

What do today's regulators and regulatees need to know?

George Yarrow

Regulatory Policy Institute, Oxford, UK

www.rpieurope.org, george.yarrow@rpieurope.org

ACCC Regulatory Conference, Queensland

July 2008

The advertised brief

- Why and how do we regulate?
- What are the key skills and information sets?
- Key messages for a new regulator?
- Dealing with the public.
- Managing resources.
- How to interact with government and politicians.
- Differences in requirements between authorities and regulatees.
- Differences between the UK and USA?
- It's about regulatory know how. A tricky brief.

Theme: understanding

- *“I have striven not to laugh at human activities, nor to hate them, but to understand them.”* (Spinoza)
- Understanding regulation:
 - the outputs: what regulators actually do
 - the drivers of demand for regulation.
 - the characteristics of the supply-side of regulatory activities.
- Understanding markets and competition.
- Understanding the relevant limits of knowledge.
- Understanding what can go wrong: the sources of regulatory failure.

Regulatory activities and “outputs”

- What does a regulatory agency like Ofgem actually do?
 - Control use-of-network prices
 - Enforce UK and EU competition law
 - Participate in rule making (network codes, etc)
 - Set performance standards
 - Monitor and enforce compliance with rules and standards
 - Advise and inform
 - Administer government programmes (eg environmental programmes)
 - Represent, bargain, negotiate
 - Prod (disturb unsatisfactory equilibria)
 - Format information flows
- Conglomerate? Different skill sets? Culture clashes?

Drivers of demand and supply

- Demand
 - Consumer/customer interests. Excessive pricing and all that.
 - Producer interests. Frequently demand for relief from competition.
 - Single issue groups.
 - Public ‘opinion’ and media: “something must be done”.
- Supply
 - Tends to be monopolistic.
 - Can be private as well as public.
 - When public, the supply structure can be fragmented.
 - Suppliers include: international bodies (eg. EU), national legislatures, state/regional legislatures, executive departments of government, specialised regulatory agencies, etc.

Understanding markets and competition

- Competition (rivalry) is a discovery process; markets are arenas for discovery.
- *“If anyone actually knew everything that economic theory designated as “data”, competition would ... be a highly wasteful method of securing adjustment to these facts.”*
(Hayek)
- Discovery is the central driver of improvements in economic welfare over time. Allocative and productive/cost efficiency gains would be rapidly exhausted in a static environment.
- But there can be different ‘rules of competition’, so there are substantive collective choices to be made.

Understanding different types of regulation

- Regulation that *substitutes* for individual decision making (price control, central planning).
- Regulation that is *complementary* to individual decision making (establishing and enforcing market rules).
- Regulation is itself a discovery process – in the first case it substitutes for market discovery (how do we value the output of this particular network?); in the second case it seeks to discover institutional frameworks in which market discovery will be more effective.
- Awkward trade offs between innovation/experimentation (discovering rules of competition/regulation that work well) and conservatism (good for stability and certainty).

Avoiding regulatory cul-de-sacs

- Healey's law: when in a hole, stop digging.
- Almost all theory can be expected to be wrong.
- Even where not 'wrong', it can be over-abstract (eg the efficient component pricing rule (ECPR)).
- Some theorising is 'not even wrong' (Pauli) – eg the market failure paradigm. *“Climate change is the biggest market failure in history”* – like telling a five year old he/she is a failure in maths because he/she can't handle differential topology.
- The 'Ricardian Vice' according to Schumpeter.
- Economic models are potentially vehicles for the introduction of unexplored prejudices and assumptions into contexts where they have no place.
- Bad heuristics? Bad metaphors?

“It’s about information, stupid”

- The first reaction of political systems to big new problems (egs. rocketing energy prices, environmental impacts) tends to be dysfunctional.
- ‘Something must be done’ -> ‘demand’ for central planning/ command and control, and politicians tend to respond. But ...
- Central planning generally fails because of its inability to handle informational complexity in general, and because of poor discovery incentives in particular.
- It tends to be based on a pretence of knowledge, whereas recognition of the limits of current knowledge would point to a premium on discovery in the relevant circumstances.
- *“If the partial genius of market economies lies in their capacity to achieve co-ordination without a co-ordinator, the greater genius lies in their ability to innovate and adapt in an environment of uncertainty and change.”* (John Kay)

Learning how to do economic assessments

- Effective economic assessment is generally bespoke: it starts from the detail of the context (the factual matrix), much in the way a judge will do.
- “*Context is everything: circumstances alter cases*” (Sir Christopher Bellamy).
- But it also rests on the application of principles to the specific factual matrix.
- It is consistency in the application of principles that can provide the necessary stability and certainty in changing market conditions.
- Unfortunately, much economics training is biased away from the necessary skills.

The importance of regulatory discourse: internal and external

- Recall the characterisation of regulation as a discovery process.
- The process is collective/institutional in nature.
- Good discourse is required for discovery and learning.
- Internal discourse: *“I expected to find a bureaucratic mentality, but what I found was hard headed intellectualism, something much closer to a university.”*
- External discourse: *“Companies tend to get the regulators they deserve”*.
- Again, it is all about the way information is processed and translated into decisions/actions.

Understanding regulatory failures

- All economists are taught about market failure. There is much less teaching about sources of regulatory failures: we are left to find out on our own, which is often not until middle age.
- Beams and motes?
- We know quite a lot about the sources of regulatory failure, but that knowledge is not well codified and not well transmitted from generation to generation.
- Eg. the most serious restrictions and distortions of competition are often caused by regulation.
- *“When we investigate a competition problem, we almost invariably find the hand of government at work, somewhere or other.”*
- Better awareness of the sources of failure can potentially assist in avoiding some of the largest policy mistakes.