

## OECD REPORT

### ALTERNATIVES TO TRADITIONAL REGULATION

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*This document has been declassified and is made available to the public. The views are the author's responsibility.*

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## **ALTERNATIVES TO TRADITIONAL REGULATION**

### **Introduction**

0.1 This report updates and extends the earlier work of the OECD on alternatives to traditional regulation, drawing on the experiences of individual countries in using alternative approaches. It also provides a framework to assist policy makers in selecting those instruments that are particularly applicable in different circumstances, facilitating the desire of many countries to reduce red tape and the burdens imposed on agents by unnecessary or overly prescriptive regulation. Consideration of alternative instruments is a key element in the 1995 OECD checklist for regulatory decision-making and greater guidance to policy makers can help ensure that alternatives are more fully considered.

0.2 The challenge for government is to ensure that the regulations and instruments it uses to achieve the public's objectives are both effective and efficient: effective in the sense that they resolve the problem they were introduced to address; and efficient in the sense that they minimise both the direct compliance costs borne by those subject to the regulation, and other, often more indirect, costs which may be imposed on the public.

### **Encouraging consideration of alternatives**

0.3 The first response by governments to a perceived policy issue is often to regulate, but it may be appropriate to ask whether traditional regulation is the best possible course of action. In many situations there may be a range of options other than traditional 'command and control' regulation available, including more flexible forms of traditional regulation (such as performance-based and incentive approaches), co-regulation and self-regulation schemes, incentive and market based instruments (such as tax breaks and tradable permits) and information approaches.

0.4 There continues to be considerable experimentation with the use of alternatives in OECD countries, but policy makers remain reluctant to seriously consider the use of alternative instruments in many situations, perhaps because of the uncertainties and perceived risks attached to alternative approaches, or because of institutional impediments. Some obstacles can be overcome by developing policy-making processes that involve a thorough consideration of the advantages and disadvantages of the options available, such as regulatory impact analysis (RIA). Information regarding what works and under what circumstances is also a key tool for breaking the 'regulate first' culture that may exist in some ministries and among some regulators. It is also important that information is made available to citizens in order to increase acceptance of alternative instruments as legitimate and effective responses to policy issues.

### **A framework for assessing regulatory alternatives**

The framework can be summarised in the form of a checklist designed to determine the extent to which the options under consideration:

- address clearly specified policy objectives;
- are consistent with other, existing regulations;
- have effective monitoring and compliance mechanisms;
- maximise benefits and minimise costs;
- provide a degree of flexibility where possible to allow the regulated to find the lowest cost way of complying with specified requirements;
- minimise compliance costs – both those borne by regulated entities and the government itself;
- are transparent in their operation and impacts;
- contain appropriate appeals mechanisms.

0.5 The alternatives to traditional regulation fall into three main categories: market-based instruments, self-regulation and co-regulation approaches, and information and education schemes.

### **Market-based instruments**

0.6 Market-based regulatory instruments act to change or modify behaviour through the economic incentives facing citizens and businesses. They primarily operate through changing relative prices or making trading opportunities available where they did not previously exist. Trading schemes are a common form of market-based instrument. Such instruments can involve the government setting an allowed level of an activity, such as the production of carbon dioxide, and allocating emission permits to firms. But the firms are then free to trade these permits amongst themselves. In this way the government is able to specify the total level of emissions but not impose limits on individual firms. Fiscal measures – such as the use of taxes and subsidies – are also commonly used market-based instruments. Taxes are often imposed on harmful activities to make them relatively more expensive. For example, in many countries high tax rates are imposed on tobacco products to discourage their consumption. Alternatively, subsidies can be used to encourage production or consumption of activities or products which are considered desirable.

0.7 In many cases the objectives of a market-based instrument are clearly specified. Trading schemes, for example, generally have clearly specified goals, to cap emission levels, for example, or to allocate the use of sections of the radio frequency spectrum. But in other cases the objective may be relatively clear and easy to understand, but lack precision. The introduction of a tax to ‘reduce’ emissions or ‘encourage’ recycling is a clear objective, but it lacks precision in terms of the quantifiable change required for the instrument to be considered successful. Moreover, instruments that have multiple, and possibly conflicting, objectives are highly unlikely to be effective. In particular, taxation instruments, or the sale of marketable permits, may also have a revenue maximisation objective that is not explicitly stated, and may cause problems if the objective of maximising revenue for the government is in conflict with the attainment of other objectives.

0.8 While market-based mechanisms are often used in combination with other policy instruments, there can also be problems in integrating them across jurisdictional borders, for example between national and sub-national levels of government. The use of fiscal instruments, including taxation and subsidies, can be difficult across jurisdictions where the rates may need to be approved by different levels of government. These cross-jurisdictional problems are not necessarily insurmountable, and there are examples of market-based mechanisms being used successfully across jurisdictions (such as the European trading system for

carbon dioxide). But the need to ensure consistency with other regulatory arrangements can complicate the introduction and use of market-based instruments.

0.9 More positively, compliance with market-based instruments is likely to be high given that these instruments act through the economic incentives facing businesses and citizens. However, avoidance or evasion can weaken their effectiveness. The complexity of the tax or subsidy arrangements will also be an issue. If the arrangement is very complex, there will be stronger incentives not to comply. Effective monitoring by governments or regulators is therefore necessary to prevent abuse and manipulation of market-based schemes.

0.10 The key advantage of market-based instruments is that they reflect decisions made by citizens and businesses in response to the incentives they face. The decisions taken will reflect the preferences of the individuals involved – market-based schemes are therefore able to draw on information that is unlikely to be known by governments and regulators. Market-based instruments are, therefore, generally very flexible instruments.

0.11 Consideration of compliance costs should take account of the costs borne by both the regulated entity and the government or regulator itself. The extent of these costs will depend on the type of economic instrument being used, and the distribution of these costs between the regulator and the regulated will differ widely between fiscal instruments (taxes and subsidies) and trading instruments. In the case of fiscal instruments, the regulated are likely to bear most of the cost, and will have little scope to reduce direct compliance costs. However, they will have some flexibility to change production processes or to take other steps to minimise the costs of compliance, providing the tax or subsidy rates involved are not changed frequently. In the case of trading mechanisms, the costs involved are likely to be more evenly distributed between the regulator and the regulated.

### **Self-regulation and co-regulation**

0.12 Self-regulation typically involves a group of economic agents, such as firms in a particular industry or a professional group, voluntarily developing rules or codes of conduct that regulate or guide the behaviour, actions and standards of its members. The group is responsible for developing self-regulatory instruments, monitoring compliance and ensuring enforcement. Examples of self-regulation include: codes of practice; industry-based accreditation arrangements; and voluntary adoption of standards. The specific types of instruments or mechanisms that may be created under a self-regulatory regime are similar under a co-regulatory framework, but co-regulation entails explicit government involvement. It is the degree of government involvement and legislative backing that determines the difference between the two. Self- and co-regulatory approaches are frequently used in the professions and by industry associations, where detailed technical knowledge is likely to be important.

0.13 When used in the right circumstances these instruments can offer significant advantages over traditional command and control regulation, including: greater flexibility and adaptability; potentially lower compliance and administrative costs; an ability to address industry-specific and consumer issues directly; and quick and low-cost complaints handling and dispute resolution mechanisms. Both self and co-regulatory approaches have the potential to be very efficient policy instruments because of their flexibility. They can be tailored to the specific issue they are designed to address and can change quickly in response to changing circumstances. However, there can also be negative consequences: there must be adequate protection in place to ensure that the regime is not captured by the industry or professional association and so promote narrow interests rather than the wider community interest.

## **Information and education**

0.14 These instruments work to change behaviour through the provision of greater information or by changing the distribution of information; that is, making information that may be available to some businesses and consumers available to others. Examples of these instruments include: information and education campaigns, labelling requirements, or requirements to disclose other information to the market. For example, many OECD countries have conducted campaigns to increase awareness of the risks of driving while under the influence of alcohol. Labelling requirements also provide information to consumers. Practical examples of labelling campaigns include, for example, energy efficiency labels on electrical appliances; ‘eco-labelling’ of environmentally friendly products; and labelling of clothing to show that workers have not been exploited in its production.

0.15 This type of instrument is often characterised as being ‘light-handed’ because the degree of direct government involvement in decision making or directing behaviour is more limited than with other instruments. They do not directly impose legally binding rules on the behaviour of consumers or businesses. They may, however, impose quite stringent requirements on businesses to collect and disseminate information that they may not otherwise have chosen to disclose, and this may impose compliance costs on the producer.

0.16 In terms of their effectiveness, information and education campaigns often address clearly specified objectives and can be well integrated with other regulations. But in many cases there is no attempt to monitor compliance with the campaign nor to impose penalties or sanctions for non-compliance, because the objective is to provide information that should lead to a change in behaviour as consumers and businesses make better informed decisions. In relation to the criteria for efficiency, the benefits of these types of instrument will only be realised if the appropriate information is made available to those who need it. It is therefore necessary to ensure that these instruments are well targeted, which will also help to minimise costs.

0.17 Information and education approaches are very flexible instruments in the sense that they do not impose or require certain actions to achieve their objectives. But the flexibility to ‘fine tune’ them may be limited because of the time taken for them to influence people’s behaviour. It may also be difficult to determine, when designing the instrument, how citizens and businesses will change their behaviour given the information provided. This means that these instruments may not be appropriate in circumstances where policy objectives or the policy environment are changing rapidly. Such instruments may lack the flexibility to be able to change behaviour quickly and precisely in changing circumstances.

## ALTERNATIVES TO TRADITIONAL REGULATION

### Introduction

1. Alternative policy instruments can often achieve policy objectives at lower cost and more effectively than traditional ‘command and control’ instruments. They can therefore be a means of reducing administrative burdens imposed on businesses and others. Often, however, alternative instruments are not fully considered or they are considered too late in the policy making process for them to be viable options. Alternative instruments are not always the best response to a policy issue, they have drawbacks as well as advantages, and hence the merits of alternative instruments need to be assessed on a case by case basis.

2. This report significantly extends the description of alternatives to traditional regulation presented in the 2002 Flagship report<sup>1</sup>, updating country experiences with the use of alternatives and including a more rigorous analysis. It assesses these instruments using a consistent and detailed framework. This framework will be applied in further chapters analysing more flexible forms of traditional regulation, market-based instruments; and policy instruments promoting information dissemination (such as advertising campaigns and reporting requirements). The report draws on recent examples from a range of OECD countries to ensure that the analysis is both timely and relevant to policy makers.

3. The analysis is then drawn together in the concluding chapter to develop a check list of factors which should be considered when choosing between alternative instruments. The check list will provide guidance to policy makers to help identify which instruments are particularly applicable in which circumstances, thereby aiding the decision making process and facilitating the desire of many countries to reduce red tape and the burdens imposed agents by unnecessary or overly prescriptive regulation. The report should help governments adopt more efficient and effective regulations when a decision to intervene has been made, reinforcing parallel work on regulatory indicators and reducing administrative burdens by providing guidance on when alternatives to traditional regulation are likely to be superior policy responses.



## ENCOURAGING CONSIDERATION OF ALTERNATIVES

### Introduction

4. Governments regulate and intervene in the daily lives of citizens and businesses. This section briefly considers why governments intervene, and how. It then considers why alternatives to traditional regulation often do not seem to be widely considered.

### *Why regulate?*

5. There is a long history of government regulation ‘in the public interest’, that is, regulation essential for the functioning of society and the economy. At a basic level, laws define and enforce property rights, which are essential underpinnings for the operation of markets. The public interest requires that governments intervene in the areas of health and safety, the environment, social policy and the economy and it is through traditional regulation and, increasingly, other policy instruments, that governments meet societal demands and desires, and maintain frameworks for markets.

6. In many countries there has been a move away from direct government provision of goods and services towards a greater reliance on the market to provide citizens’ needs and ensure economic growth. Because markets do not operate in a vacuum, there are circumstances when markets may not generate optimal outcomes. These cases of ‘market failure’ provide a rationale for governments to intervene and correct the perceived failure. Typical examples of market failure which have led to government regulation and intervention include:

- The existence and abuse of market (monopoly) power;
- Information asymmetries or deficiencies (that is, where one or more of the parties involved in a transaction have incomplete information upon which to base their decisions and actions); or
- Externalities and spillovers (that is, when one or more of the parties involved in a transaction do not take into account the full effects of their decisions on others).

7. In addition, governments may also intervene in the operation of markets to achieve objectives other than economic efficiency. For example, governments may regulate to achieve citizens’ social, environmental and cultural objectives. Such objectives could include: a more equal distribution of income and wealth; ensuring equal access to health and other essential services; protection of native flora and fauna; and support for domestic film and artistic productions.

### *How to regulate and achieve policy objectives?*

8. The challenge for government is to ensure that the regulations and instruments it uses to achieve public objectives are both effective and efficient: effective in the sense that they resolve the problem they were introduced to address; and efficient in the sense that they minimise both the direct compliance costs borne by those subject to the regulation, and other, often more indirect, costs which may be imposed on the public.

9. The first response by governments to a perceived policy issue is often to regulate. A government may, for example, pass a law to prohibit or regulate an undesirable action. The community can see that the government has acted and may consider such ‘command and control’ regulation a clear indication of the government’s resolve to deal with the issue. Of course not all regulation can be categorised as ‘command and control’, telling actors what to do or what not to do. Many regulations are designed to allow firms and citizens to initiate and coordinate actions – these regulations facilitate economic and social activity. Nevertheless it may be appropriate to ask whether regulation was the best possible action by the government.

10. In many situations there may be a range of options other than traditional ‘command and control’ regulation available to achieve the government’s [community’s] policy objectives. Alternative instruments available to policy makers include:

- More flexible, less prescriptive forms of traditional regulation. (The aim is to minimise some of the major shortcomings of traditional regulation). Examples include performance-based and incentive regulation;
- Co-regulation and self-regulation. (Co-regulation usually involves the industry or professions developing and administering its own rules but with government providing legislative backing to enable the arrangements to be enforced. Self-regulation is generally characterised by the industry (or profession etc) formulating rules and codes of conduct, for which the industry itself is responsible for enforcing);
- Incentive and market based instruments. (Incentive-based approaches include the use of taxes, subsidies, etc. to change the incentives faced by economic agents to ensure that they correspond more closely with society’s objectives. Market-based approaches include tradable permits); and
- Information approaches. (Education and persuasion can be used to achieve the community’s objectives. Strategies which attempt to address perceived problems by providing more information, or changing the distribution of information can improve market functioning by enabling people to make better informed decisions).

11. While there continues to be considerable experimentation with the use of alternatives in OECD countries, the first response often remains to regulate. The ‘regulate first’ approach may mean that more effective and efficient policy instruments are being overlooked. The use of a ‘second best’ policy instrument may have significant implications for competition and economic performance as it imposes unnecessary costs on businesses and citizens and can often dampen and restrict competitive pressures.

12. This is not a new issue among OECD countries. The OECD has previously emphasised the importance of considering a range of options when considering how to deal with a policy issue. The 1995 OECD checklist for regulatory decision-making states that: ‘Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects and administrative requirements.’ A number of countries have also published guidelines or recommended that alternatives to traditional regulation should be considered during the policy making process. In addition, the 2002 Flagship report; *Regulatory Policies in OECD Countries: From Interventionism to Regulatory Governance*, provided a summary descriptive overview of the range of regulatory alternatives available to governments.

13. Policy makers, however, remain reluctant to seriously consider the use of alternative instruments in many situations. The aim of this section is to discuss:

- Some of the reasons why alternatives to traditional regulation are not more widely considered; and
- Develop a framework for assessing alternatives to regulation.

14. This framework is then used in the report to assess various alternative policy instruments and provide some guidance to policy makers to help them choose between the available instruments.

### **What are some of the impediments to using alternatives to traditional regulation?**

15. The first stage in the process to try to encourage greater consideration and use of alternative instruments is to consider why they are not more widely used now. Identifying the impediments to the wider use of alternatives will help focus any prescriptive measures where they are likely to achieve maximum benefits.

#### *Uncertainty and perceptions of risk*

16. The perception of risk can exercise a significant influence on policy makers' choice of instrument. Regulators are likely to be risk averse, especially when promotion and rewards are performance based. As noted in a previous OECD report "... the failure of a non-traditional approach is likely to have more serious consequences for the regulator than a failure of traditional regulation." (OECD, 2002, p. 53). This perception of risk is a critical factor impeding the more widespread consideration and use of alternative instruments.

17. The factors which create the perception of risk in the minds of policy makers also produce scepticism and uncertainty in the minds of the public. In many ways the two are linked: public perception and acceptance of an instrument influences the extent to which policy makers consider it 'risky'; and raises the stakes if the alternative instrument is a failure.

