Jerusalem Papers in Regulation & Governance

Working Paper No. 46
July 2012

REGULATION AND RISK: LESSONS FROM THE CRISIS ERA

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Keynote address – Conference on New Perspectives on Learning, Regulation and Governance, The European Consortium for Political Research (ECPR),
Exeter University
27 June 2012

הפורום הירושלמי
לרגולציה וממשליות
האוניברסיטה העברית
הר הצופים

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ISSN: 2079-5882

Regulation and Risk: Lessons from the Crisis Era

The implications for regulatory policy are the subject of these introductory remarks at the outset of a major conference bringing researchers from Australia and the Far East, the Americas and Europe together. That most of the attendees came from OECD countries only reflects the extent to which regulatory policy has matured in developed economies as a key dimension of economic governance, to the point that it can now be the subject of academic research drawing on tested methodologies in political science. How the insights of scholarship about what works, about the functions and performance of institutions, and about the gap between theory and intent on the one hand, and practice and outcomes on the other, can be applied by practitioners and policy advisers, could be the subject of a future conference. The crisis is changing the regulatory landscape. 2008 seems a long time ago. What follows is an abbreviated set of comments that follows the outline of the original speech rather than, as is often the case, an expanded and more academic textual version.

Regulatory policy, which barely existed 20 years ago, has a substantial, positive record of achievement, marked by convergence among all OECD and some non-member, emerging economies about its objectives, methods and results based on shared experiences and collective discussion. The OECD played a critical role on their behalf, developing the 1995 Reference Checklist for Regulatory Decision Making, the 1997 Report on Regulatory Reform, 2005 Guiding Principles for Regulatory Quality and Performance and 2005 APEC-OECD Integrated Checklist, and then the 2012 Principles on Regulatory Policy and Governance. OECD indicators show the extent to which governments have implemented recommendations for regulatory tools and institutions, adopting explicit policies and often appointing a minister to take responsibility. This proves that governments of countries with different political cultures, some centuries old, others barely more than a generation, can achieve more collectively than they can on their own. Today there are thousands of practitioners, hundreds of academic specialists, fields for consultants and lobbyists, and debates which get on the front page of the news.

The big picture was clear: an end to command-and-control regulation, leaving a gap to be filled by more regulation, and more mixed-mode public service delivery, and a larger agenda for accountability, consultation, compliance and enforcement. Key links between regulatory policy and a range of structural policies emphasize the benefits for consumers and for business, including the faster diffusion of innovations, the ease of opening and expanding a business, more efficient infrastructure sectors with greater capacity for growth, and a whole-of-government strategy cutting across sectors and levels of government. These come with a change of administrative culture, and with institutions such as independent regulators and well-functioning central oversight bodies.

But: the crisis of 2008 and its endurance as the post-crisis crisis has revealed the limitations of normative systems and strategies. In retrospect, the end of the Cold War started a process which was too idealistic about the capacity of political systems to cope with the social and economic consequences of reform and globalization. In particular, two problems were set aside: the linkages between sectors and across borders which define systemic risk; and the problem of investing for the future – in education, infrastructures, the environment, and quality public institutions – when deficits become unmanageable.

The OECD highlighted the risks in the housing sector in the 2008 survey of the US economy before the Lehman Brothers crash, and after the crash, generated models of economic trends which foresaw a steep recession, thereby encouraging governments to provide additional liquidity at a time when it mattered. The creation of the OECD Regulatory Policy Committee with explicit responsibility to apply regulatory quality across all sectors, and the development of the 2012 Principles, were deliberate responses to the crisis.

On the other hand, modeling by academics and governments alike which assumed that the crash and recession would follow past patterns may have encouraged politicians to wait until 2010-11 when the signs of a recovery would become evident, in the hope that when going to the polls in 2011-12 unemployment figures would be in decline. If the archives show that two precious years for structural reform and regulatory reform were lost because governments decided to "tough out" the recession, then certain assumptions for economic policy making must be found at fault. Now the familiar refrain, that those who lose from reform will be vocal in their opposition while those who stand to benefit lack voice, shows the limits of political economy. Simulations by the OECD can show how much a country can benefit from adoption of international good practices in the regulatory field, measured by increases in per capita income, for example, and overall growth. Such models can help governments develop strategies for reform and communicate better with the public and stakeholders. By the time a crisis erupts, however, it is too late to run through a simulation of this kind: it has to be on hand to be useful, when there is a "window of opportunity."

