WORKING PAPER

Business Regulation for an Independent Scotland — a view from down under

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Introduction

The future prosperity of Scotland will depend on the ability of its people and its firms to innovate and adapt to ever changing global market conditions. Viewed from Australia it seems the debate around the economic outcomes of independence has focused mainly on fiscal issues, resource (read oil) ownership, banking, and relationships with Europe and the remainder of the United Kingdom. Microeconomic policy, which in the era of integrated global markets is, or at least should be, largely about regulation in one shape or another, seems to have received little attention. To the extent that microeconomic policy has received attention, infrastructure and competition regulation, and mainly the institutions that might undertake these functions, have been to the fore.

There is no end of literature from official national and multinational sources, and academia, on what constitutes good regulation and good regulatory processes. All communities face different challenges and given finite resources and that regulatory change is never easy, governments need to prioritise their efforts — what might be most important for the provincial government of Jakarta keen to improve small business formation outcomes will be very different for a small developed European economy on the edge of Europe with a long history of embeddedness in a larger economy.

Regulating the economy in an independent Scotland would be based on some general principles that guide policy makers in all cases:

- Regulation must be solving a problem that is well understood and be implemented in a transparent and deliberative way

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† The opinions expressed in this paper are those of the author alone and should not be attributed to the Productivity Commission or the Australian Government in any way.

1 See for example the ESRC Conversation conducted by the David Hume Institute on Competition Policy and Regulation in the context of Constitutional Change in Scotland available at http://www.davidhumeinstitute.com/research.html.
• The benefits of regulation should exceed the cost and those benefits should be achieved at the least cost

• Regulators should act in an accountable and transparent way with appropriate frameworks existing to challenge their decisions and behaviour

• Regulation and regulator performance must be subject to systematic, periodic and independent review.

There is no unique set of measures to maximise the prospects for Scotland’s economic future (although there are identifiable traps to avoid). But what is required is a coherent regulatory framework that, whilst remaining flexible, has a strong degree of commitment on the part of all participants in the policy community.

Given the focus on competition and infrastructure regulation mentioned above and the position already adopted by the Scottish Government on these issues\(^2\), this paper focuses on the regulation of business activity more generally. Informed by Australian experience, it is hoped this paper will throw some light on these issues for an independent Scotland and stimulate further debate.

**Why do we regulate and what does it cost?**

The economists’ standard answer to the first part of this question is because there is some sort of market failure. It easy to argue that market failure exists almost everywhere — there are not always markets for everything valued by the community, and where markets do exist, consumers rarely have perfect information, buyers and sellers have market power and incentives to use it in a non-welf are maximising way, and so on.

The appropriate policy response is easier to determine for some issues than others — competition policy is one example and infrastructure regulation is often another. But for others— if consumers know that an airline operates on a low cost business model and makes clear that in certain circumstances payments won’t be made to compensate for an adverse outcome, is regulation really necessary or should the normal requirements of consumer and contract law be sufficient?

But in all cases, regulation is never costless and these costs can be a significant burden on businesses. All businesses face costs in relation to compliance — staff time, external advice, capital modifications and so on. However these burdens can be reasonably seen as excessive if they relate to regulation that is ineffective in achieving its regulatory

\(^2\) Scottish Government (2013) *Economic and Competition Regulation in an Independent Scotland*
purpose, or if they are greater than might be the case for an alternative framework that achieves the same regulatory outcome.

Furthermore, it is important to realise that the costs of regulation fall more heavily on small businesses than large ones. The European Commission has recently estimated that regulatory compliance costs of a small business are around ten times that of a large one and about two and a half times that of a medium sized one. Unnecessary regulatory burdens may well be the difference between new firms commencing operations or not and established firms continuing to trade profitably. Given the preponderance of small businesses in most developed economies — some 95% of Australian businesses have fewer than 20 employees as do 97% in Scotland — it is a wonder that the starting point of regulatory design is not the impacts upon small business.