18. This perception of risk and scepticism on the part of policy makers and the public results, in part at least, from:

- A lack of knowledge of what alternatives have been used and the circumstances in which they have been successful;
- A lack of understanding of how alternative mechanisms work (e.g. the role of incentives) means that the outcomes may not be regarded as predictable as for traditional regulation; and
- A fear that alternative instruments (especially market-based instruments) result in a loss of control by governments over the problem being addressed.

19. It is through the provision of information regarding successful examples of alternatives and a framework to help guide policy makers that this report can help overcome some of these concerns.

#### *Impediments to using alternative instruments: a lack of knowledge*

20. Although there is little robust information on the use of alternative instruments, there is anecdotal evidence that the use of alternatives to traditional regulation in OECD countries is increasing. In some sectors in particular there appears to be greater use and experience with the use of alternative instruments. Environmental policy provides a good example where alternative instruments, especially economic instruments have been used for some time.<sup>2</sup>

21. However, the details about the success or failure of the use of alternatives are often not widely disseminated amongst policy makers. The lack of knowledge of successful cases where alternative instruments have addressed policy issues in an effective and efficient manner may mean that they are not regarded as having a successful 'track record'. They may therefore be regarded as a more risky untried option compared with traditional regulatory approaches.

22. Policy makers do not often have the time to research and investigate alternative ways of achieving the government's objective, especially in cases where governments (and citizens) are demanding urgent action to deal with a policy issue. The response is likely to reach for the traditional regulatory instrument which can be enacted quickly and placate the citizen's demands for government action.

23. Information may be lacking especially in cases where alternative – particularly innovative – instruments are tried on a small scale before being considered for more general use. The project may be overseen by a small unit within the civil service, and information not widely disseminated. There may also be an incentive to cover up any perceived (or actual) failure of the experiment to minimise adverse public reaction and political fallout.

24. Time is also an issue in relation to the dissemination of information. There may be a significant time delay between the introduction of a new instrument and being able to judge whether it was a success or failure. In some cases there may be no independent evaluation of the effectiveness and efficiency of the instrument. Even when an evaluation of an instrument is undertaken it may be difficult to judge the effectiveness of the instrument if there were conflicting policy objectives or objective was not clearly specified at the beginning of the process.

*Impediments to using alternative instruments: understanding how alternatives work*

25. Regulation is concerned with changing behaviour – it aims to make people do something they would not otherwise have done. In this respect traditional command and control regulation is a very blunt and direct mechanism for changing behaviour. Those subject to the law are required to comply with its provisions or they face penalties (financial or custodial). There is, for the policy maker, government and citizens, a reassuringly direct link between the regulation and the expected outcome.

26. If the policy objectives and the requirements imposed by the regulation are specified clearly, it will be easier for those subject to the regulation to understand what is expected of them. This will especially be the case where traditional command and control regulation specifies in detail what must be done. For example, environmental regulation may specify permissible emission levels and the measures which must be taken to achieve these levels – it is clear to those being regulated what must be done and how.

27. In many cases the link between an alternative instrument and the outcome may be less clearly observable compared with traditional regulation. Performance based regulation may specify the required outcome but not the specific measures by which it will be achieved. In such cases, those subject to the regulation may be able to choose from a range of measures which will achieve the required outcome. This may make monitoring of compliance more costly and difficult.

28. In the case of more market based approaches which rely on changing the incentives faced by businesses or citizens, the link between the instrument and the outcome may be considered even more tenuous. For example, a tax on harmful emissions will result in a reduction in the level of emissions, but by how much? How long will it take? Similarly, how will a voluntary information disclosure regime affect the behaviour of a firm with market power? There may also be concerns regarding the equity and fairness of market based instruments. Concerns regarding the use of such instruments are likely to be greatest where

there is limited experience with market determined outcomes and there is a mistrust of market mechanisms.

*Impediments to using alternative instruments: fear of losing control*

29. There may also be a perception by both policy makers and citizens that the government risks losing control of the outcome when using some market-based instruments. It may be feared that once put in place a market-based instrument, such as a tradable permit system for example, will become well established and may develop in a way which may lead to undesirable or unexpected outcomes. It may be thought that it will be difficult to make incremental changes once the system is in place. In contrast, a more traditional regulatory approach may be considered under more direct government control – especially where the regulatory requirements are specified in detail (for example as may be the case for technical regulation). Governments can change the provisions of the regulations, their scope and penalties easily if a change is considered necessary.

30. There may also be a concern that some alternative instruments, for example, self-regulation or voluntary agreements, may be more vulnerable to ‘capture’, that is, the nature of the regulation is influenced unduly by those that it is meant to regulate. The regulation therefore serves, to some extent, the interests of those being regulated rather than the general public interest. Once special interests have such an influence over the way they are regulated they have a strong incentive to maintain the current arrangements. In some cases these sectional interests can become a powerful force against regulatory reform.

31. There may also be fears that governments will be unable to enforce effective compliance with alternative instruments. This is especially the case where the alternative instrument focuses on changing incentives and getting the desired outcome. The extent of compliance may be difficult or costly to determine. In contrast, compliance with more traditional regulation which is often more input focused can be easier to assess, such as, for example, assessing whether a firm has installed required safety equipment.

*Institutional impediments*

32. Regulators and policy makers may face incentives, in addition to the perceived risk associated with such instruments, to continue with the use of traditional instruments rather than considering more innovative alternatives. In some cases, firms may also prefer traditional regulation to alternative instruments.

33. Precedent and a reluctance to change can exercise a strong influence over choices made by regulators and policy makers. Regulators want to regulate. This is especially the case for a regulator who has argued strongly for one course of action or approach for some time. To some extent their reputation rests on the success of the system put in place by their past actions and decisions. It may be difficult, at least in the short term, to suggest the use of a different sort of instrument when a similar type policy issue arises.

34. An important factor, but perhaps difficult to measure and assess, therefore is the existence of an entrenched regulatory culture among some policy makers. The OECD has noted that "... the choice of policy instrument tends to be based more on habit and institutional culture than on a rational analysis of the suitability of different tools to addressing the identified policy problem" (OECD 2002, p.52). The regulatory culture can differ not only between regulators and institutions within a country but there may also be differences between countries. Some countries may be more likely to regulate in a given situation than others.

35. The use of similar instruments may also reflect the expertise and knowledge built up over a long period of time by the regulator or policy maker. The regulator may not have the skills or knowledge necessary to design and implement an alternative policy instrument. For example, in some technical areas regulators and policy makers may be influenced by the desire to specify highly technical standards, where they have very specific knowledge. The specification of such standards may be suited to highly prescriptive traditional regulation but less suited to alternative approaches such as more 'light-handed' outcomes based mechanisms.

36. Regulators and policy makers may also be influenced by public opinion. Just because a regulation is popular does not mean that it is necessarily in the best interests of the citizens. For example, a regulation which sets electricity prices at a low level may be popular among consumers and electricity users, but this short-term popularity may be at the expense of long-term development and investment in the electricity industry. The short-term gains are immediate and highly visible; the long-term costs are remote and hidden.

37. Businesses themselves may prefer the government continue to use traditional approaches rather than alternative policy instruments. They understand how the current arrangements work, but they would incur costs in learning how new regimes operate and how they should respond to the new arrangements. Business may also think that their knowledge of the existing arrangements confers an advantage on them over new entrants who would have to learn about the regulatory regime. A change from traditional regulation to a new approach would remove the actual (or perceived) advantage enjoyed by incumbents.

38. Businesses may also be concerned about the uncertainty generated by a move to use an alternative policy instrument. They may be unsure how their competitors will react to the new arrangements and what impact it will have on the environment within which they conduct their business. This uncertainty may be seen as an added complication in their business planning which they would rather avoid.

### ***Overcoming impediments: a supportive policy making process***

39. The policy making process establishes the framework within which policy measures are discussed, analysed and policy responses formulated. A policy making process which supports and encourages the consideration of alternative instruments is essential if governments are to make informed decisions regarding the options available to deal with policy issues. It is important that policy makers be encouraged to carry out, early in the regulatory policy making process, a thorough consideration of the advantages and disadvantages of the options available. If the consideration of alternatives is left until very late in the policy making process they are unlikely to be explored fully and policy makers may have developed a preconceived notion of the need for regulation.

40. The OECD's reference checklist for regulation decision making provides a framework for making good policy (box 1). The checklist questions reflect principles of good decision-making that can be used to improve the effectiveness and efficiency of government regulation. It is not limited to promoting the use of alternative instruments but a much broader framework for improving the quality of regulations put in place by governments. A key element of the checklist is, however, that there should be a full consideration of alternatives to regulation early in the policy process.

#### **Box 1. The OECD Reference Checklist for Regulatory Decision-Making**

##### **1. Is the problem correctly defined?**

The problem to be solved should be precisely stated, giving evidence of its nature and magnitude, and explaining why it has arisen (identifying the incentives of affected entities).

##### **2. Is government action justified?**

Government intervention should be based on explicit evidence that government action is justified, given the nature of the problem, the likely benefits and costs of action (based on a realistic assessment of government effectiveness), and alternative mechanisms for addressing the problem.

##### **3. Is regulation the best form of government action?**

Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects and administrative requirements.

##### **4. Is there a legal basis for regulation?**

Regulatory processes should be structured so that all regulatory decisions rigorously respect the "rule of law; that is, responsibility should be explicit for ensuring that all regulations are authorised by higher level regulations and consistent with treaty obligations, and comply with relevant legal principles such as certainty, proportionality and applicable procedural requirements.

##### **5. What is the appropriate level (or levels) of government for this action?**

Regulators should choose the most appropriate level of government to take action, or if multiple levels are involved, should design effective systems of co-ordination between levels of government.

##### **6. Do the benefits of regulation justify the costs?**

Regulators should estimate the total expected costs and benefits of each regulatory proposal and of feasible alternatives, and should make the estimates available in accessible format to decision-makers. The costs of government action should be justified by its benefits before action is taken.

##### **7. Is the distribution of effects across society transparent?**

To the extent that distributive and equity values are affected by government intervention, regulators should make transparent the distribution of regulatory costs and benefits across social groups.

##### **8. Is the regulation clear, consistent, comprehensible and accessible to users?**

Regulators should assess whether rules will be understood by likely users, and to that end should take steps to ensure that the text and structure of rules are as clear as possible.

##### **9. Have all interested parties had the opportunity to present their views?**

Regulations should be developed in an open and transparent fashion, with appropriate procedures for effective and timely input from interested parties such as affected businesses and trade unions, other interest groups, or other levels of government.

##### **10. How will compliance be achieved?**

Regulators should assess the incentives and institutions through which the regulation will take effect, and should design responsive implementation strategies that make the best use of them.

Source: OECD (1995) *Recommendation of the Council of the OECD on Improving the Quality of Government Regulation*, OECD/GD(95)95, OECD, Paris

41. One tool which can be used to help put the checklist into practice is the use of regulatory impact analysis (RIA). RIA examines and measures the likely benefits, costs and effects of new or changed regulations. RIA is about providing the information necessary to make better regulatory decisions. It aims to make transparent the costs and benefits of different regulatory and non-regulatory options that may be suggested by ministries and policy makers. In this way, the trade-offs between different policy options are more apparent to policy makers.

42. Many OECD countries have substantial experience with the use of RIA in some form, even though it is of relatively recent introduction. The majority of OECD countries began to introduce RIA in the latter half of the 1990s. The use of the tool has spread rapidly and currently the governments of most OECD countries use some form of RIA in their decision making process.

43. A key element of an effective RIA process is that once a decision has been taken that government action is required to address an issue, RIA ensures that all options to deal with the issue are assessed. It therefore explicitly requires a consideration of alternatives to traditional regulation, including the option of taking no policy action.

44. In addition, the increased use of RIA will have an important educative impact on policy makers. The publication of RIAs will help disseminate information about the types of alternatives that are available and the costs and benefits of each. The stock of published RIAs will be a resource which can be used by policy makers.

45. Like all tools, the usefulness of RIA in encouraging the consideration of alternatives to traditional regulation will depend upon how it is used. There is no single model for a good RIA program. When designing a RIA program it is necessary to take into account institutional, social, cultural and legal contexts in the relevant country. An OECD study has identified a number of best practices in member countries which maximise the benefits to be gained from implementing a RIA program (box 2).

**Box 2. Getting maximum benefit from RIA: best practices**

1. Maximize political commitment to RIA.
2. Allocate responsibilities for RIA program elements carefully.
3. Train the regulators.
4. Use a consistent but flexible analytical method.
5. Develop and implement data collection strategies.
6. Target RIA efforts.
7. Integrate RIA with the policy-making process, beginning as early as possible.
8. Communicate the results.
9. Involve the public extensively.
10. Apply RIA to existing as well as new regulation.

*Source : OECD (1997) Regulatory Impact Analysis. Best Practice in OECD Countries, Paris.*



46. RIA is most effective when it is integrated into the decision-making process. It provides a useful framework for policy makers at the initial stage of thinking about what type of policy response is required to deal with an issue. In particular, RIA, if done properly, requires that policy makers abandon the traditional 'regulate first' approach and consult widely and consider alternative policy instruments.

47. The most benefit will come when it is more than an 'add-on' or after thought in the process. Unfortunately, RIA is often done as an after thought once a decision to regulate has been taken. It is important that RIA be conducted early enough to inform policy maker's decisions. It is also important that the RIA be of sufficient quality. It must be based on thorough and objective research and analysis.

***Ultimately cultural change is required***

48. The preceding discussion demonstrates that the policy making environment has a crucial impact on the consideration of alternatives to traditional regulation. If alternative instruments are to be actively considered and used when they are the best option to deal with a policy issue, there needs to be a good policy making process in place, supported by information about alternatives approaches and their advantages and disadvantages.

49. A good policy making process is essential if the full range of options to deal with a policy issue are considered and evaluated fully. The use of RIA is an important step in the right direction. In countries where the concept of RIA is new, it may be prudent to introduce RIA elements over time as support for it grows and expertise in its use develops. Initially, for example, there could be a general requirement to identify and consult with those affected by a regulation prior to its introduction. In itself, such a consultation requirement could generate information about possible alternatives to the approach being considered. This could develop over time to require more quantitative estimates of costs and benefits to be prepared for the full range of possible policy responses.

50. Process, while essential, is not be sufficient to effect the cultural change required to ensure a more complete consideration of alternative instruments. Information regarding what works and under what circumstances is also necessary to overcome many of the impediments to using alternatives. This information is a key tool for breaking the 'regulate first' culture that may exist in some ministries and among some regulators. It is also important that information is made available to citizens in order to increase acceptance of alternative instruments as legitimate and effective responses to policy issues.

## A FRAMEWORK FOR ASSESSING REGULATORY ALTERNATIVES

51. This section discusses a number of criteria which can be used to construct a framework which could be used to assess and evaluate the appropriateness of using alternative instruments in various situations. Overall, the instrument or approach chosen to address a policy issue should be ‘effective’ in terms of addressing the identified problem and ‘efficient’ in terms of minimising costs. To these rather broad criteria a number of more specific criteria – relating mainly to implementation and practical considerations – can be added to build a useful framework for assessing various alternative instruments and highlighting the advantages and disadvantages of each instrument in specific circumstances.

### **Effectiveness**

52. An important criterion for choosing among alternative policy instruments is their effectiveness in achieving the desired objective. This criterion is concerned with degree to which available instruments produce outputs or results that meet policy goals. Clear specification of the objective(s) is central to being able to assess the effectiveness of the various policy responses. This is not always the case: often objectives are not explicitly stated, poorly specified or there may be several potentially conflicting objectives. It is also preferable that the policy response be targeted to deal with the underlying problem and not simply treating the symptoms of the problem. For example, if there are concerns that a monopolist utility is using its market power to price above competitive levels, it may be preferable to adopt policy responses which deal with the existence of market power (for example by structurally separating elements of the utility and introducing competition where possible) rather than simply setting prices.

53. The relative effectiveness of some instruments may be difficult to determine ex ante. This may especially be the case when considering instruments which have not been widely used in a particular circumstance – there may be a lack of empirical evidence upon which relative assessments can be made. However, tools which may be used include cost-benefit analysis, cost effectiveness analysis, statistical analysis and quantitative modelling of expected impacts and outcomes. Ex post evaluation of effectiveness can be easier because of the availability on actual outcomes and impacts.

54. The effectiveness of a policy option should also include an evaluation of compliance and enforcement. Some countries have published guidelines to help policy makers design policies and instruments with high levels of compliance. The Dutch, for example, have developed the ‘table of eleven’ which provides a checklist of points to be applied to draft legislation to assess its likely level of compliance and enforceability. A policy instrument is not very effective if it targets its objective very well but there is an inadequate level of compliance. There needs to be some mechanism for monitoring compliance so that the government or regulator is able to determine the extent of compliance and determine reasons for non-compliance.

