LI-Briefing

# Ways to leaner and smarter regulation

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According to the latest PwC Global CEO Survey (2016), overregulation belongs to the main worries of business; 79% of respondents cite overregulation as the top concern for their organization's growth prospects, before geopolitical uncertainty and exchange rate volatility. In the financial sector, the consumer goods industry, or commodities markets, legislative overreach threatens economic and entrepreneurial freedom, consumer choice, and innovation.

Overregulation tends to become increasingly international and adds to the different layers within states. Bodies such as the European Union (EU), the Basel Committee, the World Health Organization, the OECD not only produce standards, they also issue regulatory recommendations for national governments setting the direction for more regulation.

The regulatory environment influences heavily a country's competitiveness, whereby regulation of labor, product markets and business in general play a key role. Both competitiveness and economic freedom are positively correlated with innovation, economic growth, and well-being, including life expectancy.

## Three current trends toward overregulation

*Increasing compliance costs*

Governments and government organizations often aim at fighting overregulation and bureaucracy (as evidenced by numerous initiatives, reports, and commissions addressing this issue). It is generally accepted that cutting red tape promotes job creation. Yet the density and complexity of regulation continue to increase. This is true in every major developed country, where legislative and regulatory activity leads each year to new records of additional pages of regulation. Compliance costs are estimated at 10% of GDP in major economies (CEI, 2016). What is not seen, are entrepreneurial initiatives stifled by overregulation, while significant resources must be affected to compliance instead of business expansion.

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*Inaccurate diagnoses of crises*

Short-term crises in some overregulated sectors are often attributed in public opinion to “deregulation” or “insufficient regulation”. This was apparent in the financial sector following the latest crisis in 2008-2010. Yet the financial sector was by far the most overregulated sector even before the crisis, and this overregulation was ineffective in preventing the crisis, while studies show that some regulations (notably in the housing sector) contributed to the crisis.

*Nanny state regulations*

Government paternalism (or maternalism) has become more prevalent in bloated welfare states. Lifestyle regulations, sin taxes, or nudging are aimed at protecting consumers against themselves. This is apparent in the cases of sugar, fat, tobacco, or alcohol. Yet there is no evidence that these regulations are effective. The Nanny State index (Epicenter, 2016) shows for the 28 EU member states that there is no correlation (a) between nanny state regulation and higher life expectancy, (b) between heavy regulation of alcohol and lower rates of alcohol consumption, and (c) between nanny state anti-smoking policies and lower smoking rates.

## Underlying causes of overregulation

*Structural incentives*

Officially, regulation is supposed to correct for “market failure”, such as free-riding on public goods, externalities (damage to the environment or third parties not easily internalized in market-determined cost structures), alleged asymmetric power or information problems. Yet public choice research shows that regulatory agents are also driven by self-interest. Reelection, being seen as “doing something” (where isolated problems lead to overarching regulation), power and prestige, more staff and higher budgets are typical incentives for more regulation. Failure is then used as a further justification for more regulatory activism.

*Rent-seeking*

Regulation allows agents to grant privileges to lobbying groups in exchange of electoral support. Typical examples include tariffs and quotas, monopoly rights, barriers to entry, price controls, quality controls, or safety regulations. This allows special interests to hinder competition by “regulatory capture”. The benefits for the privileged group are concentrated, while the dispersed and “rationally ignorant” public does not necessarily perceive the higher prices and lower quality resulting from rent-seeking.

*Victimization*

Precautionary protection (for example, of consumers against producers, employees against employers etc.) and more recently, social and environmental regulation have become major factors of increasing regulation. NGOs and political groups influence the public through emotionally charged campaigns assuming a zero-sumgame view of markets, where firms exploit consumers, employees, resources, etc. Yet the overwhelming experience over 200 years shows that consumers and employees are best protected by competition, i.e., free markets.

