

Quality Regulation why and how?

Regulation: where is it? What is it?

Is this a real issue?

A hundred days out from the election a number of issues are buzzing: housing, immigration, water, climate change, electricity bills, and the perennials, economic growth, incomes and taxes and law and order. Based on previous contests, some of these will become the raw material of the political debates while others will fade to the background.

So why are we writing this piece about the quality of our regulatory system? The simple answer is that most of the things mentioned above depend to a greater or lesser extent on the working of one or more aspects of the regulation system. So, despite the lack of visibility, its effect is widespread and it is going to feature one way or another in the campaigns.

We are focused on economic aspects of regulation and on the high-level design factors that ensure that our regulatory mechanisms are fit for purpose, and

remain fit for purpose. Limited space means we will not deal with operational quality and the need for skilled people to deliver the services effectively.

How do we think about regulation?

Regulation is difficult to define, but Black (2002) has identified three ways in which state authority is exercised to change behaviour. Regulation is:

- the promulgation of rules by government accompanied by mechanisms for monitoring and

enforcement, usually assumed to be performed through a specialist public agency;

- any form of direct state intervention in the economy, whatever form that intervention might take; or
- all mechanisms of social control or influence affecting all aspects of behaviour from whatever source, whether those mechanisms are intentional or not.¹

Regulation takes many forms. It can be legislation, standards, advice, education or exhortation, legal rules, codes of practice (formal and informal), or a combination of these. Regulation includes domestic laws and international treaty commitments; it comes from international bodies, central, regional and local government, and self-regulation.

Regulation design is usually about choosing a balance between the various aspects of the issue, positive and negative. Clearly, some members of society get enjoyment out of alcohol, gambling and illegal substances such as marijuana. However, there are downsides. The sweet spot is not fixed. By 'the sweet spot' we mean getting the right balance, which – in this instance – reflects societal views (e.g. as proxied by current regulation), current scientific knowledge (e.g. around addiction), overseas trends (e.g. partial

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legalisation of marijuana in US states) and the ability to implement (are the regulations workable?).

What's at stake?

So regulation abounds. But the role of the modern state is complex and covers subtle goals. Its aims in economic management go beyond just growth, particularly as we become more wealthy. Income distribution, safety at work and at play, the state of the environment, our views of what is right – all are vital features in the design of the regulatory system in 2017.

Regulation affects our efficiency, in terms of both cost impositions and how easy it is to innovate. For example, it is much easier now to set up a company in New Zealand than ever before; however, businesses are monitored much more closely. It is highly unlikely that root stock from the Hayward kiwifruit variety, which became the basis of the kiwifruit industry, would be allowed into New Zealand under current regulations. This creates fundamental challenges and opportunities for our international competitive advantage.

Like other aspects of our institutions, this system is surrounded by, and acting in, a constantly changing environment. To stay up with the play the system's components need to be designed to flex and adjust.

The New Zealand Productivity Commission has put some numbers around the effort the state makes: 'New Zealand has a large and complex regulatory sector, made up of 200 or so regulatory regimes. More than 10,000 people work in regulatory roles' (Productivity Commission, 2014, p.1). Further, the regulatory reform project (2011–14)² and the Productivity Commission identified that the quality of regulation is important. The regulatory system underpins economic and state activity, seeks to protect the rights of people and their property, delivers goods and services in an efficient and equitable fashion, and encourages innovation.

The real impact (as intimated above) is the constraining of the range of economic activities possible. While tighter guidelines can produce new, more useful (to society) innovations – for example, greater incentives for greener technologies

create greater demand for more efficient electricity storage batteries – poor regulation can rule out useful innovations.

Where are we?

Efficiency given societal norms

The purpose of New Zealand economic regulation is to 'promote and protect a market based economy that increases economic growth and maximises the wealth and prosperity of society' (Scott, 2011). Like Australian and United States law, our focus is on economic efficiency. Economic efficiency needs to be considered in the light of the institutional

controls. The results were mixed. While efficiencies were achieved and some regulatory approaches have been successful (Searancke et al., 2014), privatisation and regulation of telecommunications did not have the desired impact.

The light-handed approach was not just a New Zealand problem. The failure to regulate financial institutions has been cited as one of the main contributors to the 2007-08 global financial crisis. Locally this approach was superseded by a ministerial enquiry and the creation of a more heavy-handed regime in part 4 of

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settings that determine the social, cultural, environmental and economic behaviour of New Zealanders. Regulations frame the political discourse; decision-makers focus on the specific policy trade-offs, and the institutions form the mechanism by which the state carries out its functions.