55. The design and implementation of the policy instrument can influence compliance levels. Several factors will influence compliance levels for a particular instrument:

- The target group has to be aware of the regulation and understand it;
- The target group has to be willing to comply (whether through economic incentives or enforcement actions); and

- The target group must be able to comply.<sup>3</sup>

56. Compliance is an important element of effectiveness and the level and scope for compliance with the various alternatives to traditional regulation is an important criterion with which to assess their appropriateness. However, the aim is not necessarily for 100 per cent compliance. The trade-off between higher levels of compliance and increased monitoring and enforcement costs may be such that less than full compliance is optimal.

57. Overall, the preceding discussion indicates a number of characteristics of effective policy instruments. In particular effective instruments should:

- Address clearly specified objectives;
- Be integrated and consistent with other regulation; and
- Have effective monitoring and compliance mechanisms.

### **Efficiency**

58. Where there are a number of policy options open to policy makers they should assess which is the most efficient instrument available to meet their objectives. The most efficient instrument is that which maximises benefits it creates while minimising the costs it imposes<sup>4</sup>. The most efficient policy instrument maximises community welfare.

59. A problem for policy makers is that it can be very difficult to assess the costs and benefits of various instruments and therefore to determine which is the most efficient instrument. Techniques such as cost benefit analysis, cost effectiveness analysis and others can help provide some of the information required by policy makers. But these techniques can be data intensive and difficult to apply in some situations. This does not mean that there should be no attempt to assess the relative costs and benefits of different instruments – rather it is a call for it to be done early in the policy process and to be realistic about the results which will be obtained.

60. The degree of flexibility given to the target group in terms of how they can comply with the policy instrument can influence the efficiency with which the instrument is able to achieve the objective set for it. Those subject to the regulation will have incentives to comply at the lowest possible cost, but in order to act on the basis of these incentives they must have the flexibility to choose the course of action which complies with the government's requirements and also minimises their costs. Flexibility will provide the target group with the opportunity to look for innovative (lower cost) ways of complying with the government's requirements. Some members of the target group may find ways of complying with requirements which had not been considered by the government or regulators when the policy instrument was introduced.

61. In cases where the government has decided to act to achieve a given objective, cost effectiveness may be the appropriate tool to choose between policy options. This criterion requires that the specified benefits be achieved at the lowest possible cost; it does not require the full quantification of benefits. It is therefore less demanding in terms of information required regarding the benefits of the action than a full cost benefit analysis.

62. Administrative and operating costs may be more readily measured or estimated. This would include the cost of designing and implementing the policy option and the ongoing cost of running and overseeing the operation of the policy. Policy design, implementation and operation costs are borne by governments (or regulators).

63. Those subject to the regulation will bear the costs of complying with the requirements imposed on behalf of the community. These costs may be direct financial costs (which may be relatively easy to measure) such as the cost of paying for a permit or equipment required by a regulation or they may be in terms of time (for example, filling in forms and applying for permits). All policy options are likely to impose compliance costs on the target group. The question for choosing between policy options is whether the compliance costs are proportionate to the size of the problem being addressed and to ensure that the option chosen does not impose unnecessary costs.

64. Overall, this discussion indicates a number of characteristics of efficient policy instruments. In particular efficient instruments should:

- Maximise benefits and minimise costs;
- Provide a degree of flexibility where possible to allow the regulated to find the lowest cost way of complying with specified requirements; and
- Minimise compliance costs – both those borne by regulated entities and the government itself.

### **Equity and fairness considerations**

65. Equity and fairness considerations also have a bearing on the choice of policy response. Not only can different instruments result in different levels of benefits and costs, but the distribution (or perceived distribution) of the benefits and costs can differ between groups in society and/or between geographic areas (commonly for example, between urban and rural areas).

66. The perceived fairness of different instruments can influence the public's acceptance of the instrument, and hence the level of compliance. In turn this has implications for the effectiveness of the instrument – a policy instrument is unlikely to be effective in achieving the government's objectives if there is a high level of non-compliance. Perceptions of fairness can also have direct cost implications. An instrument which is perceived to be unfair is unlikely to be the most cost effective instrument available if the government must devote significant resources to enforcement and monitoring compliance.

67. The degree of political accountability also has an important influence on perceptions of fairness. Those who make decisions should be subject to some oversight to ensure that they implement regulations as intended and do not overstep their authority. Transparency can be an important mechanism for ensuring accountability of regulators. An important mechanism which can enhance the transparency of regulation is the publication of guidelines covering the process by which regulations are made, and how they will be applied.

68. Avenues of appeal are also an important element of accountability. Those subject to the regulation should feel that there is an opportunity for review by an independent body if they disagree with decisions or actions of the regulator.

69. In some cases it may be that perceptions of the fairness of an instrument may not be based on fact or objective analysis. Transparency when specifying the objectives of the policy and why it is needed, as well as information regarding the suitability of alternatives, can help overcome inaccurate perceptions.

70. This discussion suggests that equity and fairness considerations are best embodied in policy instruments which:

- Are transparent in their operation and impacts; and
- Contain appropriate appeals mechanisms.

### **Summary: A framework to guide the choice of policy instrument**

71. The preceding discussion can be summarised in a form of checklist which can be used to assess the merits of different policy instruments to deal with a particular policy issue. It can be characterised as a series of questions – to what extent do the options under consideration by government or regulators:

- Address clearly specified policy objectives?
- Integrated and consistent with other regulations?
- Have effective monitoring and compliance mechanisms?
- Maximise benefits and minimise costs?
- Provide a degree of flexibility where possible to allow the regulated to find the lowest cost way of complying with specified requirements?
- Minimise compliance costs – both those borne by regulated entities and the government itself?
- Transparent in their operation and impacts?
- Contain appropriate appeals mechanisms?

## ALTERNATIVES TO TRADITIONAL REGULATION: MARKET-BASED INSTRUMENTS

### 1 Introduction

72. Market-based regulatory instruments act to change or modify behaviour through the economic incentives facing citizens and businesses. They primarily operate through changing relative prices or making trading opportunities available where they did not previously exist. Businesses and citizens respond by making decisions based on their own assessment of the costs and benefits of various actions given the incentives put in place by the market-based policy instrument. This is in contrast to traditional command and control regulation which often specifies in detail how the objective is to be achieved.

73. The degree of government intervention involved in using market-based instruments to achieve policy objectives varies widely. In some cases the instrument may involve very direct government intervention – such as the manipulation of tax rates or subsidy payment to achieve objectives. In other cases the government's role may be to help establish the legal or institutional structure required for a market to function – but not be involved in the day to day operation of the market.

74. It is important to note, however, that the government is responsible for determining the overall objective of the policy. In addition, governments have an important role in establishing the regulatory and institutional environment within which market-based instruments operate. The challenge for governments and policy makers is to ensure that the framework of incentives created by the market-based instruments achieves the policies specified objectives.

### 2. What are market-based instruments?

75. Market-based instruments (also often referred to as economic instruments) work by using market signals – that is prices – to provide an incentive to businesses and citizens to act in a way which will achieve the government's policy objective. An important category of market-based instruments are fiscal measures such as taxes and subsidies which are used to influence pricing signals facing businesses and citizens. The direct use of markets and the creation of markets is another way that market-based instruments can be used to achieve the government's objective. As an alternative to intervening in decisions directly, the government can facilitate the opportunities for agents to participate in voluntary exchanges (of for example, permits or rights to undertake certain activities) in a way which achieves the policy objective.<sup>5</sup>

76. Box 3 provides some examples of the types of market-based instruments used in OECD countries.

### **Box 3. Market-based Instruments: Some Examples**

Trading schemes are a common form of market-based instrument. Such instruments can involve the government setting an allowed level of an activity, such as the production of carbon dioxide, and allocating emission permits to firms. But the firms are then free to trade these permits amongst themselves. In this way the government is able to specify the total level of emissions but not impose limits on individual firms. Trading schemes have also been used to allocate water between competing uses or to allocate 'slots' for aircraft to land at congested airports.

Fiscal measures – such as the use of taxes and subsidies – are also commonly used market-based instruments. Taxes are often imposed on harmful activities to make them relatively more expensive and so less will be produced or consumed. For example, in many countries high tax rates are imposed on tobacco products to discourage their consumption. Alternatively, subsidies can be used to encourage production or consumption of activities or projects which are considered desirable.

#### **2.1 *When are market-based instruments commonly used?***

77. Market-based instruments have a long history in dealing with environmental problems and natural resource management issues. This is where there is a vast literature and experience.<sup>6</sup> But market-based instruments have also been used in other areas, often as a mechanism to allocate scarce resources such as airport landing slots or radio frequency spectrum.

##### **2.1.1 *Environment and natural resource management***

78. Many types of environmental problems arise because of a form of market failure known as an externality. An externality arises when the actions of one person affect the welfare of another (in an either positive or negative manner) and these affects are not the result of a market transaction or are not reflected in relative prices. For example a factory which discharges pollution into a river may adversely affect a downstream fishery. The factory does not take this cost into account when it decides how much pollution to discharge into the river – it therefore produces more pollution than would be optimal if it was required to take this cost into account. This is referred to as a negative externality.

79. Corrective actions like taxes have been used to deal with this sort of externality. The government can impose a tax on the harmful activity – that is the pollution – so that the factory takes account of the full cost of the pollution when deciding how much to produce. Alternatively, a subsidy could be paid to the downstream fishery to compensate it for the negative effects of the pollution. The role of the economic instruments is to ensure that the private costs and benefits of actions undertaken by businesses and citizens correspond with the wider social costs and benefits of their actions.

80. The taxes have been used to achieve explicit environmental objectives for some time in OECD countries. Box 4 provides some examples from Norway, which has been explicitly using taxes as a policy instrument to achieve environmental objectives since 1971.

#### **Box 4. Environmental taxes in Norway**

Norway uses taxes extensively as an instrument to achieve environmental policy objectives. It is also important to note that these instruments have been used for some time, for example, the first tax levied with an explicit environmental purpose was in 1971, when a tax was imposed on the sulphur content of mineral oil.

There was a significant increase in the use of tax instruments during the late 1980s and early 1990s in Norway. At present taxes are imposed for environmental purposes in a range of cases including:

- Taxes on greenhouse gases;
- Carbon dioxide tax on petrol, auto diesel, mineral oil, incinerated waste and the offshore petroleum sector;
- A sulphur tax on mineral oil, petrol and auto diesel (with tax levels differentiated according to the sulphur content of the product);
- Environment tax on beverage packaging (differentiated according to the return rate of materials, with a base level of tax on non-refillable beverage containers);
- Tax on environment and health damaging chemical products; and
- Tax on pesticides.

This is not a full list of all environmental-based taxes used in Norway, but it is intended to give an insight into the range of objectives for which taxes can be used as a policy instrument.

*Source* : Government of Norway

81. Trading systems are also used to deal with pollution emissions. These instruments allow the government (or authority responsible for establishing the scheme) to specify the total amount of the emissions to be allowed and then to allocate the permits to polluters to allow them to pollute. The system then enables permit holders to trade their allocation to other entities. Box 5 provides a multi-country example of a trading scheme for carbon dioxide emissions.

#### **Box 5. EU trading scheme for carbon dioxide emissions**

The EU emissions trading scheme commenced operation on 1 January 2005. The initial focus of the scheme is on carbon dioxide emissions from large industrial emitters. The scheme is designed to operate in two phases; the initial or pilot phase runs from 2005 to 2007 and a second phase from 2008 to 2012.

Each participating member state must develop a national allocation plan which set out the total level of emissions allowed and how they will be allocated among national industries. The unit of the trading scheme is the 'EU Allowance' a single EUA allows the holder to emit one tonne of carbon dioxide within a given year. The scheme requires that at the commencement of market 95% of permits must be allocated by EU Member States free of charge.

Permits are issued to allow emissions and firms must hold sufficient permits to cover their total emissions each year. Firms which do not require their total allocation are free to sell them to other firms, while those with a deficit can buy additional permits on the market. If a firm emits more carbon dioxide than the amount for which it holds permits it is subject to a penalty of 40 euros per tonne (rising to 100 euros per tonne from 2008).

Monitoring of the scheme in each country is undertaken by a government approved 'competent body'. This body must establish and manage a registry of allowances. The authority is also responsible for ensuring that firms report



their emissions each year and verify the validity of the data submitted.

Since the commencement of the market there has been a significant increase in the prices per tonne of carbon dioxide.

Source : European Environment Agency 2005

82. Market-based instruments are also used to deal with natural resource management issues in a broader sense (that is beyond pollution and waste issues). This could include the use of market-based instruments to protect native forests and habitat and for biodiversity conservation. An example of such an instrument is the use of transferable permits for clearing native vegetation to create agricultural land. The government, on behalf of society, may have an objective of regulating the clearing of native vegetation in order to protect the natural environment and biodiversity. Rather than simply banning all clearing – which imposes a blanket ban on clearing regardless of the agricultural value of the land, the government could specify how much clearing will be permitted and issue clearing permits. Farmers would then be able to trade these permits so that farmers with valuable agricultural land could buy permits, from those with less valuable farming land. In this way the restriction on the total amount of land clearing is protected and in addition the mechanism helps ensure that the land which is cleared is of high agricultural value.

83. Auction type mechanisms have also been used by governments to purchase environmental ‘services’ or benefits. For example, the Conservation Reserve Program has been operating in the United States since 1985. Under this scheme farmers can receive annual rental payments for up to 15 years and other financial assistance to establish programs and undertake work to reduce soil erosion, improve water quality and wildlife habitat on agricultural land.<sup>7</sup> Participation in the scheme is voluntary and the administering agency ranks applications for assistance using an Environmental Benefits Index (EBI) to measure the impact of the proposed conservation measures. Funds are allocated to those projects which offer the highest EBI.

84. The Victorian State Government in Australia has recently piloted a similar program. The BushTender scheme involves landholders bidding to provide management services to improve the quality or quantity of native vegetation on their farm. The State Government provides funds to the farmers on the basis of a Biodiversity Benefits Index, which measures the conservation value of the site and the value of services offered by the landholder per dollar of payment. Those proposals ranking the highest on the Biodiversity Benefits Index receive priority funding.

### 2.1.2 *Allocating scarce resources*

85. The creation of markets, especially through the use of auction type mechanisms can be used to allocate scarce resources rather than relying on governments to administratively allocate them using a command and control regulation.

86. One example is the allocation of radio frequency spectrum. In the past sections of the spectrum were allocated to different uses (such as commercial television, radio broadcasting, military use, amateur radio operators etc) and specific users within each category (for example to specific channels within the spectrum allocated to television) through government regulations. Each user was allocated specific parts of the spectrum for their use and a change in regulation was required to amend the allocation. Often a regulator was established to ensure compliance with the regulation and deal with any disputes. However, it is increasing common in OECD countries to use auctions to allocate new spectrum (or spectrum freed up when existing users leave or reduce their requirements) among potential users. Government specifies the amount of spectrum available (and any conditions or restrictions on its use) and then opens the allocation of that spectrum to uses on the basis of competitive bids.

87. A similar auction mechanism can be used to allocate landing slots for aircraft at congested airports. Airlines require ‘slots’ which give them permission to land and take off at certain times. These slots are used to ration the number of aircraft that can take off or land during a particular time. The issue of slots is very important at major airports which suffer from congestion problems – not all aircraft can take off or land at the same time. Rather than rely on very detailed administrative allocation of slots between competing airlines governments can specify the number of slots to be available each period and allow airlines to trade the slots among themselves to get the allocation which best meets their demands.

### **3. Assessment of the advantages and disadvantages of market-based instruments**

88. The advantages and disadvantages of market-based instruments relative to other policy instruments will depend, in part, on the specific policy issue to which they are applied. However, this section will examine in what cases market-based instruments are likely to be the most effective; efficient and equitable instrument to achieve the government’s policy objective.

#### **3.1. Effectiveness**

89. This criterion examines the extent to which the policy instrument achieves the objective for which it was introduced. The framework for analysis used in this report highlights three characteristics of effective policy instruments, they should: address clearly specified objectives; be integrated and consistent with other regulations; and must have effective monitoring and compliance mechanisms.

##### *3.1.1 Addressing clearly specified objectives*

90. The objective that the policy instrument is trying to achieve must be clearly specified if it is to be an effective instrument. A clear specification of objectives is also necessary to enable progress towards attaining the objective to be measured and for feedback back to policy makers regarding changes that may be required to the policy instrument.

91. In many cases the objectives of a market-based instrument are clearly specified. Trading schemes which aim to limit harmful emissions set a cap on emission levels and then permit polluters to allocate the total amount between them using a market-based trading. The objective is clear – harmful emissions will be restricted to a certain amount. Similarly, a mechanism to permit the allocation of airport landing slots through market mechanisms has the objective of allocating slots to those who value them most highly.

92. In other cases the objective may be relatively clear and easy to understand but lack some precision. The introduction of a tax to ‘reduce’ emissions or ‘encourage’ recycling is a clear objective, but it lacks clarity in terms of what quantifiable change is required for the instrument to be considered successful. Is any reduction in emissions sufficient? The lack of targets or quantitative indicators of success is unlikely to be conducive to the successful use of a market-based policy instrument.

