from anticompetitive conduct across the economy, seem likely to be far larger than what the government spends on antitrust enforcement and firms spend directly or indirectly on antitrust compliance.
- Aghion *et al.* (2001) and Gust and Marquez (2002) show that an increase in the intensity of competition can enhance productivity by improving the allocation of resources at a firm level.
- Nicoletti and Scarpetta (2003) reports that regulatory environments that favour competition have a positive impact on economy-wide productivity even when other potentially important factors, such as human capital and country- and industry-specific effects, are accounted for.

The link with higher employment rates

Product market competition can also play an important role in lowering structural unemployment rates, mainly because competitive pressures eliminate rents and make it possible to expand potential output. The gains in employment rates to be obtained from competition-friendly policies may be substantial. Conservative estimates suggest that many EU countries could raise trend employment rates by up to 2% simply by aligning their regulatory frameworks with the average among OECD countries. Even larger gains could be expected from further product market reforms that would bring EU countries closer to OECD best practice. Part of the explanation for differences in trend employment rates across the OECD can be found in the different pace and scope of product market reforms.

A number of studies have done initial empirical analysis and they generally show a positive effect of competition-friendly policies on employment at both sector and macro levels: Peoples (1998) and Bertrand and Kramarz (2002), use single-country sector-specific proxies for the stringency of regulation; Boeri *et al.* (2000) and Nicoletti *et al.* (2001) use cross-country OECD indicators of economy-wide regulation for 1998; Messina (2003) uses cross-country proxies of entry cost for 2000; and Griffith *et al.* (2004) uses cross-country indicators for 1995 and 2000.

The links with product market regulation

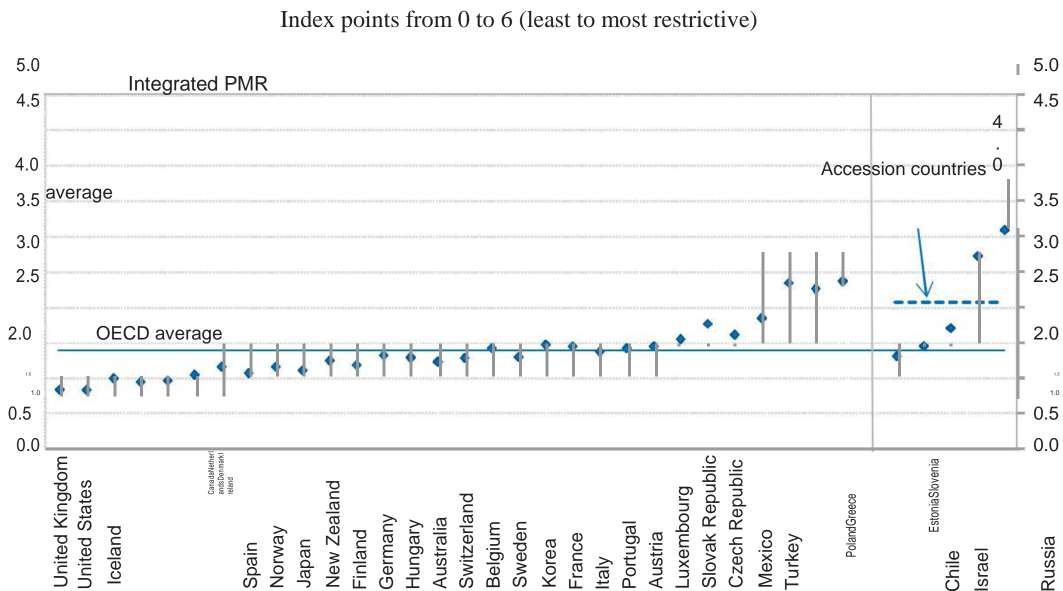
The OECD has developed a unique set of indicators on product market regulation in OECD countries. These indicators summarise a large set of formal policies and regulation and classify into three categories, *i)* state control, *ii)* barriers to entrepreneurship and *iii)* barriers to international trade and investment.

