General Distribution **OCDE/GD(96)115**

REGULATORY REFORM: OVERVIEW AND PROPOSED OECD WORK PLAN

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Paris 1996

40520

Regulation in its many forms plays a vital role in serving and balancing the diverse interests and values of complex democratic societies and market economies. As an instrument of governance, regulations will continue to be used to meet a wide variety of legitimate social and economic needs. Yet there is growing evidence that reform of regulation, properly designed and carried out, can improve economic performance, and that potential effects of reform on other policy objectives can be better managed.

Noting the importance of regulatory reform to national economic policy agendas, Ministers requested in their 24 May 1995 Communiqué that the OECD "examine the significance, direction, and means of reform in regulatory regimes." In response, a major substantive report will be presented to Ministers in Spring 1997. This note presents a preliminary overview of regulatory reform in OECD countries and identifies key policy challenges for effective reform. It also proposes a detailed workplan for the Organisation's work on regulatory reform through May 1997.

I. OVERVIEW

A. WHY REGULATORY REFORM?

The **core objective of regulatory reform, and the focus of the OECD work, is improvement of economic performance**: increasing productivity, job creation, and "competitiveness", while retaining the public benefits of regulatory programmes. Countries seeking more dynamic and flexible economies are using reform of both economic and social regulations to address a range of rigidities, disincentives, barriers to competition, and market distortions that reduce efficiencies at firm and sector levels. But the efforts underway in OECD countries to reform regulations also address other economic objectives, in particular to:

- Respond to **consumer needs, including those of user industries, and desires for lower prices, more choices, and increased convenience.** This is an important shift from the post-war period during which regulatory regimes tended to protect producer groups at the expense of consumers and other users.

- Respond to **technological innovation** and more rapid product cycles in such sectors as communications, transport, and energy in order to support economic adaptation. Regulatory structures designed for outdated technologies penalise rather than protect consumers and user industries.

- **Improve government effectiveness**. If governments are to provide the framework to maximise economic wealth or to efficiently pursue important social objectives such as environmental quality and social cohesion, they must be capable of choosing the right policies, designing cost-effective regulatory instruments and approaches, and responding more quickly to change.

- **Improve the compatibility of national regulatory systems with a globalising economy**. As tariffs and quotas fall and the potential for trade expands, economic and social regulations assume greater importance as barriers to the flow of goods, services, investment or technology. International regulatory co-operation can produce economic gains from globalisation, such as fuller utilisation of economies of scale, while helping avoid unnecessary regulatory barriers to trade.

DEFINING "REGULATION" AND "REGULATORY REFORM"

There is no accepted definition of regulation applicable to the very different regulatory systems in OECD countries. In the OECD work, "regulation" refers to the diverse set of instruments by which governments require that private sector actors behave in specified ways. Regulations can include both formal legal instruments and more informal instruments, such as guidance, that are issued by all levels of government. "Regulation" in this work can also include rules issued by non-governmental bodies, such as self-regulatory bodies, to whom governments have delegated regulatory powers.

"Regulatory reform" is used in the OECD work to refer to changes that improve regulatory quality, that is, enhance the performance or reduce the costs of regulations; deregulation, a subset of regulatory reform, refers to complete or partial elimination of regulation in a sector.

B. STRATEGIES FOR REGULATORY REFORM: SOME PROMISING RESULTS

The key questions underlying reform are neutral and do not preclude a pro-active regulatory role for government. They are: Are regulatory costs justified by benefits? Does regulatory intervention produce more social and economic benefits than would alternatives? Are regulations designed to achieve policy objectives at lowest cost? These questions, which can be answered only by close scrutiny of the specific conditions applying to each sector and regulation, are reflected in the two major thrusts of regulatory reform in OECD countries: (i) increasing market incentives for efficiency and innovation; and (ii) improving regulatory quality where protective regulations are needed.