93. It is also possible that some market-based instruments may have implicit objectives. In particular, taxation instruments, or the sale of marketable permits, may have a revenue maximisation objective which is not explicitly stated. This will be a problem when the objective of maximising revenue for the government is in conflict with the attainment of other (perhaps explicitly stated) objectives – it may lead to tax rates being set too high or restrictions on competition in order to maximise the value of permits.

94. Instruments which have multiple, and possibly conflicting objectives, are highly unlikely to be effective. It may be unclear which objective is being pursued as the primary objective and how this impacts on the design and implementation of the instrument. This is not an issue affecting market based instruments alone – the effectiveness of other policy instruments will be affected if objectives are not clearly specified.

95. An issue with the use of market-based instruments to achieve policy objectives is that they rely on altering the economic incentives facing citizens and businesses as a way of changing behaviour. However, it can be difficult to determine the size of the incentive necessary to achieve the objective. For example, if there is consideration of a policy to use a tax to reduce the discharge of pollution into a river it is necessary to determine what tax rate should be used.

96. Timing is also an issue with the use of market-based instruments. Not only may there be uncertainty with regard to the effects, but there may also be uncertainty with regard to when the effects will occur. It may take time for businesses and citizens to change their behaviour in response to changed incentives as a result of a market-based instrument.

97. This suggests that monitoring will be an important element in ensuring the effectiveness of market-based instruments. The government or the relevant regulator will need to ensure that the instrument is achieving its objectives in a timely manner. The monitoring process can be used to adjust the instrument as more information regarding effects and timing becomes available over time.

98. Market-based instruments will then be best used where there can be explicit monitoring of how well the instrument (tax, subsidy, trading scheme etc) is achieving its objectives. The objective being targeted should therefore be explicitly quantifiable or measurable in some way. Quantification enables the government to assess how well the instrument is working and what modifications might be required to ensure it achieves its objectives.

99. The time taken for market-based instruments to have an impact also suggests that they are unlikely to be suited to policy problems which require a rapid and immediate impact. Discharge of highly toxic chemicals or pollutants, for example, may require traditional regulation to stop the action immediately.

### *3.1.2 Integration and consistency with other regulation*

100. An effective instrument should not act against other instruments and should complement them if they are trying to achieve a similar objective. Integration with other regulation is important when implementing market-based instruments because they must operate within the legal and institutional framework established by other regulation.

101. Market-based mechanisms are often used in combination with other policy instruments to form a package of instruments to achieve a given objective. For example, container deposit schemes to encourage recycling of bottles may be accompanied by an information campaign to encourage recycling. In addition, a market-based instrument can also be used in combination with traditional command and control regulation. The traditional instrument could set a base requirement which must be complied with but with the market-based instrument offering some flexibility beyond the minimum stipulated by the traditional regulation.

102. There can be difficulties in integrating market-based mechanisms across jurisdictional borders. This can be because of different regulatory systems across jurisdictions – both between national jurisdictions and sub-national jurisdictions in federal systems. The use of fiscal instruments, including taxation and subsidies, can be difficult across jurisdictions where the rates may need to be approved by different governments and administrations.

103. The use of trading instruments can also be more complex across jurisdictional boundaries where the framework for the market will need to be established in a number of jurisdictions to ensure an effective scheme. This may slow their introduction as the jurisdictions involved put in place the framework necessary to ensure the market can be established. One model is to appoint a market manager who has responsibility for monitoring the performance of the market and ensuring that the rules in place to ensure the smooth running of the market are respected.

104. These cross jurisdictional problems are not necessarily insurmountable, and there are examples of market-based mechanisms being used successfully across jurisdictions – the European trading system for carbon dioxide being an important example. But the need to ensure consistent with other regulatory arrangements across jurisdictions can complicate the introduction and use of market-based instruments.

### *3.1.3 Effective monitoring and compliance mechanisms*

105. An effective instrument must be monitored to ensure that it is working as intended and is achieving its objectives. It is also necessary that those subject to the policy instrument comply with it. The compliance and monitoring issues are likely to vary in nature between fiscal and trading type instruments.

106. Compliance with market-based instruments is likely to be high given that these instruments act through the economic incentives facing the businesses and citizens. Once the incentives structure is put in place, citizens and businesses make decisions based on their own assessment of the costs and benefits of different actions. If the appropriate incentives have been put in place, their actions will help achieve the government's policy objective.

107. However, there may be possibilities for avoidance or evasion of market-based instruments which would weaken their effectiveness. For example, it may be possible to understate the level of taxable emissions produced and so evade payment of appropriate taxes. Alternatively, there may be unregistered companies operation in the unofficial economy, thereby avoiding payment of taxes.

108. Complexity of the tax or subsidy arrangements will also be an issue. If the arrangement is very complex, for example, if it requires significant data on emissions and there are various tax rates applicable, there will be stronger incentives not to comply. This will especially be the case if the tax or subsidy benefits are not considered to be significant relative to the effort required to comply.

109. Trading-based schemes may be less subject to deliberate avoidance – and the incentives may be such that firms do not want to avoid participation. The complexity of the system will be an important consideration. The more complex the system – in terms of, for example, needing to register to participate, completing documentation during trading, complexity of the rules governing the trading arrangements etc, the greater the costs involved for those participating in the scheme. These costs may be both direct financial costs, for example, paying to register, but also indirect costs in terms of greater uncertainty affecting future investment plans.

110. High participation costs (relative to the benefits of participating) will discourage citizens and firms from actively trading. This can have the effect that there may be less trade than would otherwise have been the case or only large firms will participate.

111. Compliance strategies may therefore be as important in relation to market-based instruments as for other instruments which aim to change the behaviour of businesses and citizens. Prior to introducing a market-based instrument there should be an analysis of the likely level of compliance with the instrument and the factors which affect compliance. This information can then be used to improve the design of the instrument before it is introduced.

112. Effective monitoring of the operation of market-based instruments is particularly important given the potential uncertainty regarding the impact of the policies. Unlike command and control regulation which may, for example, set a strict limit on some activity, many market-based instruments which work through incentives will depend upon the individual reactions and decisions of agents.

113. Because the effects will take time to be known, there may need to be revisions to the instrument over time to ensure that it continues to achieve the government's objectives. A tax on a harmful emission may need to be adjusted if the impact on emission levels is greater or less than envisaged when the instrument was introduced. An effective monitoring regime will help provide information necessary to make the adjustments to ensure the government's objectives are met. However, constant changing of the instrument will lead to uncertainty and impose additional costs on citizens and businesses. Market-based instrument are therefore unlikely to be the most appropriate instrument if there needs to be constant adjustments.

114. Effective monitoring by governments or regulators is also necessary to prevent abuse and manipulation of market-based schemes by those whom the schemes are intended to regulate. Anti-competitive behaviour by those subject to the scheme may be problem – especially in the case of regulatory instruments based on market trading. Large, dominant firms participating in the market may be able to use their market power to harm potential competitors. For example, if there is a market for permits to pollute, a large firm may try to buy up permits in excess of their needs in order to prevent their competitors from obtaining a permit or to push up the price to impose a financial penalty on others. Incumbent firms may also collude and manipulate the market as a way of preventing new entry to the industry.

115. Existing anti-trust regulation may apply in situations where market participant abuse their market power or act in other anti-competitive ways. Alternatively, a market manager may have the power to take corrective action to ensure the proper functioning of the market. It is therefore essential that the market-based instruments operate within a supportive regulatory framework.

### **3.2. Efficiency**

116. The efficiency criterion relates to the extent to which the policy instrument maximises community welfare or net benefits. This criterion indicates that when choosing between several policy instruments which may be capable of achieving the government's objective, it is possible to distinguish them according to their efficiency in terms of achieving the objective. Efficient instruments should maximise benefits and minimise costs; be flexible; and minimise compliance costs.

#### *3.2.1 Maximising benefits and minimising costs*

117. The key advantage of market-based instrument is that they rely on decisions made by citizens and businesses in response to the incentives they face. The individual agent therefore decides how to respond given his or her individual assessment of the costs and benefits of different responses. The decisions taken will reflect the preferences of the individuals involved: the market-based schemes are therefore able to draw on information which is unlikely to be generally known by governments and regulators. This information can then be used to further refine the regulatory regime to ensure that the government's objectives are being achieved. Often when governments use traditional command and control regulation, they are required to estimate or infer such information when trying to develop the regulatory regime.

118. If the market-based scheme is well designed, it will put in place incentives which encourage businesses and citizens to act in a way which facilitates the attainment of the government's policy objectives. That is, the benefits of the scheme will be maximised by the agents acting in their own interests. The businesses and citizens will also have an incentive to minimise the costs of complying and achieving the government's objectives.

### 3.2.2 *Degree of flexibility*

119. Market-based instruments are, in general, very flexible instruments in the sense that they often do not specify in detail how firms or citizens are to respond. These instruments create and manipulate incentives, but individual agents make their own choices and decisions based on the incentives facing them.

120. Businesses and citizens can therefore respond to the induction of market-based instruments in the short term and in the longer term. This enables both static and dynamic efficiency gains to be achieved.

121. At the time when a market-based scheme is introduced, businesses and citizens factor in the new incentives and revise their decisions and the actions they take accordingly. While the agents themselves have the flexibility to respond to the new incentives their ability to respond in the short term can be limited by, for example, existing technology, contractual constraints or a lack of knowledge of alternative responses. The response of businesses and citizens in the short term will give rise to static efficiency gains.

122. In the longer run, businesses and citizens have much more flexibility to change behaviour and adapt to the new incentive structure created by the market-based instrument. Agents will face ongoing incentives to find the most efficient way of responding to the regulatory environment, and they may be able to respond by changing technology or the production process in order to maximise the benefits they receive given the incentive structure.

123. While providing businesses and citizens with a great deal of flexibility, once implemented market-based instruments may be difficult for governments to change easily. For example, once a market to trade in permits has been established there may be concerns that the market will develop independently of government and be difficult to change once established. Similarly, tax or subsidy rates, once established may take time to change – especially if they are to be made less attractive to businesses and citizens.

124. The extent to which governments can easily change market-based instruments is likely to be reduced where there are multiple jurisdictions involved. There may need to be protracted negotiations between governments and extensive consultation with stakeholders before changes can be made.

125. The flexibility that market-based instrument provide to citizens and businesses in terms of how they respond to the incentives created suggests that these tools are likely to be particularly useful (compared to command and control regulation) in situations characterised by:

- Rapid technological change – market-based instruments provide flexibility to adopt new technology easily, whereas command and control regulation may lag behind the latest technological developments and 'lock in' outdated technology;
- The industry or sector uses complex technology or processes – those involved in the sector are likely to have more information about the technology than regulators and so they can decide how best to respond to the incentives created. Traditional command and control regulation may attempt to 'micro manage' the production process by enforcing very details and precise requirements, but which may not be the best approach; and

- A degree of certainty as to the impacts of the instrument so that it does not need to be subject to continual change or adjustment.

### 3.2.3 *Minimising compliance costs*

126. Consideration of compliance costs should take account of the costs borne by both the regulated entity and the government or regulator itself. The extent of these costs will depend on the type of economic instrument being used – the type and extent of costs imposed on both the regulated and borne by government will differ widely between fiscal type instruments (taxes and subsidies) and trading instruments such as tradable permits or auction type mechanism.

127. In relation to fiscal instruments, the regulated will bear the direct cost of compliance (filling in the tax forms, applying for subsidies etc). The extent of these costs will depend upon the complexity of the arrangements, the amount of detail required in the application, the frequency of application etc. There is likely to be minimal scope for businesses and citizens themselves to reduce these direct compliance costs, which depend upon the design and implementation of the scheme by the government or regulator. However, there may be the opportunity for businesses and citizens to have some input into the design of the scheme if there is early consultation with affected stakeholders when it is being developed.

128. The advantage of these instruments is that they leave the regulated entities a great deal of flexibility in terms of how they respond to the incentives put in place by the tax or subsidy instrument. For example, in response to a tax on harmful emissions firms are free to change their production process in order to minimise the emissions, they may change the technology they use, or they may chose to put in place some form of filters to remove the emissions from the environment. In this way firms are free to choose the cost minimising option for them. They have a strong incentive to find the cost minimising response given the incentives established by the regulatory regime.

129. This suggests that compliance costs will be minimised if the tax or subsidy rates do not change often. There may therefore be a trade-off between altering rates to ensure the government's objectives are attained and minimising compliance costs (including uncertainty and disruption to the businesses' future investment plans).

130. The firms will also have an incentive to be very innovative in responding to the incentives framework created by the regulatory regime. The regulated entities may develop very innovate solutions which would not have been considered by government if they had used more prescriptive command and control regulatory approaches.

131. The creation of trading mechanisms will create a range of costs for both those participating in the market and the government or regulator who is responsible for establishing and providing oversight of the market. For those participating there may be direct costs such as registering to participate, but there are also likely to be significant indirect costs, such as the costs involved in understanding the market rules and how the market operates. This could involve significant expenditure on training staff and equipping them with new skills to operate in a new environment. It may be that the introduction of a trading scheme replaces other forms of traditional regulation and so it may require staff and citizens to develop a very new skill set.

132. The government will also bear costs in setting up a trading mechanism. There will be the initial set up costs involved in putting the market framework in place, including developing and passing any regulatory measures required. In addition, the government will bear on-going costs monitoring the operation of the market. These could include the costs associated with established and operating a market oversight body or undertaking periodic monitoring of the market to ensure that it is operating as intended and that participants are not trying to abuse any market power that they may have.

133. The more complex the trading mechanism, the more costly it will tend to be for both participating entities and the government. Prior to introducing such a mechanism there must be an assessment of the potential benefits of the trading systems against the costs involved in its operation.

### **3.3 *Equity and fairness***

134. A regulatory instrument should be considered equitable and fair in order to maximise its impact and ensure compliance. An aspect of many market-based instruments, which is perhaps less of an issue for command and control regulation, is the fact that in many cases these instruments work directly through prices – often involving increasing prices to reflect scarcity or to encourage reduced consumption. These price effects are often regarded as having direct equity consequences, especially for consumers.

135. The impact of price increases, for example, increasing the price of water in counties which face severe water shortages, is often regarded as impacting adversely on low income households. Such concerns can add to the political difficulties in implementing such mechanisms – especially when the price increases affect ‘essential’ goods or services which are regarded by the community as being basic requirements for normal living.

136. There are mechanisms which can be used to overcome such concerns. For example, one way to overcome the negative impact on low income households would be to compensate the household directly for its financial impact. In this way the pricing effect will continue to impact on the household’s decision making with regard to water use, but the household would not suffer from an overall reduction in disposable income.

137. It may however be a costly (and possibly controversial) process to calculate the compensation to be given to households. It would be necessary to assess the benefits of introducing the market-based instrument against the perceived negative impact on equity and the additional costs involved in providing financial support to low income households.

138. Other aspects of equity and fairness require that regulatory instruments should be: transparent in their operations and impacts; and contain appeals or dispute resolution mechanisms.

#### **3.3.1 *Transparency***

139. Transparency is an important attribute of an equitable and fair policy instrument because it ensures that those subject to the regulation can see its impacts and ensure that all regulated entities are being treated in a similar manner. If there are differences in the way entities are treated by the regulatory regime, the reasons should be open to scrutiny.

140. The transparency of fiscal type measures is likely to be relatively high because measures such as taxes and subsidies are likely to have been discussed as part of the government’s annual budget discussions.



141. The transparency of trading instruments will depend upon the design of the mechanism. The commercial importance of some trading arrangements may require that the details of individual purchases and sales be kept confidential. However, it may be possible to publish market information in a manner that protects commercially sensitive information but still provides enough data to reassure market participants and the community generally that the market is operating as intended. For example, in the case of permit trading schemes there could be an ownership registry which records who owns which permits but not the price paid for them. This would help ensure that a single entity was not trying to buy up all permits and then take advantage of its market power.

142. The transparency of a trading mechanism can be enhanced if there is an oversight body responsible for monitoring the market and ensuring that there is no abuse of market power or attempts to manipulate outcomes. Such a body may have access to all market data, including commercially sensitive data and so would be able to closely monitor the performance of the market. The oversight body could report to government and publish periodic reports on the market's operation.

### *3.3.2 Appeals and dispute resolution mechanisms*

143. Appeals and dispute resolution mechanisms help ensure that all stakeholders regard the regulatory instrument as being fair and equitable – both in terms of its impact on those whom it is intended to regulate and in ensuring accountability of those making and implementing the regulation.

144. In the case of fiscal instruments such as taxes and subsidies, those citizens or businesses who believe that they are being unfairly treated may be able to have an administrative review of the decision. If the result is unsatisfactory there may be recourse to an ombudsman to adjudicate the dispute. The details will vary between countries and will depend in part on how the instrument is implemented.

145. In the case of trading schemes, the design and nature of the scheme will determine the nature of the appeals and dispute resolution mechanisms open to those with a grievance or dispute. It would be possible, for example, for the market manager to have a role in resolving disputes among market participants.