*The welfare state*

With the growth of government involvement in society, opportunities for more laws and regulations necessarily expand. With healthcare spending being largely collectivized through social insurance systems that have led to exploding costs, governments seek to contain expenditure by increasing regulation. This is evidenced by the nanny state. Similarly, there is constant regulatory pressure on providers, such as the pharmaceutical industry. Welfare state spending currently amounts to over a quarter of GDP in advanced countries.

*"Harmonization" or centralization*

With the increasing globalization of trade, it is often superficially assumed that governments should create a "level playing field" to facilitate cross-border trade. Yet competition means differentiation. In fact, the benefits of harmonization are overestimated, while the costs of regulatory cartels or monopolies are underestimated. A workable alternative to harmonization would be a mutual recognition system, whereby inefficient standards would be weeded out by regulatory competition, while incentives to seek out new and better standards would be strengthened. Centralization at the international level multiplies the opportunities for regulatory overreach as well as rent-seeking given that it adds far-reaching layers of regulation and is more remote from democratic control.

*Crises and the ratchet-effect*

Crises generally call for government action. Historically, the great depression of the 1930s led to a substantial increase in government intervention. Since the attacks in the U.S. in 2001 the role of the state in the economy, and regulation in the name of security, have grown phenomenally. With the latest financial crisis in 2008-2010, both regulation and public expenditure have grown in many countries. Yet the rent-producing policies introduced during a crisis are politically difficult to roll back once the crisis is over (ratchet-effect) because by then, the welfare losses will fall to below the "transitional" cost of reform. More regulation is piled up on top of existing regulation, with little attempt to rethink the entire picture. On the other hand, times of crises also allow exceptional ideas to float to the surface, which can translate into liberalization.

## Possible answers and solutions to overregulation

Solutions to overregulation need to address both current trends and underlying causes, with an emphasis on the climate of opinion and the role of the private sector itself. "Less is more" should be the guiding principle of effective regulation. Experience shows that "smarter and leaner regulation" produces better outcomes than heavy-handed regulatory overreach.

## Direct institutional instruments

A number of institutional instruments can be designed to directly fight over-regulation (in addition to renouncing new regulation altogether). Alone the promotion of these instruments can raise awareness to the challenge. Some instruments might be systematic, whereas others can be used on a case-by-case basis or within a limited timeframe depending on the context and the issue.

*Independent oversight*

An independent oversight can be instituted to evaluate the costs and (in)effectiveness of proposed new legislation before the consultation and legislative process (quality checks). In the medium term, this can lead to qualitative improvements of regulation. The oversight body should be independent from the government agency in charge of the proposed regulation to avoid a conflict of interest. Organization leanness and efficiency of such a body are instrumental to its success. In Germany and Sweden, such a body has 8 members, in the Netherlands 3; it is supported by a secretariat of 10 people. Such an organization would strengthen checks and balances by creating immunity from political and administrative influences. It would ideally lead to “smarter” regulation.

*Regulatory brake*

A “one in, one out”, or “one in, two out” rule can be implemented to reduce the constant increase in regulatory standards. The norms to be discontinued should be proposed by the same government agency in charge of the new norms, and the reduction should occur in the same area of regulation within one year. Qualitative aspects should also be taken into consideration.

*Sunset clauses*

The limitation in time of new laws and regulations can be applied on a case-by-case basis. It has the advantage of leading to a reevaluation of a law or regulation designed to address a perceived problem that may be resolved through other means (such as existing laws). This rule can also be useful when the costs of a regulation are difficult to assess. At sunset, the regulation can be changed or discontinued. This tends to reduce the obsolescence of many regulations over time.

*Opting-out clauses*

Firms could have the option of opting out from some regulations depending on their size, structure, or market, according to regulatory relevance. To avoid threshold effects, this should be implemented in cases with obvious benefits. In principle, “smarter, leaner regulation” should apply to all firms equally (equality before the law), otherwise regulations should be rejected or discontinued as excessive.

*Political objective for compliance costs reduction*

The reduction of regulation costs can be better achieved if the government agrees on a clear quantified objective, such as a reduction of 25% of costs, as has been done in Germany from 2007 to 2013. The German statistical office created a “bureaucracy costs index” to monitor compliance costs in firms arising from regulation. Generally, an objective of 25% costs reduction over 5 years would be realistic; it would imply a systematic evaluation of regulation compliance costs, which can be done with standard costs modelling.