(i) Increasing market incentives for efficiency and innovation

Regulation can artificially impede or replace market competition, even where industries are structurally competitive. Where competition can produce greater benefits, reform requires, as a first priority, the **targeted dismantling of barriers to entry and exit, of price controls, and of other restrictions on competition**. These steps often follow the privatisation of state-owned enterprises. Since the mid-1980s, these kinds of reforms have gone forward, albeit unevenly, in many sectors in OECD countries. In most countries, for example, at least some competition against traditional monopoly suppliers has been permitted, and privatisation of state-owned enterprises is undertaken in a growing number of countries. Evidence from most sectors supports the view that effective deregulation of barriers to competition has produced gains for consumers (see box on page 6).

Where monopolies or other market failures persist, governments have a strong case for regulation. But privatisation of public monopolies within regulatory frameworks providing incentives for innovation and productivity improvements have produced impressive gains. Moreover, governments have found that privatisation not accompanied by adequate regulatory structures may result in worse performance. In the transition to competitive markets, competition policy enforcement can prevent private price-fixing from replacing government price-setting, anti-competitive mergers from eliminating the benefits of restructuring, or dominant firms from acting to prevent the emergence of competitors. Competition policy can also be used pro-actively to stimulate broad-based reform across sectors, by, for example, extending its scope into protected areas of the economy.

A variety of **improved regulatory techniques can also boost efficiency** when competition is not present. Compared to traditional rate-of-return regulation, price cap regulation appears to substantially increase productive efficiency and lead to more rapid diffusion of new technology. Several countries are creating independent expert agencies to regulate monopolies, an institutional reform that seems promising in improving the stability and efficiency of regulatory regimes.

An increasing number of OECD countries are revising economic regulations and regulatory procedures to improve industrial competitiveness and stimulate innovation. Streamlining regulatory processes and introducing more flexible rules can stimulate product and process innovations. These reforms are showing evidence of positive impacts.

With respect to regulatory distortion of international competition in goods and services, a growing body of evidence suggests that here, too, reforms -- not only deregulation, but also co-operative regulatory approaches across national borders, including through multilateral trading regimes -- can produce benefits. These are especially promising where co-operation in reform strengthens international competition, such as in the EU's single market programme.

(ii) Improving the quality of needed regulations

Many regulations produce important social benefits by remedying market failures in such areas as environmental and consumer protection, health and safety, and labour protections. While the economic effects of these regulations are often incidental or even unanticipated, they are nonetheless real and can be substantial. Direct compliance costs are high, especially for small businesses. Indirect costs can be even more important. Product standards that differ even slightly among countries can protect domestic markets for single suppliers. Permits and licenses intended to protect the public can delay investment decisions and increase uncertainty, reducing investment levels.

Regulatory Reform and Deregulation: Gains for Consumers

Regulated industries often have little incentive to improve efficiency and reduce costs. Regulatory reform that improves market competition has generally resulted in lower costs and prices:

- Domestic air transport deregulation in the United States in 1978 was followed by a sharp reduction in prices. Prices in real terms have remained well below pre-deregulation levels. Deregulation in New Zealand (1983) resulted initially in a 20 percent price reduction, while in Australia (1990) it prompted price reductions of 15 to 41 per cent.

- Road transportation deregulation in most countries typically led to rapid price reductions. The liberalisation of road freight transport in France in 1986 showed up in a 6 percent fall in prices in 1987. However, a sharp reduction in prices in long-distance coaching after deregulation in the United Kingdom in 1980 was subsequently reversed, largely because the dominant firm was not prevented from maintaining some degree of monopoly power.

- Electricity market deregulation in Norway (1990) prompted a reduction in spot prices of 20 per cent (partly reflecting overcapacity in the industry), and privatisation and regulatory reform of the British electricity industry was accompanied by sharp cost compression (e.g. labour productivity up by 50 per cent and an improvement in capital productivity).

- Since the deregulation of the telecommunication market in Japan in 1985, relative telephone charges have fallen by more than 40 per cent. The abolition of entry regulations in the United Kingdom in 1991 prompted an increase in labour productivity of up to 100 per cent in the dominant telecommunication company.

- Liberalisation of the Large Scale Retail Store Law in Japan over the past five years has contributed to falling prices. The implicit price deflator for distribution fell by two per cent in both 1992 and 1993.