Better regulation benefits all, while mis-specified, poorly designed or badly implemented regulations have significant costs. Therefore, given the dynamic environment, the stock of regulation should always be under scrutiny. This is especially pressing since we have no cookbook solution to achieving 'better regulation', and even after it is enacted we have a monitoring problem.

Good regulation uses sound principles, but is fit to the situation. It is thus always under review, as situations are fluid. So the best regulation systems include the ability to adopt a plan B as part of the design. As an example, in the 1980s the creation of state-owned enterprises out of government monopolies (electricity, telecommunications and railways) gave rise to economic regulation. The initial approach to network industries (Mladenovic, 2011), was a 'light-handed' regulatory stance with the threat of

the Commerce Act. This brought us more into line with other OECD countries. Internationally, the light-handed approach did not deliver a convincing framework for further integration with our near neighbour Australia and other Pacific Rim trading partners.

The current settings are a series of regulatory interventions that focus on specific problems (electricity, housing, immigration, etc.). There are inconsistencies: how we value saving a life, for example, depends on what services you access – search and rescue, health, road accident. There are good practical reasons for this, which often have more than a little to do with international practice (in health and safety, the Robens model in the 1970s, for example), and deal with the presenting issue but lack a well-developed, consistent intellectual framework. They are also subject to political boundaries rather than logical ones. What determines the inclusion of industries in a closely monitored regulatory regime, and how do airports stay out? Why is the limit of lightly regulating consumer trusts set at a fixed number of consumers? Why did it take another – they occur at about 30-year intervals – mine tragedy to bring about

reform of the health and safety policy approach?

Another vital design consideration is the clear economic and social advantage of a relatively stable set of institutions (North, 1991). This points towards 'durable policy settings' (NZIER, 2016). The simple case is to design interventions that are able to stand considerable change in the environment without being forced back to the drawing board.

Improving regulatory durability in a dynamic environment

How can designers maximise chances of durability in a dynamic system? By durability we mean a focus on policy and

'cut them off at the pass' model will not prevent citizens from having access to internet-borne materials. A different approach is called for. Typically it entails thinking harder about the mischief: just what is it about pornography that is socially objectionable, and how should it be controlled? Previously the physical manifestation was the problem, so its control was the aim.

Discussions about uniqueness in relation to regulation typically stress the value of being able to choose our own way of doing things. In a closely related point, discussions often become strongly emotive about 'sovereignty'. The key issues are understanding the elements of

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how designers meld the politics, efficiency and effectiveness and implementation objectives in a dynamic setting. Recognising this, the Treasury has created a demand by insisting on, from other government agencies, a whole-of-system, life cycle view of regulation that includes monitoring and care of systems (Treasury, 2017a).

The regulatory reform project identified cross-cutting themes where improvement in design and system features can have a significant impact. The following themes have an impact on regulatory quality and durability.

New Zealand-centric features

Features of New Zealand society are unique. They affect the way we want to live as well as creating the conditions under which we live. One example is the 'iron laws' of geography, which mean we are isolated. They also mean we are dwelling on land surrounded by water. The island border becomes a natural regulatory device. Thus, Customs and other border agencies have long had a special regulatory function. But as technology changes, so does the fit of the intervention: the simple

uniqueness, their value and how they might be reflected in specific regulation design (if at all).

Certainty and discretion

Certainty and discretion affect the quality and durability of regulation. This entails balancing New Zealanders' values, policy objectives, implementation mechanisms and outcomes. The variety of areas covered by regulation and a changing external environment suggest that durability is maximised by building in an 'allowance' for the extreme cases: a principled discretionary approach would address 'one-offs' that stretch regulatory rule design.

Monitoring, review and evaluation

New Zealand aligns with other OECD nations in having a management system for regulatory responsibilities. It focuses on the flow of new regulation rather than reviewing, evaluating and monitoring existing regulations, although there is a stewardship responsibility. This reflects a long-standing focus on passing and implementing regulation without explicit consideration of its longer-term impact.

Regulation is often driven by a messy political imperative to do something. Regulation is undertaken with fuzzy objectives and problem statements that address symptoms, not root causes. The mechanisms in place to evaluate, monitor and review tend to be weak and lack resources.³ In the experience of the New Zealand Institute of Economic Research, in its quality reviews of policy papers, monitoring and review components are often seen as add-ons, not integral to the policy paper design. This leads to more resources being put into devising new regulation and a lack of detailed learning from past regulatory efforts, characterised by the Geoffrey Palmer quip that 'New Zealand is the fastest lawmaker in the west'.