Based on these indicators Conway *et al.* (2006) describes trends in product market regulation in OECD countries between 1998 and 2003. Key findings include:

- State control and barriers to international trade and investment have fallen considerably over the period. Domestic barriers to entrepreneurship have also decreased, though only slightly.
- To a large extent, improvement in product market policies has been supported by regulatory convergence towards more liberalised countries. As a result, there is trend towards more homogeneity in product market policies across OECD countries.
- The approach to competition has also become more consistent across different aspects of regulation in some countries although relative restrictive countries tend to have a high degree of heterogeneity in product market policies. Domestic impediments to competition tend to be lower in countries that have low barriers to foreign trade and investment, suggesting a virtuous circle whereby market openness to foreign operators generates pressure for domestic policy reform.
- Notwithstanding progress in product market reform, a hard core of regulation still curb competitive pressures in many OECD countries, such as in barriers to entry in non-manufacturing industries. Moreover, significant differences persist between countries with relatively liberal and restrictive product market policies.

Figure 2.1. Product market regulation in accession and OECD countries, aggregate level, 2008[1,2]

Index points from 0 to 6 (least to most restrictive)



1. Based on the "integrated" PMR indicator [see OECD (2010f), Box 1 and Wölfl *et al.*, (2009), Figure 1]. Indicator values refer to one particular year and may no longer reflect the current regulatory stance in some (fast-reforming) countries.

2. 90% confidence intervals based on the "random weights" approach [see OECD (2010f), Box 2].

Source: OECD (2010f), "Product Market Regulation: Extending the Analysis Beyond OECD Countries", *Economics Department Working Papers*, No. 799, OECD, Paris; Wölfl *et al*., (2009), "Ten Years of Product Market Reform in OECD, Countries 1998-2008: Insights from a Revised PMR Indicator", *OECD Economics Department Working Papers*, No.695, OECD, Paris.

OECD (2009b) updates the Product Market Indicators for 2008 (see Figure 2.1) and the following main conclusions emerge from the analysis:

- Reforms appear to have slowed in the most recent period (2003-08) as compared with the earlier period (1998-2003). While countries tend to converge towards the policy stance of the most liberalised countries in both periods, this tendency is less pronounced in the more recent period.
- Over the whole period, easing of product market regulation appears to have been driven to a considerable extent by reforms in sector-specific regulation, notably as regards the gas, electricity and telecommunications markets.
- Despite ten years of liberalisation of regulation, considerable scope for further reform remains, especially as regards reducing controls of governments over businesses, in terms of public ownership and other forms of direct control over firm's decisions.
- Finally, though there has been much progress in reform in certain sectors, there is considerable scope for reform in others, such as professional services and retail trade.

Box 2.1. Relationship between product market policies and regulatory reform

Product market policies aimed at increasing competition have a strong direct relationship with high-quality regulation and regulatory reforms. Traditionally in many OECD countries, product market policies have been underpinned by rules and regulatory frameworks that have the effect of restraining market entry and competition. Regulatory reforms aimed at lowering barriers to market entry – reducing barriers to trade, developing more effective competition policies, easing entry conditions into domestic markets, and increasing the use of market based or incentive mechanisms in difficult sectors such as the network industries – have been central to recent developments in product market policy in many countries:

- *Reducing traditional barriers to trade.* With a few exceptions (such as agriculture) tariff barriers have fallen in the OECD area over recent years. Tariffs rates have declined substantially in most OECD countries. The same can broadly be said for restrictions on FDI, though the picture is more uneven.
- *Promoting domestic competition.* This has taken three main forms, better design and enforcement of general competition laws, liberalisation of entry into non-manufacturing industries, and administrative reforms. Competition laws have been reformed. Nearly all OECD countries have either established or substantially improved their competition laws over the past two decades. Though comprehensive recent data for non-manufacturing industries is not available, often extensive reforms have been carried out in the network sectors, especially in electricity and telecommunications.
- *Simplifying administrative procedures.* In the mid-1990s, procedures, costs and delays for complying with frequently opaque administrative requirements were especially burdensome in the large continental European countries and Japan. These barriers may have fallen in some countries, though this is not universal and in some cases complexity has increased.

Source: OECD (2005), *OECD Guiding Principles for Regulatory Quality and Performance*, OECD, Paris.

Regulatory reform and improving infrastructure

Starting in the 1980s, regulatory reform was actively used to restructure infrastructure sectors like power, water, telecoms and transport. There is ample evidence that where markets are contestable, the reform of infrastructure – through liberalisation, privatisation and the introduction of incentive regulation – produces positive effects in terms of price reductions, more innovation and consumer choice and higher quality services.