## Better institutional incentives

Institutional reforms can indirectly lead to better incentives leading to the avoidance or prevention of overregulation. Such reforms are usually ambitious and would likely be implemented over the longer term. However, alone the discussion of such reforms can lead to better awareness of the challenges associated with overregulation.

*Reduction of government cabinet size*

Empirical research shows that government overspending and regulatory overreach is positively correlated to the size of government cabinets. Each ministry produces more activity and identifies regulatory opportunities due to structural incentives. Government cabinets in many countries could be dramatically reduced. In a more competitive institutional environment, several Swiss cantons have reduced the number of government members from 7 to 5 in recent years, with positive results. In most countries most regulatory initiatives (up to 90%) arise from the executive branch of government, not from parliaments.

*Parliamentary reform*

Reducing legislative activism could also be achieved by reducing the amount of time spent with legislation. Some U.S. states (such as Colorado and Texas) have legislatures that meet once every two years. Once reasonable rule of law is established, there is no need for professional full-time legislative activity. Less parliamentary presence also lessens the opportunities for government to propose new regulations. Other reforms could include a better division of labor in bicameral parliamentary systems, whereby one chamber would be in charge of safeguarding constitutional freedoms against regulatory encroachments.

*Enhancing international regulatory competition*

In an imperfect world regulatory competition among jurisdictions is a powerful tool to curb overregulation. The avoidance of standardizing, harmonizing or centralizing regulation at European or worldwide level, in order to maintain room for deregulation and better solutions, and learn from best practices through trial and error processes, should be promoted as a means to converge to smarter and leaner regulation. Superficial calls for a “level playing field” should be resisted, as they often lead to regulatory overreach, duplication of national regulations, and additional layers of legislation.

In addition, it should not be overlooked that the rationale behind international regulatory efforts is often “raising rivals’ costs”: less competitive governments seek to diminish the attractiveness of neighboring or relevant countries, whereby excessive harmonized standards are used to prevent individual countries from attracting more investment and business activities.

## Changing the sociocultural climate of opinion

Normative values as well as sociocultural changes in the attitudes toward regulation should be an integral part of any effort to curb overregulation, as regulatory agents are responsive to the prevailing climate of opinion. These cultural factors precondition to a large extent the effectiveness of the fight against overregulation.

*The moral high-ground of economic freedom*

Logical and empirical evidence pleads in favor or economic freedom, which is conducive to innovation, consumer-friendly improvements, and economic well-being. Economic freedom is also associated with higher life expectancy and life satisfaction. Anti-business and anti-market ideology, as well as fear of progress, whereby governments are thought to be better planners of economic or social well-being, often claim higher virtues, yet fail in practice. Economic freedom respects individual rights and choices, and is therefore more conducive to human dignity than economic repression in the name of lofty ideals. Regulation may arise from good political intentions (for example correcting a perceived problem), yet often does not lead to good results but to a set of unintended adverse consequences, including the disruption of legitimate economic structures, an unnecessary increase in compliance costs, the development of an underground economy, and a loss in individual freedom of choice.

*The ethics of personal responsibility*

Personal responsibility is decisive for individual dignity and freedom of choice. It thereby sustains economic freedom and becomes increasingly important in the face of unsustainable, overindebted welfare states. It promotes respect for autonomous decision-making and free contracts and is the alternative to the nanny state and victimization.

*Civil society and market alternatives to regulation*

A better appreciation of how markets function would include the role of reputation and trust in the free-market economy (it is *not* in the self-interest of producers to defraud consumers or mistreat employees, even in the absence of an underlying ethical culture). In an age of rapid technological advances, contract enforcement, private-sector standards and self-regulation, as well as private governance, are superior alternatives (in terms of speed, scope, and complexity). Finally, information and education are usually more effective means to prevent undesirable behavior than sin taxes and government regulation.

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