This is where we are today, however. Experts are in danger of talking to experts only, and this at a time when public suspicion of experts is rising. People without experience of crisis are trying to deal with one whose outlines they are still trying to define and whose end they cannot perceive. The politics for greater supra-national or federal solutions in Europe have been undermined by the domestic costs of the crisis for households and business, and by the conservative instincts of politicians who have had to face the electorate in a protectionist mood. It is no surprise that governments are looking short-term, to pick "low-hanging fruit" which remains on trees which have already been harvested.

Regulatory gaps which were clearly diagnosed in 2008 are still, for the most part, just as large as before: competitive interests and the time needed to introduce reforms in the financial sector have retarded progress toward reducing systemic, cross-border risk. It is striking, for example, that all the attention has been spent on the problems of banks in countries where the oversupply of houses and the scale of negative equity are massive, leaving to one side all the problems in the regulatory field which contributed to the housing boom: lax procedures for building permits, indicators which perversely treated new housing starts as a positive sign of growth, local finances which gave towns and mayors incentives to promote housing, misallocation of labour which increased the size of the construction sector to 18% in Spain, the absence of strategic territorial planning, etc. There has been no regulatory reform of the housing sector, admittedly a huge undertaking. But when there was a crisis in the early 1990s related to a housing asset bubble and bust in several countries, including Japan, Sweden, the United Kingdom, the United States, Finland and the Netherlands, many countries carried out reform packages involving banks, tax exemptions, strategic infrastructure investments, and reallocations of budgetary resources. Similar – or bolder – reform packages have not been pushed forward now.

To explain further in a geopolitical context: Housing sector mis-management was faulted in the US as early as 2007 and remains a critical problem, inhibiting recovery and a reallocation of resources; it may turn out to be a problem in China, where manifestations of an asset bubble are evident, with potentially similar consequences for banks, private savings and debt and hence consumption, and even the appetite to continue to purchase the sovereign debt of the US and European countries. Cross-border efforts to reform housing sectors however run into the wall erected in the 1648 Treaty of Westphalia which prohibits the interference of one government in the domestic affairs of another.

Geopolitics are not sufficiently in evidence in discussions about what should be regulated, and about how, especially when extra-territoriality is being used more aggressively, especially since 9-11. The prospects for supra-national regulation and international regulatory co-operation appear diminished even as the sovereignty of all countries has been diminished by the crisis itself. To explain further: (1) The impact of the crash and subsequent recession on the countries of North Africa was far greater than either deliberate efforts to promote gradual reform or the anti-terrorist security measures taken between 2001 and 2010. And (2) The crisis has caused leading emerging economies to question the extent to which governments should disengage from direct intervention and from de-regulation.

On the positive side, officials have recognized that the financial sector can no longer remain exempt from regulatory policy disciplines, including RIA, ex-post evaluation and consultation; previous claims that somehow finance was different have fallen together with the credibility of bankers and their regulators. The OECD Policy Framework for Effective and Efficient Financial Regulation, adopted in 2009 at Council level following endorsements by the Committee on Financial Markets and by the Insurance and Private Pensions Committee, emphasizes the need for regulators to develop an understanding of the implications of changes in the macro-environment for regulated firms and for the system as a whole. The PFEEFR comes closer to adopting the standards of the OECD 1995 Checklist on high-quality regulation and the 2005 Guiding Principles on Regulatory Quality and Performance, specifically in regard to the need to carry out consultation, to consider alternatives to regulation, and to carry out evaluations. Behind OECD reports and soft-law instruments there is an intensive process of consultation and comparison across countries, exposing assumptions which had remained unquestioned, often for too long. The public does not see this work, but it may see the results. More generally, the patient development of studies on risk and regulation in the years before 2008 gave OECD committees a substantive framework for analysis when they needed it; an interest in regulatory impact assessment has advanced in areas such as corporate governance and environmental policy; and sectoral committees want to improve international regulatory co-operation by learning from and adopting good regulatory practices. Things might have been worse had there been no sustained effort over ten-fifteen years to put a regulatory policy framework in place: it serves as a barrier to protectionism.