Box 2.2. Infrastructure investment and growth

Sutherland *et al.* (2009) examines the relationship between infrastructure and growth. It uses both the stock of infrastructure and the combined investment rate in infrastructure and non-infrastructural capital.[2] The findings reveal that investment in infrastructure can boost long-term economic output more than other kinds of physical investment. In particular, the gains have been larger for countries with comparatively poorly developed energy and telecommunications networks. For countries with mature networks, as is the case for many OECD members, the gains from additional investment have relatively small effects on economy-wide activity. In fact, there is some evidence of potential over-investment in infrastructure, due to either an inefficient use of the extra infrastructure or genuine over-provision.

- *Energy*. For a majority of countries, the findings suggest that investment in generation has been associated with higher output levels. In Australia, Ireland, Korea and New Zealand there is evidence of negative spillovers from additional investment, which could reflect past over-investment and suggest that reallocating investment to other sectors may have boosted output, or the inefficient use of existing infrastructure.

- *Roads*. Positive growth is found for New Zealand and the United Kingdom for total road length per capita. Inversely, investment in roads is estimated to have a negative effect in France, Greece, the Netherlands and Spain. The estimates for motorways are generally positive, possibly reflecting the more recent development of these networks and the fact that they provide services that are more specifically business-related.

- *Rail*. Positive significant effects are found for a number of countries (Australia, Austria, Greece, Korea, New Zealand, and the United Kingdom) suggesting that investment in the rail track was associated with higher output levels. Conversely, estimates suggest that additional investment in rail track would have negative spillovers on output in found for Belgium, Portugal and Spain. Again, this may indicate that there has been over-investment in the sector.

- *Telecommunications*. The picture for telecommunications is mixed. The estimates for fixed mainlines suggests that additional investment would have negative externalities in Australia, Iceland, New Zealand and the United Kingdom, and positive ones in Austria, Greece, Italy, Mexico, Norway and Spain. However, when an alternative measure of infrastructure is used (total subscriptions, including mobile telecommunications) many of these relationships are reversed, suggesting that considerable caution is required in interpreting these results, mainly due to the technological change the sector has experienced.

Source: Sutherland *et al.* (2009), "Infrastructure Investment - Links To Growth and the Role of Public Policies," *OECD Economics Department Working Papers*, No. 686, OECD Publishing, Paris, http://dx.doi.org/10.1787/225678178357.

Over the past two decades, a number of studies have examined the influence of infrastructure on output levels and growth. While the primary focus of this analysis has been on optimal levels of investment in infrastructure, this body of research also assesses appropriate regulatory frameworks for infrastructure. OECD (2009b) considers the linkages between the provision of network infrastructure and growth and then examining the interactions between policy settings and investment. A number of conclusions can be drawn from the analysis.

- The network industries are important parts of the economy, particularly with respect to investment, where they can account for between one-tenth and one-quarter of economy-wide investment.
- While the physical level of infrastructure provision has generally increased for all sectors other than rail, there is evidence that the rate of growth has not kept pace with output growth in some sectors and countries.

The impact of infrastructure on output is difficult to pin down and the direction of causality hard to determine empirically. However, there is some evidence, from annual and multi-year growth regressions, that investment has positive effects that go beyond the impact to be expected from a larger capital stock (see Box 2.2 above).

The benefits of reducing regulatory costs

Despite the numerous administrative simplification initiatives launched by OECD governments over the past decades, governments have not always had a detailed understanding of the extent of the burdens imposed on businesses and citizens.[3] Policy has often been made without a clear understanding both of the actual size of the burdens and of the progress that can be made in reducing these. To have a clearer idea of the extent of the burden many OECD countries have attempted to measure burdens, either through business surveys, or through quantitative evidence-based approaches. OECD countries' experiences suggest that quantitative approaches are increasingly supplementing or substituting business surveys as the primary source of information for assessing the burdens.

One of the initial methodologies to measure the administrative burdens on business is the Standard Cost Model (SCM) developed by the Netherlands. The SCM measures the administrative costs imposed on business by central government regulation.[4] The costs are primarily determined through business interviews. These interviews generate data and make it possible to specify in details the time companies spend complying with government regulation.[5] In order to measure regulatory burdens or to evaluate programmes for reducing regulatory burdens with the SCM, a number of countries have developed a "baseline measurement" of the administrative burdens of all existing legislation. This baseline measurement gives an overview of the regulation and a total figure of the administrative burden on businesses; it also shows where burdensome information obligations and related activities lie, and whether they have a national or international in origin.