146. However, it would be inappropriate for the market manager to resolve disputes between itself and a market participant. In such cases the scheme may establish an independent arbitrator to mediate and rule on the dispute. Ultimately, there may be recourse to the legal system and the courts, although this is often a costly and time-consuming process.

147. Regardless of the exact nature of the appeals and disputes resolution procedure put in place the key elements of a successful and fair system are that it be transparent in its operation and be accessible to those with a dispute (that is participation is not too costly and disputes are dealt with in an expeditious manner).

## ALTERNATIVES TO TRADITIONAL REGULATION: SELF-REGULATION AND CO-REGULATION

### 1 Introduction

148. The spectrum of regulatory instruments ranges from those which involve no government intervention through to explicit traditional command and control regulation. Self-regulation and co-regulation are instruments with no or limited government involvement.

149. This chapter examines the use of self and co-regulatory instruments in OECD countries and assesses their advantages and disadvantages, and explores under what circumstances are these instruments likely to be superior to other possible policy instruments. In some cases these instruments can reduce administrative burdens and bring decision making and control closer to the sector. But these advantages must be balanced against the possibility of anti-competitive behaviour by those involved, including complicit action by the authorities. The paper draws on examples of self and co-regulatory regimes in OECD countries to illustrate the discussion, but is not a comprehensive survey of the use of these instruments in member countries.

### 2. What are self-regulation and co-regulation?

150. Self-regulation typically involves a group of economic agents, such as firms in a particular industry or a professional group voluntarily developing rules or codes of conduct that regulate or guide the behaviour, actions and standards of those within the group. The group is responsible for developing the self-regulatory instruments, monitoring compliance and ensuring enforcement. Examples of self-regulation include: codes of practice; industry based accreditation arrangements; and voluntary adoption of standards.

151. Box 6 provides some examples of the range of instruments or mechanisms which are types of self-regulation used in OECD countries.

#### **Box 6. Instruments of self-regulation: some examples**

There is a long history of self-regulation of the professions. Self-regulatory agreements generally cover such aspects as qualifications, training requirements and codes of conduct or ethics. In the European Union, self-regulatory agreements cover professions such as: engineers; lawyers; travel agents; internet service providers; estate agents; hoteliers; and many others (EESC, 2005, p. 13).

Industry may also develop voluntary agreements relating to product quality or to provide information to consumers. For example, in 1997 the European Association of Consumer Electronics Manufacturers developed an agreement to reduce the amount of electricity used by electronic products, such as TVs and VCRs, while on stand by mode (BRTF, 2005, p. 55).

Industry associations may also establish voluntary accreditation or quality assurance schemes. Under these arrangements firms may advertise that they are members of the association or scheme and hence comply with some minimum standards. Accreditation is voluntary and the industry association has the role of ensuring that those who are accredited comply with the required standards.

Self-regulation may also involve establishing external dispute resolution procedures. Industry groups may, for example, appoint an independent arbitrator or ombudsman to investigate complaints against members of the industry. Decisions of the arbitrator can be binding on the firm involved and compliance is enforced by the industry association.

Source: BRTF 2005; EESC 2005; and Ministry of Consumer Affairs (New Zealand) 2005

152. Co-regulation entails explicit government involvement in the regulatory framework. Because this involvement can take many forms, it can sometimes be difficult to make a clear distinction between self-regulation and co-regulation. It is generally considered that co-regulation involves government giving explicit legislative backing in some form for the regulatory arrangements. The UK's Better Regulation Task Force (BRTF) uses a similar definition of co-regulation noting that 'co-regulation involves some sort of legal underpinning and can therefore be described as self-regulation with a legislative backstop' (BRTF 2005, p. 26).<sup>8</sup>

153. The specific types of instruments or mechanisms, such as codes of practices, voluntary agreements, dispute resolution procedures that may be created under a self-regulatory regime are similar under a co-regulatory framework. It is the degree of government involvement and legislative backing that determines the difference between the two.

154. A group of firms may develop codes of practice to regulate the behaviour or actions of members. This would be a self-regulatory mechanism. If these codes were supported by legal backing requiring members to abide by them and imposing penalties in the case of non-compliance, it would be a co-regulatory regime. Box 2 provides an example of how Australian law allows for industry developed codes of practice to be 'prescribed' so that they are legally enforceable. Other OECD countries also have mechanisms to ensure that self-regulatory regimes can be legally enforced, for example, the Office of Fair Trading (OFT) in the UK can also have a role in enforcing industry developed codes.

#### **Box 7. Codes of practice under the Australian trade practices act**

The Trade Practices Act 1974 (TPA) is Australia's primary competition and anti-trust legislation. Its objectives are to enhance the welfare of Australians by promoting competition and fair trading and providing for consumer protection. Part IVB of the TPA permits an industry or consumer code of practice or conduct to be 'prescribed' as either mandatory or voluntary. A mandatory code is binding on all participants in the industry even if they have not signed the relevant code. A voluntary code is only binding on those firms who are signatories to the code.

The first mandatory 'prescribed' code was the Franchising Code of Conduct which requires that all potential franchisees are informed of all relevant facts when starting their business, and that they can access a fast and relatively inexpensive way to resolve any disputes.

Once 'prescribed' such codes are enforced by the Australian Competition and Consumer Commission, and businesses that are found to be in breach of a relevant code are subject to the general penalties and actions available under the TPA. Penalties and actions available include:

Injunctions to prevent the prohibited conduct continuing or being repeated;

Payment of damages; and

Other orders of various kinds in favour of persons who have suffered loss or damage because of the conduct. These may include, for example, rescission and variation of contracts; damages; provision of repairs and spare parts; and probation orders, community service orders and corrective advertising orders.

Source : ACCC (2003), "Summary of the Trade Practices Act 1974", ACCC publishing Unit, available at: [www.accc.gov.au](http://www.accc.gov.au).

155. The boundary between self and co-regulation is not always clear cut. For example, there may be government involvement in the development of self-regulatory arrangements without necessarily implying government support or official backing for the scheme. Government assistance might take the form of advice or participation by officials in the discussions establishing the scheme, but with no formal legislative backing or government responsibility for the scheme.

## 2.1 *When are self and co-regulation commonly used?*

156. These instruments have been used in a wide range of situation in OECD countries. Two key areas where the use of self and co-regulation are particularly widespread are in the regulation of the professions, and industry and business standards and codes of practice.

### 2.1.1 *Regulation of the professions*

157. There has been a long history of regulation of the professions in many countries, and this has taken many forms from explicit command and control regulation to self or co-regulation.<sup>9</sup> The overriding objective of professional regulation is generally to protect members of the public who use the services offered by the profession by providing information and ensuring the quality of the services provided, and to protect the reputation of the profession itself.

158. Regulation, in the public interest, may be required in the case of professional services where consumers of the services do not have complete information regarding the attributes or quality of the services they are buying.<sup>10</sup> The consumer may be unable to collect the necessary information. It may also be that information on the quality of the service provided can only be assessed after it is consumed.

159. This lack of information regarding the quality and type of service required may lead the consumer to make incorrect or inappropriate choices. Consumers therefore rely on the professional competence of the service provider to inform them of the options and in some cases to recommend appropriate courses of action. For example, in the case of professional services (such as, for example, medical services) consumers may rely on the professional to:

- Advise them as to what services need to be provided (for example, a consumer may not know what medical tests are required prior to prescribing them treatment);
- Provide information and assess the options available and the best approach to deal with the problem or provide the appropriate service; and
- Deliver the services necessary to meet the consumers' needs.

160. Self-regulation has been a common way in many OECD countries to help overcome the information deficiencies faced by consumers purchasing professional services. A common form of self-regulation in the professions occurs when the profession itself controls entry to the profession or the ability of practitioners to use certain labels (for example to be called an 'architect' or 'chiropractor'). Entry to a professional organisation may require candidates to meet minimum qualification levels or adhere to a code of conduct. Membership of the organisation provides information to the potential consumer as to the professional status of the person and their competency to undertake the services offered.

161. A recent review by the European Economic and Social Committee (2005) notes that self regulation of the professions has developed quite rapidly at the European level in the last twenty years, not the least within the liberal professions, which had already been widely self-regulating at national level for a long time. A wide range of professions have developed self-regulatory agreements including: engineers; lawyers; advertising agencies; restaurateurs; solicitors; travel agents; internet service providers; estate agents and hoteliers. These agreements tend to focus on qualifications, training and rules of professional conduct.

162. In relation to some aspects of industry or professional conduct the coverage of self-regulation has been reduced overtime. This is particularly in relation to pricing of services where there has been a tendency to remove recommended prices for professional services and abolish price fixing arrangements.

163. Self-regulatory or co-regulatory powers of professions can be quite wide. Table 1 provides examples of regulatory powers delegated to professions by the Government of Germany. These powers are usually exercised under a broad policy framework established by existing legislation. Membership of associations organising business in self-regulated sectors is required by law.

164. As suggested in Table 1, a wide range of regulatory functions can be devolved to industry or professional associations. In the German example these functions range from licensing professionals, oversight and provision of professional training, specification of professional duties and administering and assessing complaints.

**Table 1. Examples of professional self-regulation in Germany**

Sector/Economic activities	Players & regulatory powers
Craftsmen	Chambers of Handicraft and Guilds: Issue ordinances for examinations to become a journeyman; prepare and execute the exams (prerequisite to exercise the trade); Issue ordinances for examinations for master certificates; Oversight of apprentice-ships; Specification and oversight of vocational training; Co-administration of vocational schools.
Lawyers	Chambers of Lawyers (federal and for individual court districts) Issue licenses to become a specialist lawyer; Revocation of authorisations; Specification and supervision of professional duties.
Chartered Accountants	Chamber of Chartered Accountants Issue licenses to become a chartered accountant; Provide binding opinions to the authorities on the authorisation of new accountants; Provide opinions on the revocation of authorisations; Specification and supervision of professional duties.
Doctors	<i>Länder</i> Chambers of Doctors Organisation of emergency services and further education; Specification and supervision of professional duties of doctors; Specification of vocational training of receptionists, Setting up of bodies for examining wrongful care.
Pharmacists	<i>Länder</i> Chambers of Pharmacists Organisation of emergency services; Specification and supervision of professional duties; Specification of supplementary training.

Source: OECD (2004), p. 75.

### 2.1.2 Industry regulation

165. Self and co-regulation are also widely used by industry groups to promote ethical conduct, product standards, and fair trading. Industry associations also use self or co-regulation to provide more general consumer protection (such as policies on refunds and replacement of faulty goods) and to administer complaints and dispute resolution mechanisms.

166. The specification of product standards and certification is an important area where self and co-regulation play an important role in the regulatory framework in many OECD countries. Industry may develop and enforce quality standards for the products they produce. In some cases the industry may establish a certification process – either within the industry or using an independent body – to certify that products comply with a particular standard. Products which comply with the standards may display a symbol so that consumers know the product complies with the appropriate standard.

167. Industry also makes use of self and co-regulation to provide information and ensure other aspects of quality. For example, in many countries internet service providers have developed codes of practice to prevent the dissemination of harmful or inappropriate content on the internet.

168. Codes of conduct have also been widely used to regulate advertising and product labelling (see Box 8).

#### **Box 8. Spanish self-regulation of software labelling and advertising**

The average consumer of entertainment software in Spain is between 20 to 30 years old and the industry tends to develop products targeting this age group. As a result much of the software produced is unsuitable for young children, yet may be readily available to them.

In April 2001, prompted by the public administrations for consumer and minor protection, the Spanish Association of Publishers and Dealers of Entertainment Software (ADESE) which comprises 16 companies and represents approximately 80% of sales in the Spanish market, approved a self regulation code for labelling and advertising products for this industry. The code has two objectives:

- To give a clear orientation to consumers about appropriateness of contents for minors in topics as violence, sex, discriminatory behaviour and language; and second,
- To indicate the age of the user below which it is recommended that the material in the software is considered unsuitable.

The code was harmonised with the European system PEGI (Pan European Game Information), which was approved in 2003, and developed by the Interactive Software Federation of Europe in collaboration with consumer groups, European policy makers and parent organisations and other interested stakeholders.

In the Spanish case, the Advertisement Jury of Autocontrol, an independent watchdog for the advertising industry, is responsible for dealing with conflicts and complains provoked by misclassification and failures in the enforcement of the code of ADESE. More than 2 000 videogames have been classified in Spain but no complaint has been received.

Source: "Information provided by Public Administrations of Spain", ADESE [www.adese.es](http://www.adese.es), PEGI [www.pegi.info](http://www.pegi.info).

169. Self regulation is also widely used to provide information on product standards. The European Economic and Social Committee (EESC, 2005) observes that self and co-regulation are widely used to develop technical standards within Europe and encourage standardisation across member countries. The EESC notes that several thousand European standards have been adopted and that: 'While three quarters of these standards are covered by self-regulation by the parties concerned, one-third constitutes a form of co-regulation, developed in conjunction with the European legislator in the last fifteen years under what is known as the "new approach"' (EESC 2005, p. 7).

170. In addition, collective bargaining agreements made between workers and employers can be regarded as a form of self regulation. Collective agreements are voluntary attempts by unions and employers to regulate some aspect of the labour market. In some cases these agreements are recognised as being legally binding and so represent a form of co-regulation.

### **3. Assessment of the advantages and disadvantages of self and co-regulation**

171. As with all policy instruments, the advantages and disadvantages of self and co-regulation will depend to some extent upon the problem to which they are applied. This section explores the merits of self and co-regulation by asking in what circumstances or situations are they likely to be the most effective; efficient and equitable instrument available to achieve the desired policy outcome.

#### **3.1 Effectiveness**

172. The effectiveness of alternative policy instruments concerns how well the instrument achieves its desired objective. Does it do what it was introduced to do, for example, whether a voluntary agreement in a particular industry to reduce harmful emissions actually led to reduction in emission levels?

##### **3.1.1 Addressing clearly specified objectives**

173. In many cases, both self and co-regulatory instruments have clearly specified objectives. For example, voluntary agreements by television stations to not show material which may be inappropriate for children early in the evening are clearly focused on minimising children's exposure to such material. Voluntary rating of content in the media and video games is also intended to provide information on content and its appropriateness for children (see Box 8 for an example).

174. In other cases the objectives may be less clearly defined. When there are multiple objectives, it may be difficult to determine their relative priority – that is, which is the primary objective and which are considered to be of secondary importance. For example, in the case of a code of practice there may be potential conflicts between the objectives of ensuring the profession is of high repute and also protecting the interests of consumers. There may be incentives to 'cover up' undesirable practices or unethical members in the interests of maintaining professional reputation but at the expense of protecting and informing consumers.

175. The objectives of the scheme may change over time. The ability of a regulatory scheme to change and adapt to changing circumstances can be a positive attribute when change takes place in a transparent manner and those responsible for the change can be held accountable. However, when the objectives of the regulatory regime are poorly specified when it is introduced, it is possible that subtle changes can take place to favour those who introduced the scheme. For example, the focus of the scheme can change as a result of changes in its administration, or the priority given to different objects can change. The problem is that these changes can occur in a non-transparent manner and those responsible may not be held accountable.

176. A key issue in assessing how well self and co-regulatory instruments address specific policy issues is to ask what are the incentives affecting the behaviour of the industry or profession. This question is especially important when it is the industry or profession itself which is initiating and developing the regulatory instrument. It is important to ensure that the stated objectives of the scheme are not masking other implicit objectives. For example, a self-regulatory scheme which restricts membership to an association and only permits members to advertise themselves using a particular title such as certified accountant, may have a stated objective of providing information about quality, competence (in terms of being appropriately qualified) and reliability of the members to the public. However, the implicit objective of such a scheme may be to restrict membership in order to limit competition and enhance the competitive position of existing members.

177. In other cases, self or co-regulatory schemes may be initiated by the industry or profession with the implicit objective of acting before government introduces other, possibly more onerous, traditional regulatory remedies. For example, a study of self regulation and codes of conduct in the media industry to regulate access to 'harmful' content in the European Union concluded that "Historical analysis shows that self-regulatory schemes in the media have generally been designed in response to regulatory crisis in which legislative control could only be avoided by instituting an effective self-regulatory scheme (PCMLP 2004 p.71). This represents a form of capture of the regulatory process where the industry or professional association is able to directly influence the regulatory framework to ensure that their interests are protected, or at least suffer the minimum possible adverse consequences.

178. The extent to which industry initiated schemes replace government initiated regulation will depend, to some extent, upon the extent to which the interests of the industry or professional association diverge from the community's interests.

179. Industry initiated self regulatory schemes are more likely to be effective when the interests of the industry and the community more generally coincide. In this case the industry acting in its own interests will also be acting in the interests of the community as a whole. A code of practice or ethics developed by the an industry where there are a significant number of 'rogue' or unethical members will directly benefit industry members who sign up to the code (by ensuring them a greater market share and hence profitability) but it will also benefit consumers who will have more information to help them choose reputable industry members. Box 9 provides an example from the Australian State of New South Wales.