Lower prices and increased product differentiation have increased output in deregulated industries. Comparatively low prices in the deregulated air transport sector in the United States have led Americans to fly twice as much as Europeans, and deregulation of road transportation has generally resulted in increased activity (at times at the cost of other modes of transport). Competition in telecommunication has also resulted in increased output. And a frequently voiced fear about deregulation -- that safety standards would fall -- has not been borne out in sectors where information is available.

Reform has also had costs. Increased employment due to increased activity has in some sectors not been sufficient to offset job losses from initial rationalisation. However, sharp reductions in employment in existing telecommunication companies in Japan and Finland were offset by employment gains in new companies. Deregulation in financial markets was not always accompanied by an effective regulatory oversight system to prevent abuses. This does not argue against reform, but it suggests that lessons can be learned from others' experiences.

In many cases, social objectives can be achieved at lower cost by changing regulatory approaches, that is, by **using more efficient means to intervene in markets**. A variety of tools is available, such as flexible "performance regulation" that sets goals for enterprises, rather than detailing how enterprises are to achieve those goals. Regulators can also rely less on rules and more on other kinds of incentives. Emission trading and effluent fees can simultaneously increase environmental protection and reduce its costs. Many governments are also simplifying regulatory processes to cut costs to businesses and to themselves.

Development of transparent government decision processes that better balance costs and benefits is underway in many countries. Processes for policy integration and co-ordination are being improved; this is particularly valuable for cross-cutting ministries, such as economics, competition, and trade. OECD countries agreed in 1995 to use strategies such as regulatory impact analysis and consultation with businesses and affected groups to improve the quality of new regulations[1]. Many countries are reviewing the stock of existing regulations to identify those that no longer efficiently serve their original purpose, or that impose costs that outweigh benefits.

If it is to have value for the individual firm, **regulatory reform should consider the total regulatory environment.** Regulatory inflation is a key problem. Enterprises and governments feel overwhelmed by the growing volume and complexity of rules, and fragmentation of regulatory competencies among national, international, and subnational institutions without adequate co-ordination. Hence, even if rules are perfectly made, the regulatory system may fail. Compliance is another key area, since the efficiency of compliance strategies is crucial to regulatory performance. Governments are beginning to handle such systemic and aggregate problems by **developing new centralised management capacities to** oversee the performance, co-ordination, and evolution of national regulatory systems.

C. WHY ARE FURTHER EFFORTS NEEDED NOW?

The world is changing, and OECD countries must change with it. Yet experience in recent decades has been that many OECD economies do not adapt well to economic shocks coming from within or without. Slower growth and higher unemployment increase pressures on governments to act, but higher deficits prevent them from spending their way out of problems. Instead, they have been tempted to "solve" problems by regulating. But it is increasingly clear that strong and pervasive regulations do not insulate industries from shocks, nor ensure in the long run that the right goods and services are provided. Rather, they prevent industries from adjusting to shocks and discourage them from producing goods and services that consumers want.

For living standards to continue rising, producers must be encouraged to exploit technical and process innovations, so that consumers and user industries enjoy more variety and better products. Previous work by the OECD has identified numerous sectors where further regulatory reform would make a major contribution. Strong evidence from this work suggests that reform, properly managed, will improve economic efficiency without imposing unfair burdens on weaker sections of society.

Despite this evidence, progress has been patchy. A handful of countries have carried out ambitious reform programmes, but governments in some countries remain hesitant to reform. This is partly due to fears that reform will serve only to raise already-high unemployment rates. Yet work by the OECD shows that excessive regulation of industry may be one reason why structural unemployment rates remain so high. Reducing anti-competitive regulations would encourage supply and demand, enabling growth to speed up without inflationary pressures.

Rising trade concerns also mean that reform of economic and social regulations must "go international." International solutions, such as the use of mutual recognition and harmonisation strategies and ongoing negotiations on the Multilateral Agreement on Investment (MAI), may be one way forward. Existing multilateral trade rules and mechanisms also provide a basis for international surveillance and for reducing regulatory barriers. The Uruguay Round produced some important agreements, such as the General Agreement on Trade in Services, that liberalise trade barriers, strengthen disciplines and increase competition. In the present context of implementing the new agreements and undertaking work in the WTO on reviews and further negotiations, it is timely to consider how regulatory reform could contribute to further liberalisation.