Programmes to reduce administrative burdens have already generated important benefits across a range of countries:[6]

- Slovenia: a range of specific saving have been made including: EUR 10.66 million per year due to simplification of registration, change and suppression of companies; and the reduction of the average cost of single public contract awarding from EUR 59 to 5.4 million.
- Netherlands: Savings achieved by the end of 3rd Quarter 2009 due to 11% net reduction were EUR 2.3 billion. Substantive compliance costs' reduction was EUR 329 million, towards a total reduction of EUR 544 million in 2011.
- United Kingdom: Reductions of administrative costs were expected to deliver GBP 3.3 billion net savings annually by May 2010.
- Belgium: A clear downward trend is visible from EUR 8.57 billion (3.48% of GDP) in 2000 to EUR 5.92 billion (1.72% of GDP) in 2008.In 2008 alone, administrative burdens decreased by almost EUR 93 million.
- Australia: As part of the Reducing the Regulatory Burden Initiative, the Government of the Australian state of Victoria reduced regulatory burdens by AUD 401 million per annum.
- Sweden: A clear downward trend is visible and administrative costs to businesses fell from SEK 96.5 billion (EUR 10.5 billion) in 2006 to provisionally SEK 89.5 billion (EUR 9.75 billion) net in 2010, this presents a net reduction of approximately 7.3%.
- European Commission: Is on track to deliver on its goals to reduce red tape for businesses. Reduction measures already adopted could lead to savings of EUR 7.6 billion per year, rising to EUR 40 billion if the European Parliament and the Council back the measures pending approval or under preparation.

These programmes have, more generally, helped to address deep seated structural issues in public governance, including improvements in the clarity and accessibility of the legal environment; organisational streamlining through process re-engineering; harnessing the power of information and communication technologies (ICT) for more effective service delivery; and more transparent governance through improved access to information.

Despite the popularity of administrative burden reduction programmes among civil servants and politicians, the perception by those who should mainly benefit from such programmes, businesses and/or citizens, sometimes varies. Even in those countries, where administrative burden reduction programmes brought significant results, businesses did not express much enthusiasm about the results. In the Netherlands for example, the government met its goal to reduce administrative burdens on businesses by 25% in 2007. Despite this achievement, OECD (2010b) finds that business is frustrated at what it considers to be slow progress and the failure to tackle issues that really matter from its perspective.

Reasons for this negative perception by regulated subjects may be the following:

- The absolute and relative numbers representing the burden reduction may seem impressive when related to the whole society or the business sector in a given country.
- There may be a delay in the visibility of results of removing administrative burdens to the stakeholders.

Box 2.3. Perception surveys

Many factors influence perceptions and survey responses, some unrelated to the actual quality of regulation. Governments first need to understand the factors that shape perceptions before they take action. They need to identify why business and citizens express their dissatisfaction with the regulatory environment in most OECD countries, despite clear improvements on indicators such as the SCM:

- The choice of survey design and methodology heavily influence results. Respondents reply differently depending on the phrasing and ordering of questions, and the scale, type and number of response options.
- Stakeholders are sometimes not aware of reforms, or only see part of it. They may simply be more affected by the costs than the benefits of reform, or the benefits of some regulations are diffuse compared to the costs which are businesses experience directly.
- Reforms may have not addressed what really bothers citizens and business, i.e. irritation costs or have caused adaption costs for business which outweigh the immediate cost reductions.

A number of good practices help to make the most of perception surveys. These include sound survey design and both quantitative and qualitative research methods. The UK for instance designed their "Better Regulation, Better Benefits" survey in a two-stage approach. A qualitative phase provided important insights on question formation, perception drivers and individual experiences. The insights gained helped to adjust the design of the quantitative phase (e.g. rephrase questions to ensure respondents understand them correctly) and to better qualify the results.

