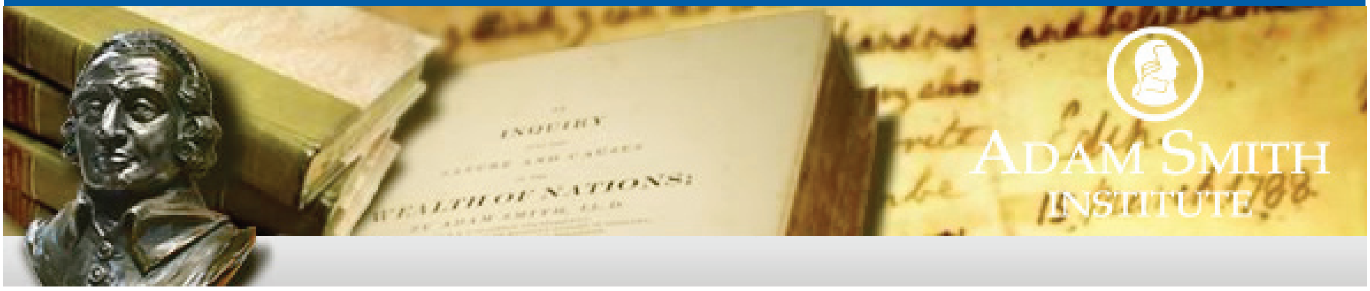

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BRIEFING

Stemming the growth of UK regulatory agencies

By Keith Boyfield & Tim Ambler

The Blair government brought an explosion in the growth of economic regulators. The Financial Services Authority's budget (FSA), for example, increased by a third between 2000/1 and 2003/4, while its payroll numbers surged by 13 percent. More recently, the FSA's annual budget has climbed from £158.4 million in the financial year ending 31 March 2005 to £196.5 million in the financial year ending 31 March 2006. Meanwhile, the FSA's average number of employees has risen from 2,356 in 2005 to 2,610 in 2006 (source: FSA Annual Report 2005/6). In his chairman's statement introducing the last annual report Sir Callum McCarthy notes, "there have, I am glad to say, been no major changes to the FSA's responsibilities". Yet clearly, as the payroll statistics demonstrate, the FSA is having to recruit additional staff to meet its current wide range of regulatory responsibilities.

The government has taken the view that regulation should deliver social and environmental objectives, in addition to the purely economic role marked out by the previous government, where regulation was primarily focused on creating competitive markets, the litmus test employed for regulatory withdrawal. This wider role was detailed in the Utilities Act 2000. However, as the energy economist Prof Dieter Helm, a Fellow of New College, Oxford, has commented, the Utilities Act was one of the 'worst examples of poor drafting in recent times'.[1] He observes that the Utilities Act revealed a woeful ignorance about how utilities operate in the real world.

Significantly, Ministers have provided the utilities with hardly any guidance on how to fund their social and environmental objectives. For instance, how far should prices rise in order to address the needs of those who cannot afford fuel? And how high should prices go in order to deal with specific environmental problems? Any

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attempt to establish priorities and outline how trade-offs should be made between these objectives has been distinctly lacking.

Indeed, the government's new consumerist agenda has proved hard to define in legal language. We would argue that it open to doubt whether any government should devolve governmental responsibilities to unelected quangos in this way.

The consumerist agenda also led to the creation of consumer councils, such as EnergyWatch, in order to second guess and exert pressure on economic regulators. This initiative partly reflected the government's distrust of market mechanisms. PostWatch, WaterVoice, and the London Transport Users Committee, were all aimed at 'protecting' consumer interests. In some cases, as with Postwatch, their staffing and costs even exceeded those of the regulator they were duplicating.

The consumers in whose name these bodies were created have little interest or knowledge of them. The NAO examined Energywatch and Postwatch and concluded they 'could be more proactive in seeking to reduce costs'. This is putting things politely![2] More damningly, it is clear from the NAO report that they do not understand their consumers' needs, nor what the DTI expects them to achieve. In short: they do not know what they are supposed to be doing, how to do it, or what it should cost. The onus should be on statutory consumer bodies like this to justify their continued existence. If they are unable to show where they add value, they should be wound up.

Since our report for the Adam Smith Institute in 2004[3], this message seems to have been received. We note that at least some of these bodies are quietly being merged - en route, we trust, to being wound up.

A great deal of regulation aimed at protecting consumers could be left to the courts, as Irwin Stelzer,[4] the economist and Sunday Times columnist, suggests. In the courts, he says 'there are no ups and downs due to changes in political fashion. It's a money driven system and I've always had great faith in the profit motive. The lawyers who do it are entrepreneurs – they take risks.'[5]

In the UK, utility customers' interests could be handled by the small claims courts, which if needs be could draw on more robust legislation protecting consumer rights. On larger cases, expert witnesses can throw light on a problem. And abuse of market power can be exposed to the glare of the media. On balance, we believe consumer redress should be left to the courts, and, where necessary, legislation protecting consumer rights should be strengthened.

Multiplicity

Some businesses have to deal with a multiplicity of regulators. This is illustrated by the back of a BT telephone bill[6] which refers potential complainants first to itself, then to OFCOM, but alternatively the Office of Telecommunications Ombudsman (OTELO – approved by OFCOM) or the Independent Committee for the Supervision of Standards of Telephone Information Services (ICSTIS – industry funded), or the British Approvals Board for Telecommunications (BABT). The consumer may consider this more confusion than protection. There are some encouraging signs that the government is making some moves to address this problem of multiple regulators, best seen in its recent decision to scrap the Strategic Rail Authority.

Accountability

To whom are regulators accountable? A previous House of Lords select committee inquiry into regulators[7] concluded – paradoxically – they were regulated by everyone and no one. The original aim was to ensure that they were independent of government, but recent demands to make them more accountable has meant that they are now far more answerable to ministers. Sir Ian Byatt, who as the first water regulator remained adamantly independent, suggests: '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.'[8] 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.