#### **Box 9. An Industry code of practice as an alternative to traditional regulation**

In 2004 the Minister for Education in the Australian State of New South Wales asked Standards Australia (Australia's peak non-government standards development and approval body) to develop a code of practice for members of the tutoring industry in response to criticisms of the industry by students, parents and in the media.

Standards Australia developed a code, addressing areas of concern in the industry such as recruitment, plagiarism, teacher qualifications and dispute resolution procedures, after widespread consultation with relevant stakeholders.

Standards Austrian argues that the development of such a code has avoided the necessity for government to resort to traditional command and control regulation. They note that "As is clear from the tutoring example Standards Australia is able to work with an industry sector to develop a code of practice as an alternative to Government regulation."

Source : "Standards Australia", available at [www.regulationtaskforce.gov.au/submissions](http://www.regulationtaskforce.gov.au/submissions), submission No. 47.



180. In cases where the interests of the community and industry or professional association members differ there may be problems – or at least concerns which must be addressed – with industry initiated self-regulation. A common concern with self-regulatory instruments is the ability of the industry or profession to use self-regulation in an anti-competitive manner. Industry or professional associations can, for example, be used to restrict new entry and thereby reduce competitive pressures or to agree on fixed or recommended prices – to the detriment of consumers (Box 10).

**Box 10. Professional self-regulation: pricing concerns in Norway**

Professional Associations of most of the high level education services, such as medicine, architecture, engineers, pharmacists, etc. organising more than 80% of the professionals, have historically in Norway used self-regulation as a key regulatory instrument in three main areas:

- Codes of professional conduct;
- Licensing of specialists; and
- Recommendations on prices/competition.

However, issues arose relating to potential conflicts between the pricing aspects of the self-regulatory arrangements and general competition regulation. Commencing around 1990, the Norwegian Competition Authority (NCA) initiated action against many rules and practices by professional associations that were restricting competition, including the practice of suggesting recommended prices for services.

While the NCA has dealt with formal price fixing arrangements, some concerns over the ability of professional bodies to remain. A report published by the NCA in 2005 concluded that professional associations formally exercise little influence on prices/competition today, but notes that “various forms of information exchange carried out by professional associations – about prices, market shares, costs etc – may facilitate tacit price arrangements.”

In addition, some agreements remain exempt from the provisions of the Competition Act, for example, fees for public medical treatment are based on negotiations between the Norwegian Medical Association and the public authorities.

Source: Ministry of Finance; Ministry of Government Administration and Reform; Norwegian Competition Authority: [www.konkurransetilsynet.no](http://www.konkurransetilsynet.no).

181. Restrictions on entry to the professions can have a significant impact on service quality and price – this is especially the case where there is a quantitative restriction on the number of people who can practice or enter the profession even if appropriately qualified. For example, a study by the Commission of the European Communities (2004, p. 15) notes that: “In the United Kingdom, the loosening of reserved rights to provide conveyancing services in the 1980s also lead to lower prices. In the Netherlands, the abolition of entry restrictions for real estate agents in the late 1990s led to an increase in new entrants, lower prices for real estate transactions and more flexible provision of services.”

182. A number of factors will influence the extent to which such anti-competitive outcomes are likely to result from self and co-regulation. A key factor will be the extent to which there is independent oversight or assessment of the instrument while it is being developed. The relevant competition authority may be involved in the development of the instrument or may be asked to assess an instrument's potential impacts on competition.

183. On-going monitoring of the performance of the regime (possibly by the competition authority) may also be necessary where there are competition concerns. This may take the form of regular voluntary reporting by the scheme administrators, or it may be necessary for the competition authority to conduct independent reviews and analysis of the scheme. Continuous monitoring can help ensure that the operation of the scheme does not change slowly over time to become more anti-competitive.

184. Transparency in the design, implementation and on-going administration of self and co-regulatory instruments is an important tool for ensuring that the instruments address clearly specified objectives. Transparency and consultation with stakeholders in the design stage of the instrument can help ensure that it addresses specific concerns relating to the industry and does not try to achieve poorly specified broad objectives. The issue of transparency – which is central to the successful operation of a self or co-regulatory regime, is discussed later in this paper.

185. The nature of the objective will also affect the effectiveness of self and co-regulation. In general, it may be expected that more technical objectives – for example technical standards which can be objectively measured and assessed and where the benefits of the regulation are retained by those party to the agreement – will be more likely candidates for using self or co-regulation than general – and less easily specified and measured – social objectives.

186. However, care must be taken that the specification of technical standards under a self regulatory regime is not used to exclude possible competitors or hinder incentives for innovation. Miller (1985) notes an example in the United States, where an industry association refused to extend standards coverage to an innovative type of valve. This action was likely to have limited sales of this product because it was not certified as having met the appropriate standards.

### *3.1.2 Integration and consistency with other regulation*

187. An effective self or co-regulatory regime must also be well integrated and consistent with other existing regulation. The effectiveness of an instrument will be impaired if it is at odds with existing regulation, or is not well integrated and consistent, and therefore adds to the complexity of the overall regulatory system. Such complexity in regulatory arrangements increases uncertainty affects business planning and investment and increases the costs of regulation.

188. In some cases, a self or co-regulatory regime can complement the existing regulatory framework. Traditional regulation may, for example, specify the minimum standard or objective required, but a self regulatory regime could ‘lift the bar’ higher by putting in place requirements that are more stringent than the minimum required by legislation. For example, occupational health and safety laws covering safety in the workplace may set out limits for worker exposure to hazardous chemicals or noise, but an industry developed code of practice may establish higher standards.

189. The role of incentives is again central to the issue of whether self regulation can be relied upon to ensure that those participating in the regime use it to deliver results in excess of those specified by existing regulation. Firms and professions will ‘lift the bar’ if they believe it will be in their best interests – in terms of increasing profitability or in enhancing their position or economic situation in other ways.

190. Problems in terms of integration with existing regimes may occur if the self regulatory regime is intended to address an issue for which the existing regulation is administered by different jurisdictions, and there are differences in requirements across jurisdictions. This may occur, for example, in countries with a federal system of government. The self-regulatory regime may be developed by a national business or professional organisation, but the detailed existing ‘black letter law’ is administered by lower levels of government.

191. The difficulty of integrating self regulatory regimes with existing regulatory arrangements can also occur in an international context. A study of alternatives to classic regulation in a European Union context noted that “Self-regulation obviously raises issues about how to ensure implementation and consistency across Member States. It is always going to be difficult to engage the whole EU market without the active support of European-wide trade organisations” (BRTF 2005, p. 27).

192. The need to co-ordinate self regulatory instruments across jurisdictions (either within federal systems, or in some cases internationally) suggests that the industry or professional association should have coverage over all the jurisdictions. A national industry association in a federal state, for example, could ensure that the regime is consistent with the legal requirements in all the sub-national jurisdictions. It would also have an important role in informing its members of the arrangements and highlighting any differences between jurisdictions for firms that may operate in multiple jurisdictions.

193. It is possible that co-regulation is more likely to integrate better with existing regulatory arrangements than poorly designed self regulation because of the active role of government officials in the development of co-regulatory arrangements.

### *3.1.3 Effective monitoring and compliance mechanisms*

194. Compliance is essential if a policy instrument is to be effective – no matter how well designed, an instrument will not achieve its objectives if those who are subject to it do not comply. An important element of compliance is monitoring. The aim is not necessarily for 100 per cent compliance because there may be a trade-off between compliance and levels of monitoring and enforcement, but for a level of compliance which balances effectiveness of the instrument and monitoring and enforcement costs.

195. The design and implementation of self and co-regulatory instruments will affect the likely level of compliance. The central issue is under what circumstances self or co-regulatory instruments are most likely to ensure sufficient compliance levels. The OECD (2000, p. 11) has noted that to ensure effective compliance with a policy instrument:

- The target group has to be aware of the regulation and understand it;
- The target group has to be willing to comply (whether through economic incentives or enforcement actions); and
- The target group must be able to comply.

196. The target group – often in the case of self or co-regulation, the industry sector or profession – must be aware of, and understand, their obligations to ensure the effectiveness of an instrument. This indicates that the association must be able to disseminate information to the membership and that the association covers a high proportion of the industry or profession being regulated.

197. In some cases coverage of the potential membership by the association is high – this is especially the case where membership is essential to undertake business. For example, it is a requirement in many countries that medical practitioners be registered by the appropriate self-regulatory body before they are able to practice medicine.

198. On the other hand where membership of an association is voluntary and coverage of the potential membership is not high, self regulatory instruments may be less effective. This may especially be the case if it is difficult for consumers to determine which firms are participating in the scheme.

199. Effective compliance with a self or co-regulatory instrument requires that those subject to the instrument have appropriate training and instruction relating to their obligations and how the instrument is administered. It is the responsibility of the industry or professional association to ensure that their members are fully informed and have the appropriate skills to ensure that they can comply with the regulatory arrangements.

200. In some cases it is also important that those outside the industry or profession are aware of the self or co-regulatory arrangements. This is especially the case where the regulatory arrangements are intended to provide information or other benefits to customers or the general public. Some techniques adopted in self regulatory regimes to inform others of their existence include the use of special logos to show membership or compliance with standards or codes of practice. For example, at the European level, members of the European Insurance Committee have adopted a logo to certify the application of a European code of good practice for the internet (EESC 2005).

201. The target group must also be willing to comply with the regulatory arrangements. Where certification or registration is compulsory to practice (such as in many professions) compliance levels and hence the effectiveness of the self or co-regulatory instrument is likely to be high.

202. Compliance will also be high when those subject to the regulation think that it will benefit their economic position. Membership of an industry association – which is regarded as reputable and which enforces a code of practice or ethics on its members – may be regarded by firms as an important way of signalling quality and reliability. Ethical firms would therefore regard signing up to the code a valuable way to differentiate themselves from ‘rogue’ elements in the industry and improve their competitive position.

203. Self or co-regulatory instruments may require external monitoring or auditing to ensure that they are achieving their objectives.

204. External monitoring is likely to be particularly important where there is some concern among the public, or policy makers, as to whether the scheme is working as intended. The external monitoring both imposes some constraints on the behaviour of the industry or professional participants in the scheme, but also provides reassurance and information to the general public.

205. External monitoring of a self or co-regulatory regime can be undertaken using a number of mechanisms. There may be periodic (for example, annual) reports on the performance of the regime prepared by the dispute resolution panel or ombudsperson (if one exists). This reporting could include information on the number of complaints received, how many were subject to a satisfactory conclusion and what other actions were taken.

206. Reporting on disputes and settlement provides some information on the performance of the scheme but it is not a complete or comprehensive overview of performance. Other relevant performance information could include the number of information requests, time taken to deal with queries, and a wider evaluation of the success of the scheme in terms of achieving its objectives. Such a review could be undertaken by an external review body.

207. There needs to be effective enforcement and penalties for non-compliance with the regime. In the case of co-regulatory arrangements the penalties could be specified under existing legislation and compliance and prosecution undertaken by a government agency responsible for oversight of the regime. (In such cases, the co-regulatory regime may, in effect, become de facto command and control regulation).

208. In the case of purely self regulatory regimes, the industry or profession itself is responsible for imposing penalties on non-complying members. Penalties can include monetary fines, requirements to print corrective advertisements or apologies to suspension and ultimately expulsion from the association.

### **3.2. Efficiency**

209. An important factor which must be assessed when choosing between alternative instruments is the efficiency of the various instruments available – in terms of achieving their objective while maximising community welfare.<sup>11</sup> Efficient instruments should:

- Maximise benefits and minimise costs;
- Provide a degree of flexibility, where possible, to allow the regulated to find the lowest cost way of complying with specified requirements; and
- Minimise compliance costs – both those borne by regulated entities and the government itself.

#### *3.2.1 Maximising benefits and minimising costs*

210. In general, the instrument chosen to address a particular policy issue should maximise net benefits to the community as a whole. It is important to note that while benefits and costs imposed on particular segments in the community can be important – as discussed in the following sections on equity and fairness – the general criteria should focus on benefits to the nation as a whole.

211. A full evaluation of all options for achieving the policy objective can be conducted by governments by undertaking an effective Regulatory Impact Analysis (RIA) prior to introducing policy measures. An effective RIA process will ensure that the objectives of the intervention are specified, the costs and benefits discussed (and possibility quantified) and the full range of regulatory options considered. To the extent that it is embedded in existing regulation, or may require the introduction of some supporting regulation, co-regulation is likely to be subject to some form of impact assessment prior to its introduction.

212. However, it is possible that industry initiated self-regulation may not go through such an assessment process. It is therefore important to make sure that there is sufficient monitoring and oversight of the scheme to ensure that it remains a suitable response to the policy problem. Again, monitoring and transparency are key elements to ensure self regulation is an appropriate policy option.

### 3.2.2 Degree of flexibility

213. The more flexible the instrument, the more industry or sector specific information can be taken into account in determining the best way to achieve the policy's objective(s). Traditional command and control regulation often imposes a prescribed 'one size fits all' solution over all those being regulated. In some cases this may be appropriate, but it fails to take account of differences between those being regulated and the possibility that those being regulated may be able to find lower cost or more innovative ways of achieving the desired policy objective. The risk in giving too much flexibility to those determining their own regulatory structure – is that the regulation may in effect be captured by the industry or professional association and developed in a way which advances the interests of those developing the regime rather than the interests of the wider community.

214. Self and co-regulatory instruments have the potential to rate highly in terms of flexibility. Those responsible for developing the regime should have an intimate knowledge of the industry or profession and the objectives of the regulatory instrument. They are free to consider a range of options to ensure that the objective is met – and if there is an economic benefit for the firms to participate they will have an incentive to ensure that the objective is met as efficiently as possible.

215. Those designing the regime can also consult with other industries, consumer and government officials in preparing the regulatory regime (see Box 11). This allows them to draw on the experiences and knowledge of others, in addition to their industry-specific knowledge. In the case of co-regulation, there may be explicit requirements for consultation both during the initial development of the scheme and on an ongoing basis.

#### **Box 11. European Electrotechnical Standardisation**

CENELEC, the European Committee for Electrotechnical Standardisation, is a non-profit technical organisation composed by the National Electrotechnical Committees of 28 European countries and 8 affiliate National Committees from Eastern Europe and the Balkans.

This institution has been working towards the creation of voluntary electrotechnical standards with the aim of promoting European harmonisation, eliminating some technical barriers to the European Internal Market, substituting European-wide standards in place of national standards and smoothing differences within Europe. This process is being driven by requests from the market and by the modification of the European legislation.

CENELEC notes that the "Standards are based on consolidated results of science, technology and experience and aimed at the promotion of optimum community benefits". The standards give flexibility and adjust to the specific nature of the relevant industries because they are reached by consensus of many involved parties: manufacturers, consumers, environmentalists and other concern parties, all processes supported by the European Commission.

Source : [www.cenelec.org](http://www.cenelec.org)

216. More flexible instruments compared with traditional command and control regulation, such as self and co-regulation, can also be more efficient due to their flexibility when the industry or situation to which they are being applied is changing rapidly. Technological change, social change or even changing community expectations, may cause regulation to be changed and updated frequently. Self and co-regulatory regimes can be changed with out the need for new laws to be passed by parliament – although co-regulatory regimes may require changes in subordinate regulation which could be undertaken by the relevant regulatory agency or ministry.

217. The disadvantage of this is that the regulatory rules may be changed without adequate scrutiny and review by those outside the industry or profession. The lack of transparency may make it easier for the industry or profession to use the self regulatory regime to protect their interests at the expense of the community more generally.

218. Again, transparency of the process for changing the rules becomes a key factor in ensuring that those who are implementing the self regulatory regime are not able to change it in a way which advantages them at the expense of the community as a whole. Transparency (and associated external monitoring) provides an important system of checks and balances on the behaviour of those responsible for establishing and administering the regulatory regime.

### *3.2.3 Minimising compliance costs*

219. Those involved in a self or co-regulatory scheme have a strong incentive to minimise compliance costs, especially if the costs are to be borne by members of the association. This includes the costs of operating the scheme in general and encompasses enforcement costs as well as direct compliance costs. There is therefore an incentive to minimise overall scheme operation costs when the costs are borne by those initiating and administering the scheme. The incentive to minimise compliance costs is likely to be higher when membership of the association is voluntary. Prospective members will weigh the advantages of membership against the disadvantages (including compliance costs).

220. In other circumstances the costs of the self regulatory regime may be passed onto consumers or the public in the form of higher prices for services. This is more likely if the association or profession has significant market power in the market into which its services or goods are sold. If there are few or no alternatives to using the service the industry association or profession will be able to pass the costs of the regulatory regime on directly to the consumers.

221. The market structure of the industry initiating the self regulatory regime, and the degree of downstream competition in the market into which their goods or services are sold, are important factors in assessing who bears compliance costs and the strength of the incentive to minimise such costs.