Best practices include:

- Bringing in business and citizens into the rule making and reform process to: *i)* identify early what irritates business and citizens and to inform reform design and implementation accordingly; *ii)* help business to better anticipate regulatory changes; and *iii)* increase identification and compliance with regulations.
- Improving the service quality of the administration. Perception studies revealed that negative perceptions of regulations are in many cases not linked to the quality of regulations themselves, but to negative experiences with the administration in the attempt to comply with them.
- Adjusting the communication strategy to raise awareness of business and citizens of regulatory reform and its impact. Often awareness of costs is higher than awareness of the benefits of regulations.
- Using the results of perception surveys and studies as a basis for discussion with business and citizen representatives.

Source: OECD research and findings from the OECD June 2010 workshop "Measuring progress in regulatory reform – through the use of perception surveys in OECD countries". Further information: *www.oecd.org/regreform/perceptions*.

- Some countries or agencies may focus on easily removable red tape, for example regulations that are obsolete and/or not actually complied with, regulations that affect the biggest part of the regulated sector (which means that removal of the costs they impose multiplied by the number of affected subjects will be significantly higher).
- Governments do not take into account the perception of regulations by regulated subjects. Sometimes those regulations perceived by regulated subjects as most irritating may not be those that are the most burdensome concerning the result of a quantitative measurement.
- Communication with stakeholders may have been neglected in the past. The results of simplification projects, especially those with quantifiable outcomes may be attractive for the media but may be too abstract for individual citizens or entrepreneurs to understand in terms of their own benefits.

In order to address these concerns, some countries have tried to strengthen communication with stakeholders both in the process of administrative simplification itself but also when it comes to results of such efforts. Perception of regulatory burden by regulated subjects is taken into account often, and qualitative criteria for identification of potential "candidates" for reduction among regulations are being used as a complement to the quantitative ones.

Support for quality of life, social cohesion, and the rule of law

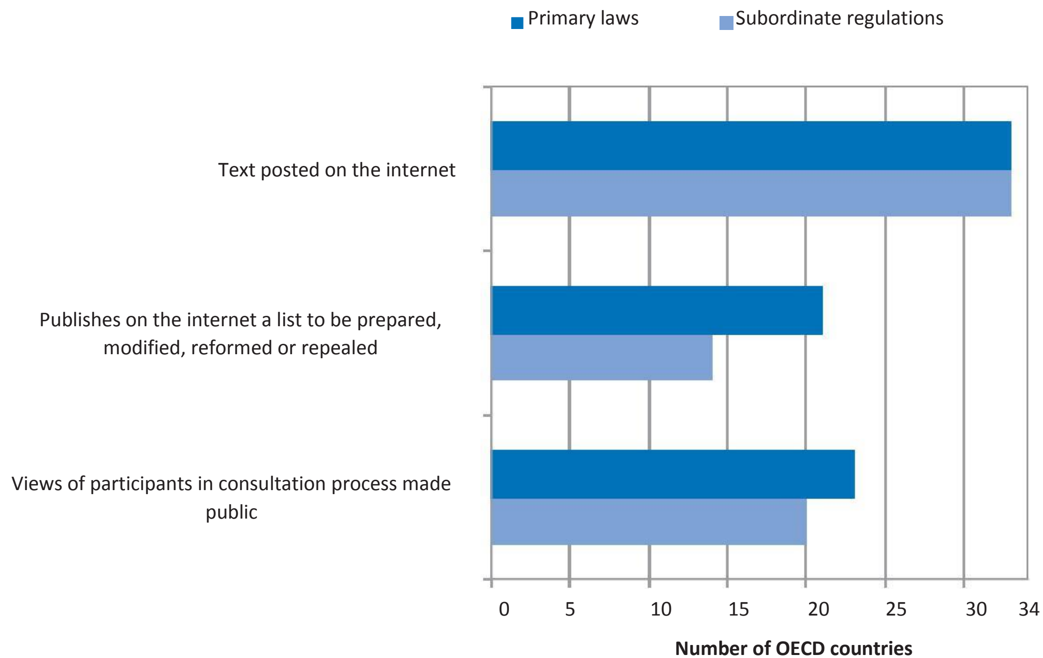
Regulatory policy has also started to support broader goals for society such as, quality of life, social cohesion and the rule of law. Although the emphasis on this aspect of regulatory policy varies across countries, and it can take different forms, it is fast becoming a strong feature of the regulatory policies of most countries.