Box 1 Sources of ‘unnecessary’ regulatory burdens

- **Excessive coverage, including ‘regulatory creep’** — Regulations that appear to influence more activity than originally intended or warranted, overly prescriptive, or where the reach of regulation impacting on business, including smaller businesses, has become more extensive over time.

- **Regulation that is redundant** — Some regulations could have become ineffective or unnecessary as circumstances have changed over time.

- **Excessive reporting or recording requirements** — Companies face multiple demands from different arms of government for similar information, as well as information demands that are excessive or unnecessary. These are rarely coordinated and often duplicative.

- **Variation in definitions and reporting requirements** — Regulatory variation of this nature can generate confusion and extra work for businesses than would otherwise be the case.

- **Inconsistent and overlapping regulatory requirements** — Regulatory requirements that are inconsistently applied, or overlap with other requirements, either within governments, or across jurisdictions. These sources of burden particularly affect businesses that operate on a national basis, or across local government areas in some states.

Beyond the burdens set out in box 1, there may be other economic costs arising from ‘distortions’ — the effects of regulation on competition and on incentives for investment and innovation, which can be both internal and external to the firm. Such distortions (usually unintended) can be due to:

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• substitution effects resulting from changes in relative prices, including distorting investment decisions which have long term consequences

• overly prescriptive regulation which prevents innovative or lower cost approaches to meeting the intended outcomes of the regulation

• interactions between regulations and other pieces of public policy that can compound costs, create inconsistencies, and otherwise pose dilemmas for business compliance.

Finally, if regulation is not effective, there may be ‘opportunity costs’ in terms of the foregone benefits that regulation intended to deliver, especially in relation to environmental and public safety outcomes.

These burdens do not just fall on business, than can fall on the community as a whole. In Australia in the 1990s the Hawke-Keating Labor Governments, in co-operation with state and territory governments, embarked on a broad ranging reform agenda lasting many years usually known as the ‘National Competition Policy’ which probably increased Australia’s GDP by in excess of 3%.4

Getting regulation right is a matter of national prosperity.

The political economy of regulation

Regulation is ultimately about constraining individuals and firms from undertaking activities they might have otherwise undertaken. In Scotland as in Australia the body imposing the regulation, or undertaking some form of enforcement activity, can trace its power back to an elected body of some sort. Thus, it is useful to briefly consider what might be called ‘the political economy of regulation’.

There are a couple of important observations to be made about the political economy of regulation. The first is that when given the choice between an appropriation and a regulation, politicians are more likely opt for the latter. In part this is because the statutory basis for regulating is often more immediately available (and often less accountable) than spending but also that regulation often seems cheaper as the greatest proportion of direct costs falls on those that are regulated. Further, these direct costs are rarely properly assessed ex ante (especially in a ‘crisis’ when something has gone wrong) let alone those longer run costs associated with allocative and dynamic distortions.

It would be interesting to consider whether in drafting the final constitution for an independent Scotland some provisions should be included to ensure the same level of

rigour and scrutiny over regulatory policy that will inevitably be provided over expenditure and revenue matters.

Regulation properly assessed and tailored to achieve its objectives at minimum cost is welfare enhancing. However, markets are dynamic and there is a fair chance that over time better regulatory responses may become available or the world has moved on in such a way that means the risks that regulation had sought to mitigate are no longer of great (objective) concern to the community. In such circumstances, firms, individuals and indeed government and regulatory agencies may resist change if they derive benefits from the existing framework that would be lost in the process of reform. Periodic independent review provides the community with some protection against such conduct.

There is an opportunity for a newly independent Scotland to develop a national regulatory culture that supports sensible regulatory outcomes. Such a culture exists within many United Kingdom regulatory areas today and should be relatively easy to continue after independence. At the core must be an acknowledgement by policy makers, and an acceptance by the community, that not all risks can be eliminated.

Alongside this will need to be robust risk based approaches that are transparently applied in a way that assures the community that risks are being addressed and at the same time costs being minimised. In all likelihood the basic risk management skills to undertake such work already exists within the Scottish policy community, especially in the oil and gas and insurance and pension industries and could, in time, lead to a service industry with significant export potential.