D. POLICY CHALLENGES FOR GOVERNMENTS

For regulatory reform to be an effective means of promoting economic growth, it must be done well. The OECD work can make an important contribution by using country experiences to produce **concrete policy recommendations for effective reform.** The OECD work can also support continued **international co-operation** in overcoming regulatory barriers to trade in goods and services.

Work to date suggests several key policy challenges for future regulatory reform.

- To strengthen public support for regulatory reform, **more clarity is needed about the concrete benefits of reform,** for consumers and user industries in particular. Better evidence of results will help support a key idea: that more dynamic and competitive markets will bring widespread economic benefits, although it is difficult to see in advance how those benefits will be distributed.

- **Opportunities and priorities for reform should be clearly identified.** Governments can use reform results in other countries to identify the most important regulatory issues. Establishment of international regulatory benchmarks and indicators could assist in highlighting lagging areas. International co-operation in reform efforts may help boost progress.

- **Balancing competing policies** is a difficult task. Regulation serves important values, and reform is often seen as contrary to policy objectives such as environmental protection, regional policies, or preserving cultural values. But experience suggests that policy trade-offs can be better managed through a more thorough understanding of policy links and careful design of interactive regulatory policies. Regulatory co-operation among countries, for example, can allay fears that competitiveness pressures will lead to a reduction in regulatory protections as governments seek to reduce regulatory costs. Regulatory reform also may need to take more account of concerns about social cohesion in competitive markets. The role of regulation in contributing to both equitable and efficient economic performance must be better understood.

- **Reform should be managed to minimise the pain of change.** While it can have durable benefits, reform can have substantial transition costs, such as short-term business disruptions and failures, job losses, and consumer anxiety about safety. It is necessary to explore ways to minimise the disruption of change through identifying "transitional" reform phases or programmes. Sequencing issues -- such as parallel changes to competition policy or labour markets - may help to reduce the risk of failure. A key challenge is one of organising decision processes in which those who benefit from current regulations cannot block change that will benefit others.

- **Efficient regulatory techniques should be more clearly mapped out.** More understanding is needed of linkages between specific regulatory approaches and economic performance.

- **Governments may need to consider how to reform themselves** to carry out and sustain regulatory reform. More understanding is needed of how governments can change long-standing administrative processes and institutions to function within new regulatory environments, including development of systems for evaluating regulatory effectiveness and costs.

II. PROPOSED OECD WORK PLAN

As the policy challenges indicate, considerable work is needed to clarify the results, processes, and priorities of regulatory reform. A substantive report addressing these issues will be submitted for consideration at the 1997 Ministerial.

Background reports that are both thematic and sectoral are being prepared. The workplan proposed here (and summarised in Figure 1) shows the outputs planned by the OECD leading up to the substantive report in 1997, and the committees and directorates responsible for each output.

This workplan has been prepared based on consultations with OECD committees and other working bodies, delegations, and consultative bodies such as BIAC and TUAC. Appropriate consultations with these bodies, as well as with other non-governmental organisations, will continue as the work progresses. The work is also being co-ordinated with the World Bank to avoid duplication of work and to optimise the use of resources.

A. SUBSTANTIVE REPORT TO MINISTERS

The 1997 report to Ministers will summarise findings and policy lessons for governments in key areas of regulatory reform, based on background reports, case studies, and other information. Responding to the key policy challenges set out in the preceding Overview, it will seek to:

(i) demonstrate both the costs and benefits of reform policies;
(ii) identify regulatory reform policies, both cross-cutting and in key sectors, that are most likely to stimulate micro- and macro-economic performance by favouring competition, innovation and trade, while at the same time giving due consideration to other policy objectives; and
(iii) identify reform processes and approaches that facilitate and sustain reform, including institutional changes in the public sector and methods for balancing competing policy objectives.