Avoiding deep structural reform, governments in some countries such as the United States yielded initiative to the courts, which have had to resolve state-federal issues on immigration and labour mobility (Arizona versus the United States), or universal health care coverage (Obama-care). Again in the United States, the case of Watters vs. Wachovia reached the Supreme Court in 2007. Wachovia, a bank which has since gone bust, used a subsidiary to widen mortgage lending in Michigan without submitting to the state's licensing and regulating authority, claiming protection under the National Bank Act dating from the 1930s. Watters, representing the State of Michigan as the Commissioner of Insurance and Financial Services, was joined by 29 other state Attorneys-General in an effort to use state laws for licensing and regulating mortgage lending to protect consumers with stricter standards for issuing credit. Michigan claimed that the lending agency was separate from Wachovia, and hence subject to state supervision; Wachovia claimed that it was an operating subsidiary, supervised by the Office of the Comptroller of the Currency. Questions of corporate governance were mixed with questions of federal-state jurisprudence. A liberal majority on the Supreme Court found in favor of Wachovia on the grounds that the federal law took precedence. In retrospect, whatever the jurisprudential issues, the result was to relax regulatory oversight in a sector which generated the asset bubble and financial collapse of 2007-08. There is another lesson: the linear process of decision-making within the executive branch of government tells an incomplete story about what is regulated, and at what level of government. Given the long life of judicial precedence, the role of the judiciary needs to be assimilated into overall decision-making process. (The back-and-forth sequence of legislation between the Budestag and the Supreme Court in Karlsruhe is another example).

In today's atmosphere, it is much more difficult for regulatory policy officials who pride themselves on their professionalism and expertise to get involved in or be consulted on policy debates about what should or should not be regulated, or fight to apply high standards of regulatory quality when new regulations on labour, finance or the environment are under discussion. The source of power today is centralized treasury control of expenditure. States, which feel the loss of sovereignty attendant on the crisis, are reacting like wounded animals, concentrating strength on vital organs. Debt reduction or retirement? Or Investment in growth? How can government expenditure be assessed against regulations which constrain and oblige private actors to spend money in certain ways, to be in compliance? Regulatory governance is handicapped by the logic that subordinates what governments do to cash management. This is not a substitute for a growth strategy; reforms take time to lift incomes, consumption, competition and productivity. Impact analysis, ex-post evaluation, enforcement and compliance, all key attributes of evidence-based decision-making – who will defend these keystones of the regulatory policy architecture when public sector budgets are being cut?

In this race against time, as economic and social conditions worsen, there are other hurdles governments must face. First, they need to develop strategies to regulate when in crisis. If governments want to restore confidence in themselves, the rules that apply in and to the public sector (regulations inside government) need to be adapted to enhance initiative, promote innovation, and simultaneously strengthen accountability and consultation. Should it be possible to adopt or suspend regulations during a crisis using exceptional procedures, and if so, under what checks? The principle of non-interference in domestic affairs, entrenched in international relations since the Treaty of Westphalia of 1648 and the Vienna Conference of 1815, leaves countries exposed to cross-border risks. How can governments confront cross-border risks for which domestic measures are impotent? Think contagion effects due to SARS a few years ago, cyber attacks, or more recently, a banking run in a country such as Australia where the banks were sound.