Market forces or regulation?

For a range of risks including fire, health, safety and environmental protection, we suggest that the use of insurance to meet certain minimum standards would provide better and more effective protection than regulation and public service inspectors. 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 could be extended to other business sectors, such as manufacturing, hotels and restaurants, which are currently controlled by regulation. One advantage would be that the goal of adequate protection for employees and the public could be achieved through ordinary market mechanisms. 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. Businesses that operated in a dangerous and unsafe fashion would not be able to arrange cover and would be forced out of the market. Second, the adjustment is automatic: if the nature of business changes, the insurers' premiums change too, without some 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 common business complaint that regulation revolves too much around officials' rulebooks and too little around common sense. As the Nobel Prize winner, 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.'[9]

This is an important point: all markets need some degree of regulation in order to work as markets. What we are advocating is that we should follow the example set by the FSA and adopt a light touch, principles-based approach to regulation for the economy as a whole. This would involve a consolidation of the existing separate regulators with the ultimate objective of establishing a single, competition authority responsible to Parliament.

One of our earlier studies[10] (published by the London Business School) argued that the UK's separate regulatory agencies should be merged into a single Fair Trade Authority, which we estimated would cost approximately 20 percent less than the existing regulatory agencies.

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Within a five-year electoral cycle, many would regard this radical option as far too difficult. However, incremental progress could be made towards this longer-term goal. Our recommended strategy would involve the trimming of annual budgets and manpower levels at individual economic regulatory agencies with progress monitored through annual reports to Parliament (not the Secretary of State as at present). These reports should include cost-benefit analyses overseen by the independent assessor, which we have proposed in a series of previous studies. These assessments should be limited to a single, measurable goal, since multiple objectives make proper assessment difficult if not impossible.[11] The reports should highlight the success or failure that agencies have experienced in streamlining, clarifying and reducing the regulations applied to their sectors.

Does regulation work?

Finally, it is worth asking whether regulation achieves its objectives? Alas, the evidence as to whether regulation actually identifies and catches rogue business figures is not so encouraging. The Enron and WorldCom accounting scandals in the US, and the corporate governance shocks at Shell and Equitable Life in the UK, occurred despite a huge volume of regulatory controls on accounting standards, financial reporting, and corporate governance.

As Elaine Sternberg has observed, ‘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.’[12] One reason 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 being ‘captured’.

Recommendations

- The costs of new non-economic regulation should be funded by national or local government.
- Regulatory agencies should be formally answerable to Parliament. This could be achieved through making them report to departmental select committees of the House of Commons or to a joint permanent committee of the two Houses. Whichever route is followed, the select committee should be in a position to recommend to the House of Commons that a regulatory agency’s remit should be clarified or reduced, and that its annual budget should be similarly modified where the goal-by-goal benefit no longer outweighed the relevant costs. Where a regulatory body has been shown to fall down in its responsibilities the select committee should be able to recommend a strategy to meet these shortfalls. In extremis, the committee should be able to close down an agency.
- A long-term programme should be agreed leading towards the ultimate merger of all regulatory agencies into a single Fair Trade Authority that intervenes only to ensure free, competitive markets.
- All offices for consumer interests for regulated industries should be abolished. Instead, regulated companies would be required to share research and other data on service provision, needs and satisfaction with the regulator, who would be encouraged to verify the accuracy of the data.
- Market mechanisms, e.g. insurance, should be more widely used in place of regulation to improve standards, e.g. health and safety in the workplace and in residential properties.

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- Alternatives should be found for punishing non-compliance other than imposing substantial fines and penalties on publicly owned organisations and companies. One way or another, these are simply passed on to the taxpayer and those at fault suffer no penalty.

Notes

[1] Energy, the State, and the Market: British Energy Policy since 1979, by Dieter Helm, Oxford University Press, page 292.

[2] Energywatch and Postwatch, NAO Report HC 1076, 15 October 2004.

[3] Keith Boyfield and Tim Ambler, Road Map to Reform: Deregulation, Adam Smith Institute, 18 February 2005

[4] Dr Irwin Stelzer was the founder of National Economic Research Associates and a past Director for the Energy and Environment Policy Center at Harvard University. He is currently Director of Regulatory Studies at the Hudson Institute, based in Washington DC.

[5] Interview with Keith Boyfield.

[6] Customer EA 3093 9177 Q064 &L, 14 July 2004

[7] Professor The Lord Norton of Louth's (Chairman of the House of Lords Constitution Committee on Regulators) term, CRI Occasional Lecture, 8 September 2004

[8] Email to authors, 6 September 2004.

[9] Capitalism & Freedom, Milton Friedman, University of Chicago Press, 1962, page 15.

[10] Do the UK Regulatory Agencies Provide Taxpayer Value? by Keith Boyfield and Tim Ambler, Centre for Marketing Working Paper No 04-902.1, London Business School, March 2004.

[11] See, for example, the academic literature on the defects of a 'multiple scorecard' approach, notably 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', Michael C. Jensen, Tuck Business School Working Paper No. 01-09; Harvard NOM Research Paper No. 01-01; Harvard Business School Working Paper No. 00-058; Journal of Applied Corporate Finance, Vol. 14, No 3, Fall 2001. Earlier versions appeared in the European Financial Management Review, Vol. No. 7, 2001, pp. 297-317, and in Breaking the Code of Change, M. Beer and Nithan Norhia, eds, Harvard Business School Press, 2000.

[12] Corporate Governance: Accountability in the Marketplace by Elaine Sternberg, Institute of Economic Affairs, Second Edition Hobart Paper 147, 2004.

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