222. An additional consideration is the possible need for external monitoring of the scheme. Given incentives for members of a self regulatory scheme to use it to their advantage, it is possible that the public or government may require some form of external monitoring of the scheme to ensure that members do not abuse any market power that may be conferred upon them as a result of their membership of the scheme.

223. There may be a trade-off between the costs of monitoring the operation of a self or co-regulatory regime and the other advantages of the scheme which must be considered prior to its introduction. This trade-off must be taken into account when a decision is made to use a self or co-regulatory instrument when there were other possible instruments which could have been adopted.

### *3.3 Equity and fairness*

224. A good regulatory instrument should be considered by those subject to it (and the wider community) to be both equitable and fair. Instruments which are not considered equitable and fair are likely to suffer from lower levels of compliance and be less effective in achieving their objectives. Equity and fairness considerations are best embodied in policy instruments which:

- Are transparent in their operation and impacts; and
- Contain appropriate appeals mechanisms.

### 3.3.1 *Transparency*

225. The transparency of the operation of a regulatory regime has been emphasised as a central element of an equitable and fair regulatory instrument. A lack of transparency can contribute to a perception that the regulatory regime is not being applied fairly and that the regime is not achieving its objectives or that some members of the community are being advantaged relative to others.

226. The self or co-regulatory regime should be developed in a transparent manner so that all stakeholders understand why the regulation is required and why self or co-regulation is the best way to address the perceived policy problem. Mechanisms to ensure transparency in the development of the regime include:

- Including interested stakeholders (including, for example, consumers and government officials) on consultation committees, or even committees involved in drafting the regime;
- Holding open public discussions on the proposed regime, and allowing for participation by the wider public;
- Publication (perhaps by electronic means using the internet) and dissemination of drafts (for example, a draft code of practice) for comment; and
- Ensuring that the self or co-regulatory regime is written in plain language to ensure that it can be understood by as wide an audience as possible, including an explanation of why the regulation is needed.

227. Transparency of the operation and impacts of a self or co-regulatory regime is enhanced if those who developed and operate the regime publish guidelines and information on how it works. But the existence of published material, such as a code of conduct, is not sufficient if consumers or the public do not see that the scheme operates in accordance with the guidelines or codes. Appeals and dispute resolution mechanisms have an important role to play in ensuring that the scheme is regarded as being fair and equitable.

### 3.3.2 *Appeals and dispute resolution mechanisms*

228. Appropriate appeals mechanisms are also important if the regulatory instrument is to be regarded as being equitable and fair. It also reinforces the accountability of those who are making and overseeing the regulation. In general, the regulatory regime should have provisions to allow complainants to officially lodge a complaint and, if the matter is not satisfactorily resolved, for some internal or external body to assess and adjudicate on the dispute.

229. The nature of the dispute resolution mechanisms will vary between regulatory schemes. In some cases disputes may be dealt with by a committee or group of association members convened specifically for that purpose. An alternative would be a panel consisting of both association members and external independent representatives. In other cases it may be necessary to establish an independent industry ombudsperson, or some other external independent panel to consider disputes.

230. The appeals mechanism established by a self or co-regulatory regime must be regarded as being accessible to those with a complaint against a member of the industry or professional association and must also be regarded as being impartial.



231. As a first stage, it is important that consumers or the public know that there is a mechanism to deal with complaints and disputes. It is therefore necessary that the regulatory regime advertise or make such information available in a way that is accessible to people who may need to make use of it. In many self or co-regulatory regimes this information is made available by advertising a complaints telephone number where complainants can seek further information on the disputes resolution and complaints procedures open to them.

232. The appeals mechanism should also be accessible in the sense that it is not prohibitively costly for aggrieved consumers to participate in. But there may also be a need to minimise frivolous claims which would otherwise ‘clog up’ and delay the consideration of legitimate claims. One way to discourage such claims is to charge a fee to those lodging a claim. This charge may help to cover the costs of the appeals mechanism but care must be taken to ensure that it does not discourage legitimate claims. An alternative approach is to charge a fee when a claim is lodged but which is refunded if the claim is successful. This approach is used in the Norwegian self regulatory scheme covering the operation of real estate agents; a fee of approximately 60 euros is required when the complaint is lodged but which is refunded if the claim is supported (this is an exceptional case, in general, most boards or panels in Norway do not charge a fee for dealing with complaints).<sup>12</sup>

233. The cost of operating the appeals and dispute resolution mechanisms must be commensurate with the nature of the complaints likely to be received. If there are likely to be few complaints of relatively low monetary value there is no justification for an elaborate and costly dispute resolution mechanism. For example, at the first level there could be a telephone line for complaints, with follow up for those which remain unresolved. At the other end of the spectrum there could be a full disputes resolution body with powers to summon the parties and recommended settlements.

234. The time taken to investigate and rule on complaints affects both the costs of the complaints mechanism (to both the industry and the complainant) and the perceived fairness of the system. Complaints must be handled quickly and efficiently so that those lodging complaints do not feel that they have been ignored or that the regulatory body is delaying the process unnecessarily. In order to enhance its perceived fairness a self or co-regulatory regime could include guidelines on the timeliness of its dispute and complaints handling process. This would provide an objective measure against which the performance of the scheme could be assessed.

## ALTERNATIVES TO TRADITIONAL REGULATION: INFORMATION AND EDUCATION

### 1 Introduction

235. These instruments act to change behaviour by making more information available so that businesses and consumers can make more informed decisions. These instruments allow people to make decisions on the basis of greater information than would otherwise be available, rather than imposing a single solution on all as is often the case with traditional command and control regulation.

236. These instruments are often characterised as being ‘light-handed’ because the degree of direct government involvement in decision making or directing behaviour is more limited than with other instruments. However, even with ‘light-handed’ instruments, the degree of involvement can vary. In some cases government can require companies to provide greater information to consumers, or government can provide the information itself. Alternatively, government can encourage and persuade businesses to provide additional product information without imposing a formal requirement on businesses to provide the information.

### 2. What are information and education policy instruments?

237. These instruments work to change behaviour through the provision of greater information or changing the distribution of information that is, making information which may be available to some businesses and consumers available to others. Examples of these instruments include: information and education campaigns, labelling requirements, or requirements to disclose other information to the market.

238. There are a number of ways in which government action can lead to greater information provision:

- The government can require information to be disclosed (this may require the enactment of laws requiring the firms to make information available, possibly with penalties for non-compliance or the provision of incomplete information);
- Government can encourage information provision (without the passing of laws requiring provision); or
- Government can collect and make the information available directly to consumers and businesses.

239. It should be noted that these instruments can be regarded as ‘light handed’ in the sense that they do not directly impose legally binding rule on the behaviour of consumers or businesses making the ultimate decisions. They may however impose quite stringent requirements on businesses to collect and disseminate information that they may not otherwise have chosen to disclose.

240. Box 12 provides some examples of the types of information provision and education instruments used in OECD countries.

### **Box 12. Information and Education Policy Instruments: Some Examples**

Many OECD countries have conducted campaigns to increase awareness of the risks of driving while under the influence of alcohol. In some cases the campaigns have prompted the advantages of nominating one person as driver who does not consume alcohol.

Labelling requirements also provide information to consumers. Examples of labelling campaigns that have been used in OECD countries include, for example, energy efficiency labels on electrical appliances; 'eco-labelling' of environmentally friendly products; labelling of clothing to show that workers have not been exploited in its production.

#### **2.1 *When are information and education commonly used as policy instruments?***

241. Information campaigns and requirements to provide information are used to address information asymmetries and provide the raw data required for consumers and businesses to make more informed decisions. In some cases campaigns may be designed to simply provide additional information to people, in other cases, they may have an explicit policy objective behind them which aims to change consumers of businesses' behaviour.

242. In cases where there is an explicit policy objective to change behaviour the information and education campaign typically relies on a form of 'moral suasion' to convince people to change their behaviour. These types of policy instruments are typically used when there is behaviour which has an externality effect on others. For example, the provision of information about the harmful effects of smoking are often aimed at changing the behaviour of those who smoke by providing information about the impact of their actions on others.

243. In other cases the provision of information may be intended to change the behaviour of the consumer in their own interests. The objective may be to provide information that is either too difficult for consumers to collect themselves or would be too costly to gather. This could include information required in food labelling, or information on the energy efficiency of electrical appliances. In other cases, it may be difficult to compare products if information on their characteristics is not presented in a consistent and comparable format. Government may require companies, for example, mobile phones or credit cards, to present information in a particular manner to facilitate comparison of the various attributes of each product so that consumers can select the one which best suits their needs.

### **3. Assessment of the advantages and disadvantages of information and education**

244. This section considers the advantages and disadvantages of education and information campaigns as regulatory instruments. The section examines the types of situations or policy issues for which this form of instrument is likely to be the most: effective; efficient and equitable instrument to achieve the Government's policy objective.

#### **3.1. *Effectiveness***

245. A 'good' policy instrument must be effective in terms of being able to achieve the objective for which it was introduced. Effectiveness can be evaluated according to how well the instrument: addresses clearly specific objectives; is integrated and consistent with other regulation; and has effective monitoring and compliance mechanisms.

### *3.1.1 Addressing clearly specified objectives*

246. In order to be effective, it is essential that a policy instrument has a clearly specified objective. This ensures that its progress and success in attaining the objective can be monitored and changes made if necessary.

247. The objective of an education or information campaign is often clearly specified. In part this may be because the objective itself is simply the provision of information to increase consumer choice and allow consumers and businesses to make better decisions – additional information is intended to empower the consumer, but there is no intention of changing behaviour in a particular way.

248. In other cases the objective is more focused on changing behaviour through the provision of information and education. The intention is to change behaviour which results from ignorance, incomplete information or incorrect or misleading information. The objective of the information or education campaign is to fill the gap so that consumers and businesses acting on the basis of more complete information will change their behaviour.

249. People may be unaware that there is a particular problem and hence information can make them aware of issues. They may voluntarily change their behaviour once given the correct information or learn about an issue as a result of an education campaign.

250. It is also possible that the information is available but the objective of the campaign is to present the information in a manner which makes it easier for consumers and businesses to use. For example, it may be difficult for consumers to compare the attributes and prices of some products (such as mobile phones or credit cards) if the information is presented in very different ways. Some governments have required information on such attributes to be presented in a more standardised manner to allow consumers to compare products more easily and make more informed choices.

251. Timing is an issue which must also be taken into account when assessing how well these instruments achieve their objectives. These tools are likely to take some time to have an impact. Citizens and businesses will need time to take in the information given and change their behaviour on the basis of what they have learned. It will also take time for the information to be diffused down to those the instrument is intended to influence. The time taken for the information to reach its intended target audience may depend upon the mechanism used to provide the information. For example, a television campaign may reach a wider audience and more quickly than a campaign of advertisement in a newspaper.

252. This suggests that information and education campaigns are unlikely to be the best instrument to use if a quick response and change in behaviour is required. In addition, it may be necessary to reinforce the message overtime to ensure that it ‘sinks in’. The government may also wish to put in place a mechanism to monitoring how well the instrument is achieving its stated objectives as the results may not be seen for some time after the instrument has been introduced.

### *3.1.2 Integration and consistency with other regulation*

253. In order to be effective a policy instrument should be integrated and consistent with existing regulation. This will ensure that different policy instruments are not working in different directions and negating their impact.

254. Policy instruments in the form of information and education campaigns can be very well integrated with other regulation, especially when the information and education campaign is part of a wider policy package. The information provided can support and reinforce the other policy elements. For example, campaigns against driving while under the influence of alcohol or drugs aim to change behaviour by showing the dangers and damage that can result from such behaviour.

255. There may be problems with integration and consistency when the objectives of the information or education campaign are in conflict with other policy instruments. For example, in some counties there are education campaigns against wasting water due to drought conditions, but at the same time there are policies to keep water prices low.

### *3.1.3 Effective monitoring and compliance mechanisms*

256. In many cases there is no attempt to monitor the compliance with education or information campaigns nor to impose penalties or sanctions for non-compliance. This is because the objective of the instrument is to provide information which should lead to a change in behaviour as consumer and businesses make better informed decisions.

257. However, it may be useful to have some monitoring to ensure that the information is being received by those who most need it. Access to information varies among those in the community and a single information campaign, using for example the internet, will not be effective in reaching those without internet access or who are uncomfortable with using such technology. Therefore, monitoring may be required not to assess compliance, but rather to ensure the campaign is effective in meeting its objective of providing information to those who need it.

258. Information and education campaigns, where the information is provided by the government can be costly to undertake. Monitoring may therefore be necessary to ensure that the instrument is being effective in terms of changing behaviour in the manner intended. The importance of monitoring is reinforced by the fact that information and education campaigns may take some time to have an impact on the behaviour consumers and businesses. If the instrument is ineffective, perhaps because the underlying problem did not result from a lack of information on the part of the citizens or businesses then it would be necessary to reassess the effectiveness of the information and education instrument and consider whether another instrument (or mix of instruments) would be more effective.

259. In cases where government requires the disclosure of information there may be a need for effective monitoring and compliance mechanisms. This is especially the case where the disclosure of information is necessary because without it consumers may make choices which lead to serious consequences. For example, food labelling requirements, especially where they require disclosure of information such as the presence of nuts to which some people are highly allergic, must be complied with and be accurate because the consequences of the product being consumed by someone with an allergic could lead to serious health problems or even death.

260. The mandatory disclosure of information, such as through labelling requirements, can be backed up by the threat of legal sanctions. The government may therefore need to put in place mechanisms to ensure compliance and enforcement in the case of non-compliance. For example, a government testing agency may have a role in ensuring that the technical specifications included in a products label are correct.

### 3.2. *Efficiency*

261. Efficiency relates to the extent to which the policy instrument maximises community welfare or net benefits. Efficient instruments should: maximise benefits and minimise costs; be flexible; and minimise compliance costs.

#### 3.2.1 *Maximising benefits and minimising costs*

262. Information provision and education campaigns are very ‘light-handed’ instruments in that they do not directly intervene in each person’s decision making process or direct how they should behave. They provide information which agents can use to improve their decision making and hence to maximise their own welfare. The benefits will only be realised if the appropriate information is made available to those who need it. It is therefore necessary to ensure that these instruments are well targeted to ensure that the information reaches those whose behaviour the government wishes to change.

263. The extent of costs will depend on the type of information provision and education campaign that is undertaken. However, the accuracy of targeting the information provided will help minimise costs by not leading to excessive information provision. It may, for example, be very costly to change all labels on a food product to include additional information on an ingredient which may have a very low risk of causing an allergic reaction – there may be other, less costly ways of providing this information to the target group. Compliance cost issues are discussed in further detail in a later section of the chapter.

#### 3.2.2 *Degree of flexibility*

264. There are two important elements of flexibility. First is the degree of flexibility given to those subject to the regulation to respond to the policy instrument. Traditional command and control regulation generally provides little flexibility as requirements are often specified in detail, in contrast other instruments allow those subject to the regulation more freedom in how to respond and change their behaviour. The other important element of flexibility is the ability of the government or regulator to change the instrument or ‘fine tune’ it to ensure that the objectives are met.

265. Information and education are very flexible instruments in the sense that they do not impose or require certain actions to achieve their objectives. They rely on individual agents in society to change their behaviour on the basis of more or better quality information or appeals to ‘moral suasion’.

266. Businesses and citizens are free to choose how they respond to the additional information provided to them – they will make decisions based on what is the best possible outcome for them. It is possible that the additional information has no impact on their behaviour – or they may make very significant changes in behaviour on the basis of the information supplied.

267. The flexibility to ‘fine tune’ information and education instruments may be limited because information and education campaigns can take some time for them to influence people’s behaviour – it may take some time for citizens and businesses to process the information and build it into their decisions. It may also be difficult to determine, when designing the instrument, how citizens and businesses will change their behaviour given the information provided.

268. This means that these instruments may not be appropriate in circumstances where policy objectives or the policy environment are changing rapidly. The instrument may lack the flexibility to be able to change behaviour quickly and precisely in such changing circumstances.

### 3.2.3 *Minimising compliance costs*

269. The ‘best’ possible instrument to deal with a particular policy issue should minimise the compliance costs borne by both those being regulated and the government or the relevant regulator.

270. In many cases, a direct outcome of information and education campaigns will be to reduce the cost of collecting information by consumers and citizens. These groups will not have to search for the information or try to obtain it from other sources.

271. However, the search costs may be borne by the Government which collects the information to make available to citizens. The government will also bear the costs of disseminating information or running the education campaign. The extent of these costs will vary widely depending upon the difficulty in collecting information and the type of dissemination process used. Government can provide information through mechanisms such as: websites; brochures; media campaigns; seminars and through specialist promotion agencies (such as agencies to promote healthy eating). The cost of providing information will vary widely between these mechanisms and will also depend on the time period over which the information is provided.