The stock and flow of regulation

Governments, especially newly elected ones, often undertake a ‘red tape reduction drive’ in order to be seen to be doing something to reduce the burden of regulation (these days green tape is increasingly included in such language). These ‘drives’ are often in response to relatively non-specific complaints from business about the burden of regulation or ideological pressure from the right of politics about the interference of the state in peoples’ and businesses’ lives.

The policy approach to regulation is often split into a discussion about ‘stock’ (policies of this type often are referred to as ‘regulatory review’) and one about ‘flow’ (‘regulatory impact assessment’ being a common term), almost in the way economists seek to analytically separate investment from the capital stock. The problem with such an approach is it assumes that more regulation is a priori a bad thing and that in some sense regulations are fungible giving rise to the notion of ‘one in one out’ or ‘regulatory budget’ policies. Moreover, the notion of a regulatory stock is a fallacy if only because in many
cases regulation is not always binding on business activity and most businesses encounter only a small fraction of the total.

It goes without saying that new regulations need to be properly assessed. The techniques for doing this are well documented and the United Kingdom has been a leader in the development of this area of public policy practice. The principle challenge in ensuring good assessment of new regulations is commitment to it by policy makers, and especially politicians. Whilst there are very good reasons why certain decisions should be exempt — national security, immediate risk of significant harm to people or the environment — there has been a tendency, at least in Australia, to exempt much wider classes of regulation from assessment and of equal concern, not to publish the reasons for exemption and not conduct appropriate post implementation reviews when the urgency has passed.

Perhaps the most concerning class of regulations exempted from assessment in Australia are those which related to election commitments — this is the equivalent of saying that expenditure commitments made during election campaigns should not be subject to parliamentary scrutiny. It should not be beyond the wit of politicians and their advisors to devise processes that enable election commitments to be met but still ensure the consequences of policies are made clear to the community and adverse consequences of such minimised.

The starting point for managing existing regulations is to recognise that even if all new regulations pass an appropriate rigorous assessment at the time of their enactment, uncertainties about their effects and benefits in the longer term must inevitably remain and grow over time. Moreover, the accumulation of regulation leads to interactions that can give rise to increased costs and other unintended consequences.

As mentioned above good regulation is welfare maximising. It is by no means obvious that to implement a regulation that improves community welfare, another regulation needs to be removed. Conversely the removal of bad regulation, that which is not welfare enhancing, should not wait until something that is welfare enhancing happens along – it should be identified and eliminated by a routine, rigorous, public process.

What then remains to be done with the ongoing stock of regulation? Some have suggested ‘sunset’ or mandatory period reviews. A better approach is to undertake periodic reviews of the regulatory outcomes of individual sectors. The frequency of such reviews would depend on considerations such as the importance of the sector to the economy, the sector’s competitive dynamics and the pace of technological change. Such reviews should have the capacity to look at the complete suite of the industry’s regulation (not just those which had reached a certain age) and their interaction with each other, the administration of the regulatory framework by the relevant regulators and their conduct,
and consider more fundamental issues about the economic need for regulation in the sector and the more general form it should take.

A limited example of such a program was initiated by the then Australian Government in April 2007 with a review of regulatory burdens experienced by Australia’s primary industry sector. It was followed in subsequent years with reviews of manufacturing and distributive trades, social and economic infrastructure services and businesses and consumer services. The final review of generic economy wide regulation (taxation, workplace safety etc) did not proceed but was replaced by a study relating to the identification and evaluation of regulation reform.