B. BACKGROUND REPORTS

(i) Sectoral Studies

Studies in six sectors will examine regulatory issues, reform processes, and results, with a focus on developing practical policy lessons that can support concrete action by Member countries. These sectors have been chosen because previous and ongoing OECD work suggests substantial potential gains from regulatory reform; the sector is significant for economic growth, consumer welfare or both; and further work will have "value-added" in the area of policy linkages.

The sectoral studies will be prepared on the basis of review and discussion with interested committees and directorates. Work on environmental implications of regulatory reform, for example, will be integrated into each study as appropriate. Case studies prepared by countries may contribute to the sectoral studies. Using a four-step outline, each study will:

i) characterise the **current status** of regulation and regulatory reform in OECD countries;

ii) identify the most important regulatory issues with respect to **stimulation of micro- and macro-economic performance**, focusing on impacts of reform on openness of markets;

competition and consumers in that market; competitiveness; innovation and its diffusion; and other major economy-wide effects;

iii) identify **costs of reform** and key **policy linkages** that make reform more difficult, and methods of managing interactions among policies. If there are important transitional or sequencing issues, look at the **process of reform** in the sector;

iv) draw **policy lessons** for regulatory reform in each sector.

The six sectoral studies are briefly described below. For each study, one directorate has primary responsibility, but other directorates and committees will provide substantial inputs.

TELECOMMUNICATIONS

(Main responsibility: DSTI
Committees: Committee for Information, Computer and Communications Policy and its Working Group on Telecommunications and Information Services Policy, Trade Committee, Committee on Consumer Policy, and WP2 of Committee on Competition Law and Policy)

The study will assess reform experiences and results in Member countries. On that basis and in line with a possible WTO agreement on telecommunications, it will identify where further reform can bring benefits, such as in interconnection frameworks, provision and funding of universal service, and appropriate safeguards. The study will review implications for regulation of converging technologies and services, e.g. merger of broadcasting, cable television and telecommunication markets, and service provision.

PROFESSIONAL SERVICES

(Main responsibility: DAFFE
Committees: Committee on Capital Movements and Invisible Transactions, Committee on Consumer policy and WP2 of the Committee on Competition Law and Policy)

In four professions -- accountants, architects, engineers and lawyers -- the study will assess experiences with reform in Member countries. It will examine regulatory restrictions on commercial practices such as price competition, advertising, and form of practice, and regulatory barriers to entry such as local presence and nationality requirements; restrictions on establishment/investment; and barriers to access by foreign professionals.

ELECTRICITY

(Main responsibility: DAFFE
Committees: Committee on Consumer Policy and WP2 of the Committee on Competition Law and Policy, IEA)

The study will cover such issues as enhancing competition in generation, which implies changes in the relationship between generation and transmission and between generators and users of electric power; improving efficiency in meeting environmental goals; providing transition rules to ensure that other policy objectives are met; and impacts of reforms on services to consumers.

FINANCIAL SERVICES

(Main responsibility: ECO, in co-operation with DAFFE and TRADE
Committees: Committee on Financial Markets, Trade Committee)

The study will identify the benefits of past regulatory reform; the effects of reform on resource allocation, macroeconomic performance, and financial stability; and the potential risks arising from the transition to a more competitive financial environment. The study will also examine obstacles to competition in domestic and international markets for financial services; and ways to strengthen oversight of globalised markets.

AGRO-FOOD

(Main responsibility: AGR
Committees: Committee for Agriculture and Working Party on Agricultural Policies and Markets)

Drawing on recent and ongoing OECD work, this study will examine regulatory issues relevant to adjustment in the agro-food sector, focusing on linkages between primary agriculture and related upstream and downstream industries. Issues could include: complementary measures for effective competition after deregulation of agricultural markets; impacts of institutional arrangements on the performance of downstream industries; pressures for increased regulation (such as food safety and environmental protection) and potential effects on adjustment and trade; design and implementation of regulatory measures to achieve policy goals with least distortion; and new regulations covering advances in biotechnology.