Social cohesion and support for citizens

Transparency and the engagement of the public

Regulatory policy has supported a growing transparency in the application of regulatory powers, and a growing direct engagement of the public (the regulated) through its emphasis on the importance of public consultation and communication. It has encouraged more open societies in which user views are heard, by multiplying the approaches to public consultation and communication, and by harnessing ICT and e-government in support of this objective. In parts of Europe this has generated a lively diversity of mechanisms for capturing views, the growing use of internet based direct communication often coexisting with the continued use of structured advisory bodies and commissions. Transparency and openness facilitate the enforcement of regulations, improving compliance and limiting the need for coercive enforcement.

Figure 2.2. Public availability of regulatory information

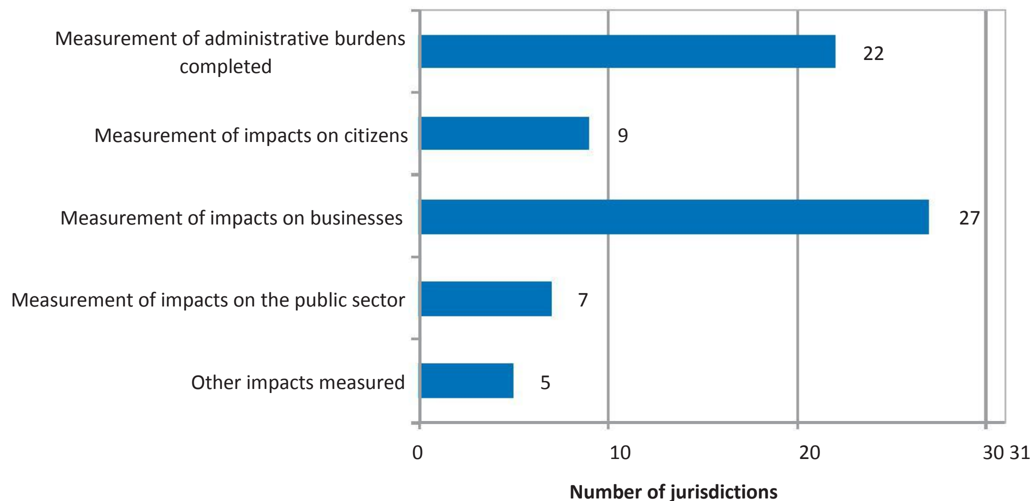


Source: OECD Regulatory Management Systems' Indicators Survey 2008-09, *www.oecd.org/regreform/indicators*.

Reducing red tape for citizens

The direct needs of citizens are a prominent driver of regulatory policy in many European countries and some others. Several countries, for example, have developed programmes explicitly designed to reduce administrative burdens on citizens, recognising that ordinary people spend considerable time on paperwork, and that this eats into their quality of life. Effective regulation in support of social cohesion through efforts to improve public services is also prominent in some countries. This is reflected, for example, in the use by some countries of policies to reduce red tape within the public service, so that public workers (teachers, police, doctors and nurses) at the front line of public service delivery can spend more time attending to the direct needs of their clients.

Figure 2.3. Groups targeted by administrative burden reduction programmes



Note: Data presented for the 30 OECD member countries and the European Union.

Source: *Indicators of Regulatory Management Systems, 2009 Report*, OECD, Paris, available at *www.oecd.org/regreform/indicators.*

Support for the rule of law

The rule of law (Box 2.4) can be defined, in the simplest terms, as a principle for the organisation of society. It has become, over time, one of the fundamental building blocks for efficient public governance in most countries. An effective application of the rule of law implies attention to a range of issues including some which are directly connected to regulatory policy such as legal transparency, clarity and accessibility, and a well functioning appeal system for administrative decisions. There is a need for rules to be enforced, and applied fairly, without which the rule of law is undermined and corruption may flourish. The rule of law thus depends, for many of its aspects, on an effective regulatory policy. The development of regulatory policy has in fact been closely associated in many countries with issues that link to the rule of law. An especially powerful reason for some countries to strengthen their regulatory policy is to minimise corruption.

Germany provides a particularly clear modern example of giving effect to the rule of law in practice through the concept of the *Rechtsstaat* – which can be loosely translated as the “legal state”. A fundamental principle underlying the *Rechtsstaat* is that the exercise of state power should be constrained by the law. The German Constitution is deeply respected, as are the formal process rules which derive from it. German regulatory policy has grown up around structural and procedural traditions which emphasise the importance of legal clarity.