### Box 2 Scope of Australian Productivity Commission regulatory burdens reviews

In undertaking the annual reviews, the Commission should:

1. **identify specific areas of Australian Government regulation that:**
   - are unnecessarily burdensome, complex or redundant; or
   - duplicate regulations or the role of regulatory bodies, including in other jurisdictions;
2. **develop a short list of priority areas for removing or reducing regulatory burdens which impact mainly on the sector under review and have the potential to deliver the greatest productivity gains to the economy;**
3. **for this short list, identify regulatory and non-regulatory options, or provide recommendations where appropriate to alleviate the regulatory burden in those priority areas, including for small business; and**
4. **for this short list, identify reforms that will enhance regulatory consistency across jurisdictions, or reduce duplication and overlap in regulation or in the role of regulatory bodies in relation to the sector under review.**


Whilst the scope of these reviews (box 2) seem quite broad, in other regards they were limited in that:

- they related only to regulatory burdens imposed by the Australian Government, and not those by the states and territories or local governments although a number of important regulatory areas were addressed on a national basis in a series of benchmarking studies\(^5\) including one particularly focused on local government\(^6\).

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• the conduct of regulators was not examined

• in the conduct of the reviews, the Productivity Commission did not examine questions around the necessity of such regulation.

The government of a newly independent Scotland may see value in commissioning reviews based on the Australian regulatory burdens examples, but broadened to avoid the restrictions placed on the Australian programme. Such reviews would serve to “rebase” Scotland’s regulatory landscape to Scottish needs, remove unnecessary material not related to Scotland and identify priorities for Scottish action in the European regulatory sphere. In addition, it would provide an opportunity to identify further sectoral microeconomic priorities for Scottish industry.

**Regulator behaviour**

As part of a recent study on regulator engagement with small business conducted by the Productivity Commission, a range of Australian business groups indicated the impact regulator behaviour can have on the regulatory experience of businesses. For example, the Queensland Chamber of Commerce and Industry claimed:

> [it] has significant evidence that in many cases it is the approach of regulators — their communication, advice and support, enforcement and reporting requirements — that have the most significant impact on business owner

Regulators have a difficult job. Energy Safe Victoria, summed up the regulators’ dilemma:

> Regulators have never been so scrutinised. We can be criticised for acting too late or too soon or not at all. We can be seen as heavy handed or captured by those we are supposed to be regulating. We must be stickler for process and procedure but not so inflexible that we are perceived as pursuing a process as an end itself.

Also, it is almost certainly the case that in a large number of instances when a regulated business or some other stakeholder is unhappy with an outcome, the regulator will be seen to be at fault - even if it is the regulation promulgated by the legislature that is the problem.

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8 Ibid p. 60.
Independence presents a specific point in time to set in place a framework to maximise Scottish regulator performance. The work of the Australian Productivity Commission over many years would suggest the following:

- **Resources are critical** — At budget time, there is rarely a vocal public constituency advocating broad-based fiscal protection for the resources of regulators. Further, it is also often the case that the cost of administering new regulation is not properly addressed at the time of regulation making — this is particularly the case when the regulation is being administered by a different level of government, especially local government. Beyond the issue of fiscal capacity, it must be understood that increasingly complex regulation requires increasingly skilled labour that may be in demand in other parts of the economy.

- **Communication is key** — Good regulation is generally associated with a regulator adopting an educative and facilitative approach, rather than a combative one. Accessible advice and guidance reduces the time taken for businesses to understand what is required of them and at the same time maximises the likelihood that they will comply thus creating a win-win for them and the community. Failure by regulators to communicate effectively can mean new businesses may not be established thereby obstructing economy-wide competition, dynamism and productivity.

- **Governance matters** — Governance is important for regulator performance in a number of ways. First and foremost is the setting of objectives. Parliaments must give clear statutory guidance to regulators as to the risks that regulators are to mitigate on behalf of the community. But in the vast majority cases the mitigation of such risk should not come at any cost to businesses, small or large. The recent decision by the United Kingdom Government to include in the Deregulation Bill a statutory duty for over 50 national regulators to have ‘regard to economic growth’ is a useful approach in this regard.

Behavioural guidance is also helpful. In the new United Kingdom Regulators Code local authorities are to be required to engage with companies in a simple and straightforward fashion, to base activity on risk, to share information about compliance, to provide clear guidance and to be transparent. Indeed, Australian governments would do well to implement similar reforms as recommended by the Productivity Commission on a number of occasions.