PRODUCT STANDARDS

(Main responsibility: TRADE
Committees: Trade Committee, Committee on Consumer Policy)

The study will review the effects of different product standards and conformity assessment regimes, as well as the benefits of reform, on technological innovation, consumer welfare, international market openness, and economic welfare. It will draw examples from several product sectors, including automobiles, home appliances, personal protective equipment, toys, biotechnology products and telecommunications equipment. The study will identify steps to improve competition and enhance trade while ensuring that quality, performance, and safety objectives of standards are adequately met.

(ii) Thematic Reports

Sectoral studies are necessary to identify reforms specific to each sector, but a number of cross-cutting regulatory issues can be properly understood only through broader analysis. To explore how governments should approach such issues, the Secretariat will produce five thematic reports by February 1997. Each thematic report will identify, on the basis of sectoral and other information, (i) the most important regulatory issues under each theme; (ii) the benefits of reform and the reform policies most likely to stimulate economic performance; (iii) important policy linkages and methods for managing them; and (iv) policy lessons. Assessment of policy linkages is an important common element of the work. The intent in each thematic report is to be frank about trade-offs, to minimise unnecessary concerns where possible, and to suggest ways to balance effects or to find approaches that are mutually supportive.

The thematic reports to be prepared are briefly described below. For each report, one directorate has primary responsibility, but other directorates and committees will provide substantial inputs.

ECONOMY-WIDE EFFECTS OF REGULATORY REFORM

(Main responsibility: ECO)

The report will examine experience with regulatory reform in six sectors -- retail distribution, telecommunications, road transport, air transport, electricity, financial markets -- to determine its impact on sectoral prices, wages, employment, output, and rates of return. Second, it will attempt to assess the consequences of sectoral reforms on overall inflation, growth, and employment under observed macroeconomic policies and labour market regimes.

COMPETITION, CONSUMERS AND REGULATORY REFORM

(Main responsibility: DAFFE
Committees: Committee on Competition Law and Policy and its WP2, Committee on Consumer Policy and its WP on Consumer Safety)

The report will broadly review the effects of regulatory reform on (1) competition in particular markets and (2) industrial and final consumers, drawing on the sectoral chapters. It will examine processes of regulatory reform, and how competition and consumer policies can be used to drive reform.

INDUSTRIAL COMPETITIVENESS, INNOVATION AND REGULATORY REFORM

(Main responsibility: DSTI
Committees: Committee for Scientific and Technological Policy and its Working Group on Technology and Innovation, Industry Committee, Committee for Information, Computer and Communications Policy)

The report will focus on how reform affects the innovative and competitive performance of firms, and on policy approaches for maximising positive effects on industrial competitiveness. It will also examine the effects of reform in related policy areas such as intellectual property rights, and the effects of improving flexibility and cost-effectiveness in regulatory processes and measures.

MARKET OPENNESS AND REGULATORY REFORM

(Main responsibility: TRADE
Committees: Trade Committee)

The study will review interactions between market openness and regulatory reform at national and international levels, drawing on evidence of the benefits of reform in opening markets in the areas of product standards, telecommunications equipment and services, and financial services. The study will examine the main regulatory obstacles to market openness; potential impacts of increased international competition arising from regulatory reform; and the extent to which multilateral trading arrangements provide a framework for pro-market-access regulations.