Regulation requires special measures because it has features that set it apart from other forms of intervention. Active evaluation of the stock of regulation is needed to prevent failure and remediation in the climate of blame.

Experimentation

Typically, the likely detailed impact of a regulation is unknown prior to implementation. Experimentation can provide valuable information about the workings of options. The idea is small-scale adoption of a new regulatory regime to assess effects. If successful, the regime can be rolled out with failures having provided evidence to be learnt from. This tests new ways, checking for unexpected consequences.

The New Zealand attitude to pilot studies is not always encouraging. They can be seen as giving a group or region preferential treatment. The political environment also sees risk in pilots, given the emphasis on success and certainty.⁴

Have we got the right tools?

Change is certain. Adapting the stock of regulation to reflect changing market conditions, technology and societal attitudes is a challenge. Using the right tools and techniques to demonstrate what changes need to be made is a crucial part of reaching desired regulatory aims and objectives. The Treasury, for example, is 'encouraging' departments to use a cost-benefit analysis tool (CBAX) as part of

their Budget bids to monetise impacts and do return on investment analysis.⁵

An instance: discretion and delegation

Best-practice regulation design includes allowing for the variety of likely cases to come under state authority. It is usually extremely difficult to draft a rule that fits all possible states of nature that will emerge. The normal way of dealing with this is to provide for the delegation of discretion to a 'regulator'. But inevitably the exercise of discretion means potential for error. Under regulation, courts act to check judgements.

What happens when courts fail to ensure that the regulator acts in a reasonable way? In the 2007 Unison judgement, the court was loath to interfere with a specialist regulator's finding unless it was blatantly at fault.⁶ This has created a high bar for correcting important but not gross errors.

Where does this take us?

Many of the issues that are going to be debated this election year involve difficult regulatory policy. The New Zealand system is setting high standards. But we are still concerned about the capacity of the wider public sector to produce durable regulation in difficult cases.

Remaining with the status quo

The status quo is sometimes prudent. We know its strengths and weakness, and New Zealand's strong public management can often improve the quality of the regulation delivered without serious policy revision, particularly in social policy. Moreover, ongoing improvements are afoot. We are becoming smarter (with tighter emphasis on data and analytics), and the spotlight is firmly on the problem definition.

Better monitoring and review systems would also contribute to a learning system

that provided more confidence in the stock of current legislation and possibly resulted in fewer major changes in regulatory regimes in the long run.

A more decentralised approach to quality

Would devolving more regulatory power to the regions improve things? The short answer is no. Duplication of resources occurs (for example, IT systems), and the sophistication of some regulatory problems demands scarce skills simply not available in all regions. But regional government may have a role: specific local knowledge or tailored implementation needs (as in water governance) suggest a

This is vital for a small country where changes in regulatory approaches (such as breaking the telecommunications monopoly) have seen more retail competition, cheaper and varied services, and increased investment in the industry.

New Zealand cannot afford to stop pushing for better regulation, wherever we rank internationally. All countries compete on the quality of their institutions. So, if a high standard of regulation is part of our competitive advantage, then further improvements are needed.

In sum: it's about strengthening durability through marginal gains. Three

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mix of central and regional approaches. But the choice of mechanism may require attention: for example, compared to Australia we appear to have too many district health boards (NZIER, 2017).

Building incremental capability

Building incrementally on the status quo by paying more attention to the problem statements and audit and review process, and being more systematic about the steps towards developing new regulation, may assist in improving the quality and reduce the amount of regulation.

This is not a result that catches the imagination, particularly politically. However, just as improving diet and doing more exercise might increase your life span, incremental system advances are likely to improve the stock of regulation.

factors are important: clearer fundamentals are required, with a focus on the problem definition; more resources need to be allocated towards monitoring and review; and more effort is required in working with sectors to socialise policy approaches.

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1 Our wording here is based on Black.
2 Described in Frankel and Yeabsley, 2014, introduction.
3 This can be seen in regulatory impact statements, where the monitoring evaluation and review sections are often minimal.
4 See discussion on this type of bias and the treatment of the Department of Corrections in Yeabsley, 2017, referencing Gill, 2010.
5 See <http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis/cbax>.
6 See *Unison Networks Limited v Commerce Commission* NZSC 74 SC12/2007 at [55], where the operative section is: 'The courts in those circumstances are unlikely to intervene unless the body exercising the power has acted in bad faith, has materially misapplied the law, or has exercised the power in a way which cannot rationally be regarded as coming within the statutory purpose.'

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