Regulations also provide a transparent framework for making the transition to open, accountable government. The next step is to develop regulations that make sense and meet a high degree of compliance with minimal coercive enforcement. For all countries, sustaining the legitimacy of government actions (the “social contract”) post-crisis, when trust in government has been badly shaken, is important.

Box 2.4. The rule of law: Definitions and implications

The principle of the rule of law is embedded in the Charter of the United Nations. This defines the rule of law as, "A principle of governance in which all persons, institutions and entities, public and private, including the state itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and standards. It requires, as well, measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, avoidance of arbitrariness and procedural and legal transparency".

Historically, the concept of the rule of law can be traced back to the Greeks. The rule of law and respect for the law is illustrated, for example, through the trial and submission of Socrates. Homer in the Odyssey depicts the island upon which the Cyclops live- each isolated in their caves- as one where there is no need for laws, the better to illustrate that social life requires co-operation under order, and order requires laws. The Romans further developed the notion of a society under the rule of law.

The modern emphasis on the rule of law came after a long period, in Europe and beyond, of civil and international war in the sixteenth and seventeenth centuries, as part of the pacification process whereby states, gaining a monopoly on violent coercion, surrendered part of their freedom to use violence against their own citizens or their neighbours. The rule of law thus includes the fundamental concept that the state itself is, or should be, subject to the law, which it is not free to change. In other words it is a check on the arbitrary use of power.

In the European philosophical tradition, the rule of law took concrete shape from the notion of a social contract between rulers and the ruled, under which the latter give up some of their freedoms to the former, in order to gain social order through the rule of law. Thomas Hobbes (Leviathan, 1651), John Locke (Second Treatise of Government, 1689), and Jean-Jacques Rousseau (*Du contrat social*, 1762) were key figures in the development of the social contract. The American John Rawls (Theory of Justice, 1971) provides a modern update on aspects of the social contract which link it to distributive justice and fair choices, an issue that resonates post crisis today in the search for an approach to regulation in support of fairer societies.

Modern democratic states function on the principle of an implicit contract between the electorate and the government, which is periodically renewed through elections, and which legitimises the use of state power.

For many countries, the Constitution stands as the first line of defence against the arbitrary exercise of state power, supported by the checks and balances of an independent parliament and judiciary to constrain the power of the executive branch of government. Montesquieu (*De l'Esprit des Lois,* 1748) highlighted the need for a balance of political power between the executive, the legislature, and the judiciary. This also resonates today. The origin of most countries' regulatory policy is in the executive, but has started to spill over into both other branches. Countries are grappling with the question of accountability as regulatory power has become more diffuse. The risk of regulatory capture, or indeed, corruption, also puts the spotlight on checks and balances, and where to find these.

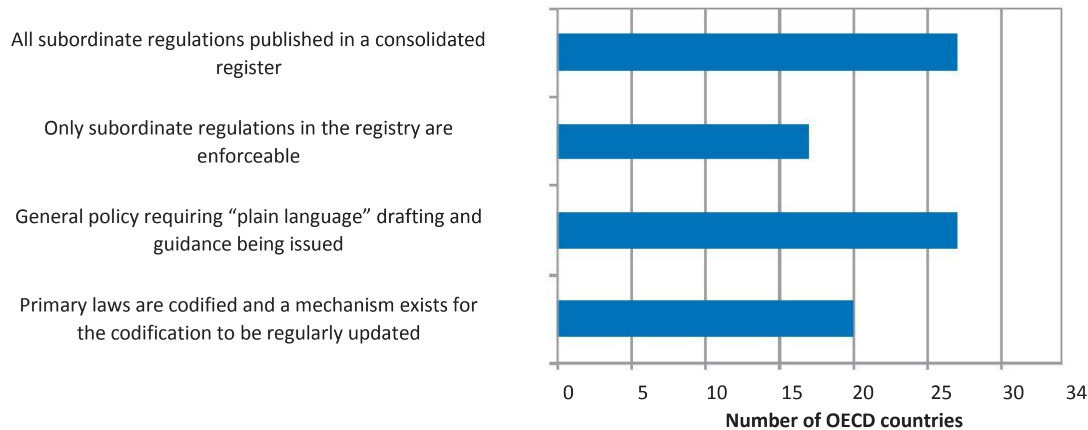
Legal simplification and accessibility

Most European countries include legal quality and legal simplification as one of the main objectives of their regulatory policy. Regulatory inflation, which is a cause for concern in many countries, has serious potential consequences for the rule of law. A proliferation of regulations obscures legal clarity and accessibility of the law, and affects legal certainty. The law is no longer transparent, and businesses and citizens cannot easily

grasp what the law says about what they need to do. Access to regulation includes communication of information, law making capacities based on evidence and clear law drafting. Regulatory uncertainty undermines trust in government, and at a practical level, it reduces the prospects of compliance and sets the scene for corrupt behaviour.