272. Information and education instruments can impose compliance costs on firms. In some cases businesses will voluntarily provide additional information into the market place. This will be the case if it is in the business’ best interest to provide information that will make its products more attractive to consumers. For example, a business may voluntarily label its product as being ‘eco-friendly’ or indicate that it does not contain genetically modified ingredients, if it believe that this will enhance the product’s attractiveness to consumers.

273. In other cases, government may require firms to provide more information than they would normally choose to provide and so may impose compliance costs on these firms. Firms would incur the cost of collecting the information if it was not part of their normal internal processes. The compliance costs in this case would include both the costs of gathering the data and disseminating it. Food labelling requirements, for example, may require additional analysis of the food and then the preparation of new labels which include the new information.

## 3.3 *Equity and fairness*

274. A policy instrument must be regarded as being fair and equitable in order to ensure compliance and for it to be accepted by the public. Unlike other instruments, such as command and control which directly dictates behaviour or market based instruments which work through changing prices, equity and fairness issues are unlikely to be significant concerns with information and education instruments.

### 3.3.1 *Transparency*

275. Policy instruments should be transparent in their impacts. This ensures that those subject to the regulation can see that all are being treated equally and in a consistent manner. Information and education based instruments rely on transparency to have an impact – they require people to receive additional information and change their behaviour on the basis of this information when they make decisions. But transparency issues can still arise.

276. Access to information and the ability to use it can vary among those in the community. This must be taken into account when designing an information or education campaign. For example, in countries where various languages are spoken by the population, a campaign in one language may be ineffective if large sections of the community are unable to understand the message.

277. The characteristics of the target group should also be taken into account when deciding on the delivery mechanism to be used. Internet based mechanisms may be efficient in some cases but are unlikely to be the best option of a large proportion of the target group does not have access to the internet or is unable to use it effectively.

### *3.3.2 Appeals and dispute resolution mechanisms*

278. Appeals and disputes are generally unlikely to arise often when information and education is used as a policy instrument.

279. In the case of government requirements to provide information there may be a need for a mechanism to deal with disputes if businesses regard the government's requirements as being too onerous or costly to comply with. The exact nature of the arrangement will depend upon the scheme design but they should be transparent in its operation and accessible to those with a dispute.



## SUMMARY AND CONCLUSIONS

280. This section summarises the discussion in the previous chapters and highlights the situations when particular alternative policy instruments are likely to be particularly useful, summarised in a table to provide a ‘quick reference’ for policy makers considering using alternative instruments. The chapter concludes by considering the scope for, and direction of future research to further enhance the consideration of alternative policy instruments by policy makers.

### **Summarising the characteristics of the different alternative instruments**

281. This section summarises the characteristics of the alternatives instruments discussed in this report. It focuses on when each instrument is likely to be particularly effective, efficient and equitable.

#### *Market-based instruments*

282. Market-based instruments, which work to change behaviour by changing the incentives faced by citizens and businesses or by creating opportunities for exchange, have been used for a long time in many OECD countries. In particular, these instruments have been widely used to achieve environmental objectives, but they have also been used in other areas.

#### *Effectiveness*

283. Effectiveness requires that a policy instrument has clearly specified objectives. In many cases this will be the case with market-based instruments. In addition, market-based instruments may be used with implicit objectives – such as to maximise revenue – which may not necessarily be consistent with the stated objectives of the instrument.

284. There are also timing issues associated with the effectiveness of market-based instruments. It may take sometime for the changed incentives put in place by the policy instrument to affect the behaviour of businesses and citizens. It may also be difficult to determine exactly how long the time lag from the introduction of the instrument to it having an effect will be. This suggests that market-based instruments may not be the most suitable instrument to use if a rapid change in behaviour is required.

285. It may also be difficult to determine exactly the size of the incentive required to promote the desired change in behaviour. For example, it may be difficult to determine in advance the size tax required to achieve the desired reduction in pollution. The issue of determining the size of the incentive change required along with the time taken for the instrument to have an effect suggests that appropriate monitoring and feedback mechanisms will be essential to ensuring that market-based instruments are effective in achieving their objects. Feedback mechanisms can help ensure that information gathered overtime is used to fine tune the policy instrument to ensure that it achieves its objectives.

286. Effective instruments should be well integrated with existing regulatory arrangements. Problems for market-based instruments may arise if they are to be implemented across jurisdictional borders. It may be complicated to ensure that they fit with differing requirements which may apply in different jurisdictions. Such problems are not necessarily insurmountable, but they may increase the cost and complexity of using a market-based instrument to achieve policy objectives.

287. High levels of compliance are also required if a policy instrument is to be effective in achieving its objectives. In many cases, compliance with market-based instruments will be high because once the incentive structure has been put in place, businesses and citizens act in their own best interests – and so they voluntarily comply. However, there may be scope for avoidance and evasion of some market-based instruments. This may especially be the case for tax-based instruments, where there may be an incentive to avoid tax payments. If there is significant scope for avoidance and non-compliance the effectiveness of the policy instrument will be reduced.

288. Compliance may also be affected if the instrument is overly complex or if the costs of participation are high. Participation costs could include the cost of applying for tax benefits, subsidies or participating in a trading mechanism, for example, for trading pollution permits. The extent of these costs will depend on the design of the market-based policy instrument.

289. The policy effectiveness of market-based instruments can be harmed if market participants use their market power to achieve their own objectives rather than those intended by the policy maker. Monitoring and oversight mechanisms can help alleviate these concerns as can effective anti-trust regulation.

### *Efficiency*

290. Market-based instruments tend to be relatively efficient because they work through changing incentives rather than directly interfering in the behaviour of individuals. Businesses and citizens are therefore able to make decisions which maximise their welfare given the incentive structure put in place by the regulation instrument. Each individual participant in the market has an incentive to look for the least cost response to the given incentives.

291. The strength of market-based instruments is the flexibility they offer participants in terms of how they change their behaviour once the instrument is introduced. The regulator or policy maker does not need a detailed knowledge of the possible responses or their respective costs and benefits. This information will be known to the individual agents and they will assess the relative costs and benefits of different actions. The flexibility of these instruments means that they can be particularly useful in circumstances where there is:

- Rapid technological change;
- The industry or sector uses complex technology or processes; and
- A degree of certainty as to the impacts of the instrument so that it does not need to be subject to continual change or adjustment.

292. Market-based instruments also often provide strong incentives to minimise compliance costs. Flexibility provides businesses and citizens with the opportunity to find the least cost way of complying with the regulations. In some market trading systems, such as carbon trading schemes, there may be some compliance costs imposed on firms participating in the scheme. The extent of such costs will depend on how the scheme is established and operated. Government can also bear some costs. The extent of the costs borne by government will depend on the characteristics of the scheme and its design.

### *Equity and fairness*

293. Market-based schemes are sometimes regarded as being unfair because they operate through changing incentives – usually by changing the prices paid by businesses and citizens. Price increases are often regarded as being unfair or regressive.

294. The transparency of market based instruments varies. In the case of fiscal instruments, such as taxes and subsidies, these will often have been discussed and evaluated during the budget cycle – and so information on their size, coverage and objectives are likely to be available. The transparency of trading instruments will depend on the design of the scheme. In some cases, transparency can be enhanced by an independent market oversight body which can publish information on the operation of the market while maintaining the confidentiality of data provided by individual market participants.

### *Self and co-regulation*

295. Self regulation involves groups of economic agents developing, monitoring and enforcing their own rules or codes of conduct. Co-regulation entails explicit government involvement in the regulatory framework, for example, by providing a legal backing for the enforcement provisions in a code of conduct developed by the industry.

### *Effectiveness*

296. It is important that the incentives facing the participants in the self or co-regulatory scheme are consistent with achieving the specified objectives. For example, providing information to consumers to help them choose reputable suppliers where there are many ‘rogue’ players enhances the interests of consumers and of reputable service providers. When incentives and objectives are consistent, the industry or professional association will work to ensure the success of the self or co-regulatory regime.

297. In situations where the interests of the profession or industry do not fully align with those of the community, self or co-regulation is unlikely to be an effective instrument alone unless there are a number of safeguards built into the system. The objectives of the regime must be clearly stated – and, if possible, performance indicators developed so that the performance of the regime in terms of achieving its objectives can be assessed.

298. Transparency in the development of the regime and in its operation is essential for ensuring that the regulatory regime operates in the interests of those it is meant to serve rather than the narrow interests of the industry or profession itself. Where there are more serious concerns over the possible divergence of sectoral and community interests, a co-regulatory regime may offer more checks and protection against capture and self interested behaviour because of the greater role for government, and possibly other stakeholders, in the development and operation of the regime.

299. There are also particular circumstances where self and co-regulatory regimes are more likely to be more effective than other possible instruments: for example for technical standards where detailed industry knowledge is likely to be important, and in situations where the flexibility of instruments to changing circumstances is important.

### *Efficiency*

300. Efficiency, in the sense of maximising net benefits to the community, requires that policy instruments maximise benefits and minimise costs; be flexible and minimise compliance costs on those participating in the regime.

301. Both self and co-regulatory approaches have the potential to be very efficient policy instruments because of their flexibility. They can be tailored to the specific issue they are designed to address and can change quickly in response to changing circumstances. However, there must be adequate protection in place to ensure that the regime is not captured by the industry or professional association and so promote narrow interests rather than the wider community interest. This requires that there be adequate transparency and monitoring of the performance of the regimes.

302. Incentives to minimise compliance costs are likely to be high if those participating in the scheme also bear the compliance costs. The structure of the market into which they sell their products or services will influence their ability to pass costs onto consumers or others. If those subject to the scheme are monopoly providers and membership of the scheme is high, the incentive to minimise compliance costs will be weak. If on the other hand services are sold in a competitive market and there are service providers, who are not members of the scheme, then those participating in the self or co-regulatory scheme will face strong incentives to minimise compliance costs.

#### *Equity and fairness*

303. Equitable and fair policy instruments should be transparent in their operation and contain appropriate dispute resolution and appeals mechanisms.

304. The extent to which self and co-regulatory regimes are equitable and fair will depend upon how they are developed and administered by the industry or relevant association. Transparency will be maximised when there is an open process for the development of the regime – with the opportunity for relevant stakeholders to participate and express their views. Co-regulatory regimes may require greater transparency because of the active involvement of the government in their development.

305. The industry or profession developing the scheme will be central to ensuring that it is done in a transparent manner. Again, the nature of the incentives facing those initiating the scheme becomes central. If they are doing it solely for their own interest and not the community or consumers then they will have an incentive to minimise transparency and consultation with those who will be affected.

306. Complaints and dispute resolution arrangements must also be seen as being accessible and impartial. There is scope for the nature of the dispute resolution arrangements to vary according to the nature of the complaints. Where complaints are likely to be of a minor nature with little impact on those involved, a lower cost, less complex dispute resolution mechanisms may be appropriate. However, as the likely financial impact and injury caused by unresolved disputes increases, the complexity and formality of the resolution process much increase commensurately.

307. If it is not possible to develop an appropriate complaints and dispute resolution process – perhaps because coverage of the regime is insufficient or the severity of the offence could require the imposition of penalties – then self or co-regulation is unlikely to be the best possible policy response.

#### *Information and education*

308. Information provision and education campaigns work to change behaviour by increasing the amount of information available to businesses and citizens.

### *Effectiveness*

309. Information and education campaigns often have a very simple objective of providing information to businesses and citizens or to raise awareness of particular issues. However, it may take some time for the message or information provided to 'sink in' and become incorporated into the individual's decision making process.

310. Information and education campaigns are often introduced to reinforce other regulatory measures and so they are therefore likely to be well integrated with existing regulatory arrangements. Problems may arise if conflicting messages are disseminated.

311. Monitoring and compliance mechanisms are generally not required for information and education campaigns conducted by the government, where the government is the information provider. However, where the government requires businesses to provide information that they may not otherwise provide, there may need to be some monitoring to ensure compliance, especially if the information is costly for the firms to provide or disseminate.

### *Efficiency*

312. Information and education campaigns do not impose strict requirements or restrictions on individual behaviour like traditional command and control regulation. Information is provided and individuals make use of it in making decisions if they believe it is relevant and useful. They are therefore a very 'light handed' type of regulatory instrument.

313. They will involve some compliance costs resulting from the need to collect and disseminate the information. These costs will be borne by either the government if it is the information provider or the private entities required to provide information. The extent of these costs will vary depending upon how the information is disseminated to the target audience.

### *Equity and fairness*

314. Information and education campaigns are unlikely to raise significant equity or fairness related issues; they are inherently transparent instruments. Issues may arise if the dissemination of information is targeted to specific groups or individuals and others feel that they should also have access to the information.

### **A check list for considering alternative instruments**

315. The 'best' instrument to achieve a given policy objective must be decided on a case-by-case examination of the particular situation. However, the discussion in this report helps identify a list of factors which should be explored and analysed in some detail when deciding among possible policy instruments. This check list of questions will help ensure that policy makers consider a complete range of factors which will impact on the choice of policy instrument.

- What are the objectives the policy instrument is trying to achieve?
  - Are the objectives clearly specified? Are they well communicated to those who will be affected by the policy instrument? What is the nature of the problem the instrument is trying to address? Does the proposed instrument focus on the underlying problem?
- What are the incentives facing those whose behaviour would be affected?

- To what extent do the interests of those being regulated coincide with those of the government? Is there sufficient alignment of incentives to make self or co-regulatory instruments a realistic option?
- Do the firms (or profession) subject to the policy instrument have market power? If so, what are the costs involved in monitoring their actions to ensure that there is no abuse of market power?
- How much industry (or profession) specific information is required to ensure effective regulation?
  - Who is best placed to have this information?
- Is the area being regulated subject to rapid change (for example, due to technological advances)?
  - How much flexibility is suitable and required in the regulatory response? Should the regulatory instrument be reviewed periodically?
- Are there likely to be significant equity or fairness concerns?
  - Are there particular groups in society who will be disproportionately affected by the regulation? Are there mechanisms available to compensate for these effects?

## Scope for future work

316. OECD countries will continue to explore and use alternative instruments to achieve policy objectives. Experience and knowledge of the circumstances in which particular instruments work well will continue to grow and develop overtime. The OECD could play an important role in synthesising this material and continuing to analyse the circumstances under which particular instruments are particularly successful or useful. Three possible areas of future work could include:

- Examining further the policy making process focusing on how well alternative instruments are considered and evaluated. This could include a particular focus on the use of RIA as a tool to ensure that alternatives are considered.
- Undertaking a comparative study of traditional regulation and an alternative instrument in trying to achieve a given policy objective. For example, in order to protect native vegetation and forests from being cleared for farming one possible command and control instrument is to prohibit further clearing. An alternative instrument could include incentive payments to farmers to protect environmentally valuable land and not clear it. This option could examine how traditional and alternative instruments have been used in for a particular policy issue across OECD countries and highlight factors which determine the success or failure of the various instruments.
- Examine the effectiveness of using a mix of policy instruments to achieve a given objective. Policy mixes are often used to achieve policy objectives, for example, to discourage smoking many countries prohibit the sale of cigarettes to children, they use taxes to increase the price and also use educational campaigns to highlight the harm that smoking can cause. However, there is little, if any, guidance available to policy makers on how best to combine the various policy instrument into an integrated package. This option could include examining how a mix of policy instruments can be used to overcome weaknesses in one instrument and how they could be used to reinforce each other.

## NOTES

1. OECD (2002) *Regulatory Policies in OECD Countries: From Interventionism to Regulatory Governance*, OECD, Paris.
2. The OECD has undertaken considerable research on the policy mix to achieve environmental objectives. See for example, OECD (2003) *Voluntary Approaches for Environmental Policy: Effectiveness, Efficiency and Usage in Policy Mixes*, OECD, Paris.
3. OECD (2000) *Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance*, OECD, Paris, p. 11.
4. From a more technical economic perspective, the efficiency criterion requires the chosen instrument results in an outcome where the marginal cost of supplying the good just equals the marginal benefit which is produced.
5. In some cases the definition of market-based instruments can be widened to include the use of competition policy and product liability laws. In this chapter the more narrow definition of market-based instruments encompassing fiscal measures and trading schemes will be used.
6. The Environment Directorate of the OECD has been very active in this literature.
7. For further information see: [www.fsa.usda.gov/dafp/cepd/crp.htm](http://www.fsa.usda.gov/dafp/cepd/crp.htm)
8. In the European context the term “regulated self-regulation” is sometimes used to describe what is referred to as co-regulation in this paper. For example, Schulz and Held (2001,p. A3) define regulated self-regulation as “self-regulation that fits in with a legal framework or has a basis laid down in law.”
9. For example, Millar (1985, p. 899) notes that the American Medical Association first established a code of ethics for its members in 1848.
10. In the economics literature, this imbalance in information between economic agents is often referred to as ‘information asymmetry’.
11. The community’s welfare will be maximised by choosing the instrument which maximises net benefits.
12. Government of Norway - information to OECD secretariat, February 2006.



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