The other central governance issue for regulators is their independence from those they regulate on behalf of. As is the case with the criminal law, it is desirable for a range of reasons that the day-to-day administration of regulatory law and the identification and prosecution of offences under it, be undertaken independently of elected officials. It is probably the case that in decreasing order of desirability this
points to the following institutional forms: independent agencies with multi-member commissions, independent statutory officers supported by dedicated staff, civil servants exercising statutory decision making powers within mainline government agencies in a transparent way. The choice of approach ultimately depends on the resources available and the extent that aggregation across regulatory tasks is sensible.

- **Accountability is essential.** Regulatory accountability has two dimensions: to individuals and businesses for the regulator’s decisions that affect them, and to the community for the outcomes regulators achieve with the resources provided to them.

It is rare to find a well-regarded regulator that does not have robust internal decision review processes in place. Where such processes do not exist, it is usually the case the resources are either simply not available or that there are internal cultural issues that prevent effective review. In either case, the existence of a generalist administrative appeals tribunal able to resolve disputes about regulatory decisions on their merits at low cost and that is accessible to the legally unrepresented, provides an important part of regulator accountability.

Businesses often encounter difficulties and disputes with regulators prior to decisions being made. They complain of lack of timeliness, unclear requirements, overbearing conduct, unreasonable or impossible information requests to name a few. And to be fair, disputes can also result from faults on the part of businesses - lack of understanding, language difficulties, an inability to comply whilst maintaining profitability and yes, simple deliberate non-compliance. Disputes in the first category are not particularly amenable to remedy through normal administrative law means if only because there is often no decision to dispute. In such cases, the intervention of third party can resolve the dispute quickly, often because what is at issue is a failure of the parties to effectively communicate. Given the preponderance of small businesses, most Australian states have enacted statutes that create Small Business Commissioners to deal with such disputes, other forms of disputes that commonly involve small business (such as retail tenancies) and to provide governments with broader policy advice on small business policy, including how they are affected by regulation.

Regulators derive their authority ultimately from the legislature (there are very few constitutionally established regulators) and must be accountable to them. It is desirable though that this accountability be shared with Ministers for a number of reasons - including that Ministers will generally appoint senior regulatory officers, they are in part responsible for the allocation of resources to regulators, and it may
be desirable that from time to time there is some Ministerial guidance to regulators as to how to perform their duties.

This last point deserves some further comment. Over time, the nature of risks being mitigated by regulators may change as will the tolerance of the community of their consequences. It is sensible then for regulatory legislation to provide for Minister to provide broad statements of policy and priorities (in Australia these are often referred to as a “Statement of Expectations”) and for agencies to formally respond to these either by way of their corporate plans or some other document (in Australia sometimes referred to as a “Statement of Corporate Intent”). Both types of documents should be public and ideally set out key performance indicators and how these are to be reported to the government and the legislature.

An independent policy and regulatory review agency for an independent Scotland – the Scottish Productivity Commission

This paper has discussed the need to ensure rigour around the general regulation making activities of government and the need to systematically and periodically review the impacts and outcomes of regulation of industry sectors with administrative review of individual decisions being left to robust internal processes and a low cost accessible administrative review tribunal.

The question is how this should be done. It is suggested that Scotland should import a southern hemisphere institution, a Productivity Commission.

Australia and New Zealand have both created Productivity Commissions that undertake these (and other) functions, with some Australian states also having agencies that do such work. All of these agencies have a general capacity to accept references from their respective governments on varying ranges of public policy issues. In the case of Australia’s Productivity Commission, in additional to producing an annual review trade and assistance measures, these references have ranged across regulator behaviour towards small business, the economic regulation of airports, adaption to climate change and the development of a national disability insurance scheme. There are also some Australian examples where statutes have provided for reviews to be undertaken into specified matters in certain circumstances or after certain periods of time such as the Wheat Export Marketing Act 2008 (Cth) and the Clean Energy Act 2011 (Cth).