And the stakes for risk regulation are high: crises of other, non-economic sources (industrial, environmental; natural catastrophes) have been increasing in frequency and intensity during the past two decades and look likely to remain as costly as they are difficult to predict. What are the regulatory frameworks appropriate for controlling urbanization in coastal zones or in flood plains? How can regulation in the building sector reduce the problems of energy demand and environmental waste management in the future? And when disasters occur, how can regulatory frameworks help business get started again, perhaps after relocation? Land use and water issues are inter-related, but the governance frameworks in place in many countries assign land use regulation to local jurisdictions and water to higher level bodies, making regulatory co-operation fraught with uncertainty and legal challenge, and regulatory coherence a theoretical dream and a frustrating reality. It is time to revisit assumptions about subsidiarity and public choice theory, and to question macroeconomists who say that well-functioning economies can cope with a one-off decline in GDP in the aftermath of a major disaster. Incremental changes to regulations will only add to the problems of complexity and coherence, but the will to take a comprehensive, strategic approach to face disasters which may occur, at a time and place that cannot be predicted, is low.

Unless there is capacity in government to handle these and other regulatory agendas - sustainably, with properly staffed institutions and agencies – we will get more reactive regulation, and policy by default not by design. Admittedly, the better regulation agenda has to compete against other agendas for the attention of and funding by ministers, who want to know how each claim on their scarce resources will benefit the public best.

The question to answer is how a regulatory strategy can help make up for lost wealth. This must be an urban agenda because, quite simply, most people live in cities, innovation is urban, and the organization of cities has a major impact on productivity and investment. Put another way, a regulatory agenda with an urban focus can address each of the main objectives of governments and elected leaders:

- Jobs – regulation of markets, opening closed or restricted sectors; promotion of innovation by substituting performance tests for command-and-control; reduction of non-tariff barriers to trade and investment; reducing administrative burdens and procedures for SMEs and business start-ups.

- Infrastructure – regulatory policies that affect sectors such as ports, railroads, energy; life-cycle planning for urban districts and housing; streamlining regulatory procedures for multiple approvals across sectors and levels of government; long-term models of the future urban economy, building confidence and certainty for business.

- Green growth – use of regulations to encourage innovation and its diffusion; standard-setting for new systems; more efficient use of materials over their life-cycle.

Each of these objectives involves significant bundles of regulations to be revised or adopted. This can be done if the political will is there. If it is not, then civic-minded experts face the dilemma between recommending structural and regulatory reforms that are politically feasible, or recommend changes to make the political system more effective in delivering reform.

A complementary effort is needed in universities to provide life-long training to public officials, leaders in civil society and businessmen alike in the fundamentals of regulatory policy and its links to public policy. And a greater effort must be made to educate people – and not just to train professionals – and equip them to deal with one another on the basis of how co-operation can produce better regulatory outcomes. Regulation remains a branch of applied economics, a course in law, or a subject in political science; it should be a horizontal, multi-disciplinary area of study, as relevant to engineering and environmental science, archeology and museum studies, as to public policy, micro-economics. Without a good understanding of regulation, it will be mis-interpreted through ideological lenses and distorted by code words and clichés: is it really illuminating or helpful to blame neo-liberal economic ideology or public choice theory?

Regulation is conservative, not in the partisan sense of defending the status quo which in fact has been how it has been used, but in the broadest sense, as a strategy to preserve the vital forces in society, an objective which may well call for greater, not for less, regulatory change. Regulation is about the interplay among factors and forces which enable individuals, firms and governments to create the conditions for mutual and collective development, not one at the expense of the other, but toward optimality. The quality of a civilization is reflected in its capacity to reproduce itself in different conditions, over time. Renewal and resilience appear today and for the foreseeable future to relate more to education and the environment – pure and mixed public goods - than to productive capital. We have seen the economic system in recent decades extract value from education as an input, and regulate the activities of firms and of individuals to reduce negative externalities in the environment. Each may have reached its limit. The transformation of education to lift productivity and sustain lifelong learning will call for substantial regulatory reforms in that sector and in the relationship between educational institutions, civil society and business. The pursuit of a better quality of life will call for more strategic, far-reaching efforts to reduce immediate and short-term risks to the environment through regulatory realignments and new modes of performance regulation. For their part, political leaders must prepare society to understand the need for and accept to focus on a new agenda.