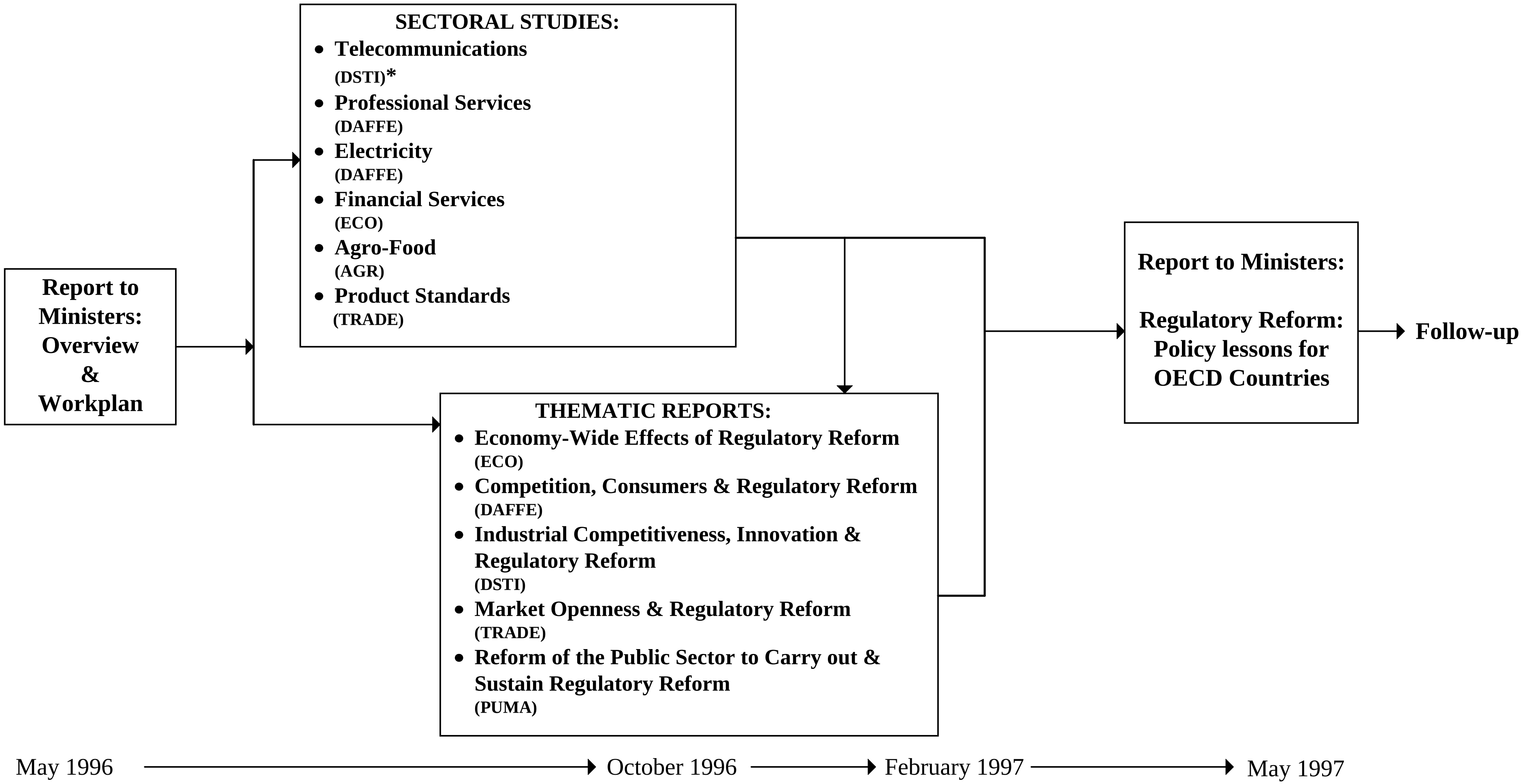
REFORM OF THE PUBLIC SECTOR TO CARRY OUT AND SUSTAIN REGULATORY REFORM

(Main responsibility: PUMA
Committees: Public Management Committee and its group on regulatory management and reform)

This report will examine how public sectors can change to carry out and sustain the blend of regulation, deregulation, and re-regulation that is included in a programme of regulatory reform. It will include such issues as: changing administrative decision processes to improve transparency and rationality, including using regulatory impact analysis and public consultation; strengthening policy integration and co-ordination; developing capacities for managing regulatory reform processes; designing processes for periodic review of regulations; and using alternatives to regulation.

Figure 1

REGULATORY REFORM: PROPOSED OECD WORKPLAN



* Main Secretariat responsibilities indicated in brackets

NOTES

1 Council of the OECD (1995) Recommendation on Improving the Quality of Government Regulation, 9 March, Paris. By 1996, some 15 countries had adopted programmes of regulatory impact analysis.