Until 2007, the Australian Productivity Commission contained the Office of Best Practice Regulation which administers the Australian Government’s regulatory impact assessment

9 For further information on the work undertaken by the Australian Productivity Commission see www.pc.gov.au.
requirements. At a state level, similar functions continue to be undertaken by independent bodies, most notably the Victorian Competition and Efficiency Commission and the Queensland Competition Authority.

Box 3  
**The functions of the Australian Productivity Commission**

The functions of the Commission are:

(a) to hold inquiries and report to the Minister about matters relating to industry, industry development and productivity that are referred to it by the Minister; and

(b) to provide secretariat services and research services to government bodies as directed by the Minister; and

(c) on and after 1 July 1997, to receive and investigate complaints about the implementation of competitive neutrality arrangements in relation to Commonwealth government businesses and business activities and to report to the Minister on its investigations; and

(d) to provide advice to the Minister about matters relating to industry, industry development and productivity, as requested by the Minister; and

(e) to undertake, on its own initiative, research about matters relating to industry, industry development and productivity; and

(f) to promote public understanding of matters relating to industry, industry development and productivity; and

(g) to perform any other function conferred on it by this Act; and

(h) to do anything incidental to any of the preceding functions.

*Source: Section 6(1) *Productivity Commission Act 1998 (Cth)*

The strength of these institutions is generally seen to stem from their independence, transparency and community-wide perspective.

Independence is the cornerstone of credibility – without it, such a body can rightly seen as just another arm of executive charged with doing the bidding of Ministers. The founding Chair of the Australian Productivity Commission noted that independence depends on two things:

- formal governance arrangements; and

10 These functions were transferred to the Department of Finance and Deregulation in 2007 and then to the Department of Prime Minister and Cabinet in 2013.
• the resourcing of the agency and the characteristics (attitudes, beliefs, experiences and interests) of its leaders, say Commissioners and senior staff.\textsuperscript{11}

The reality is that the most critical judge of independence will be the community and this will depend almost exclusively on the organisations behaviour over time.

Transparency means that advice to government, and the basis on which it is provided, is open to scrutiny. Processes should provide for extensive public input through hearings, workshops, submissions on the issues, and on published draft reports. This means everyone can have a say and that policy views are tested with all stakeholders prior to public recommendations being made to government. Transparency also means that such bodies are not best placed for the provision of rapid or “convenient” advice if they are to maintain their reputations.

The Australian Productivity Commission is required under its legislation to take a broad view encompassing the community as a whole, rather than the particular interests of groups of producers, consumers or other stakeholders. It is also required to have specific regard to a range of other matters such as the facilitation of structural change and the social and environmental implications of its recommendations\textsuperscript{12}. Properly implemented, this ensures that such a body does not develop a narrow focus.

One of the criticisms that has been levelled at the Australian Productivity Commission is that its independence is compromised to the extent that it cannot initiate its own inquiries where its compulsion powers can be used\textsuperscript{13}. Whilst it is not suggested that Ministers should not have the capacity to refer matters to such a Commission, if Scotland was to establish a Productivity Commission there is a debate to be had as to the extent that such a body could initiate its own inquiries or be directed by the Scottish Parliament to do so\textsuperscript{14}. Also, the legal form of such a Commission, and its powers, is likely to be affected by any decision in relation to how regulation would be treated in the Scottish constitution.

In any event, the early work program of a Scottish Productivity Commission should include the sectoral reviews discussed above and the establishment of an independent oversight framework for the regulatory activities of the government of an independent Scotland.


\textsuperscript{12} For a full list of these requirements see section 8 \textit{Productivity Commission Act 1998} (Cth).

\textsuperscript{13} When an inquiry is conducted under section 11 of the \textit{Productivity Commission Act 1998} (Cth), the Productivity Commission has powers to obtain documents and summons witnesses.

\textsuperscript{14} It should be noted that short of legislative enactment, there is a general view that it is not possible for either House of the Australian Parliament to refer matters to the Productivity Commission however this to be less likely in a jurisdiction with a uni-cameral parliament. See Banks (2011).
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