An important issue for developing countries is the legal complexity inherited from different political regimes and colonial powers. As a result, regulations today may be based on a mix of very different legal principles.[7] This legacy from the past generates an additional burden, and highlights the importance of legal simplification, which helps cobat regulatory discretion and corruption.

Figure 2.4. Ease of access to regulations



Source: OECD Regulatory Management Systems' Indicators Survey 2008-09, *www.oecd.org/regreform/indicators*.

Regulatory policy also supports (and depends on) an effective and impartial judicial and appeals system. Rule makers must apply and enforce regulations systematically and fairly, and regulated citizens and businesses need access to administrative and judicial review procedures for raising issues related to the rules that bind them, as well as timely decisions on their appeals. This supports the fight against corruption. Reducing delays and boosting certainty in the appeals process has been widely recognised as contributing to the quality of the regulatory framework.[8]

Conclusion

It has become increasingly clear that the social and economic outcomes of effective regulation reinforce each other. Economic growth depends on a stable setting, formalised and enforced through an effective regulatory framework. Conversely, a sound (and growing) economy is fundamental to quality of life and the rule of law. Poverty and social conditions which degrade the dignity of people undermine respect for the law and encourage illegal activity outside the formal economy. In many developing and previously planned economies, the transition to a market economy has encouraged a parallel transition toward the rule of law because of its importance to investors (especially for infrastructure investment) and economic development. In particular, property rights (the rights relating to the permissible use of resources, goods and services) are upheld by the rule of law. The establishment of a regulatory policy can help to promote the reform of rigid command and control regulations that inhibit the development of key sectors.

Notes

1. For instance, see Laffont and Tirole (1993 and 2000), Levy and Spiller (1994), and Newbery (1999).

2. This is done in order to capture the impact of infrastructure capital on GDP over and above its affect by increasing the capital stock. This helps focus attention on the possible positive externalities that provision of infrastructure can have on output.

3. The analysis of the impact of regulation on the economy has a long history and shows that regulations can have unintended economic effects. See, for instance, Olsen (1965, 1982) Baumol (1990), North (1990) and Weingast (1995). These effects go beyond those pointed out by standard public interest models, which presume that existing regulations are designed to address market imperfections and enhance efficiency.

4. Detailed information about SCM mythology can be found in "*The Standard Cost Model; a framework for defining and quantifying administrative burdens for businesses*", *www.administratievelasten.nl*.

5. The SCM breaks down regulation into individual components that can be measured: information obligations, data requirements and administrative activities. The SCM then estimates the costs of these components based on three cost parameters: 1) price, which consists of a tariff, wage costs plus overhead for administrative activities done internally or hourly costs for external services; 2) time, which includes the amount of time required to complete the administrative activity; and 3) quantity: which comprises of the size of the population of businesses affected and the frequency that the activity must be carried out each year. The combination of these elements gives the basic SCM formula: Cost per administrative activity = Price x Time x Quantity.

6. See OECD (2010b) and governments' responses to the questionnaire distributed as part of the OECD Cutting Red Tape II project.

7. For example, regulations in the Palestinian Authority are based on a blend of the principles of Islamic Shari'a, the legislation inherited from the Ottoman Empire, British Mandate Law, Jordanian legislation applied to the West Bank and Egyptian legislation applied to the Gaza strip.

8. It is part of the 2005 APEC-OECD Integrated Checklist on Regulatory Reform. The last of the eleven criteria of the Checklist addresses the appeals issue very directly: "Does the legal framework have in place or strive to establish credible mechanisms to ensure the fundamental due process rights of persons subject to the law, in particular concerning the appeal system?" It is also covered in the World Bank's "Doing Business" indicators.

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