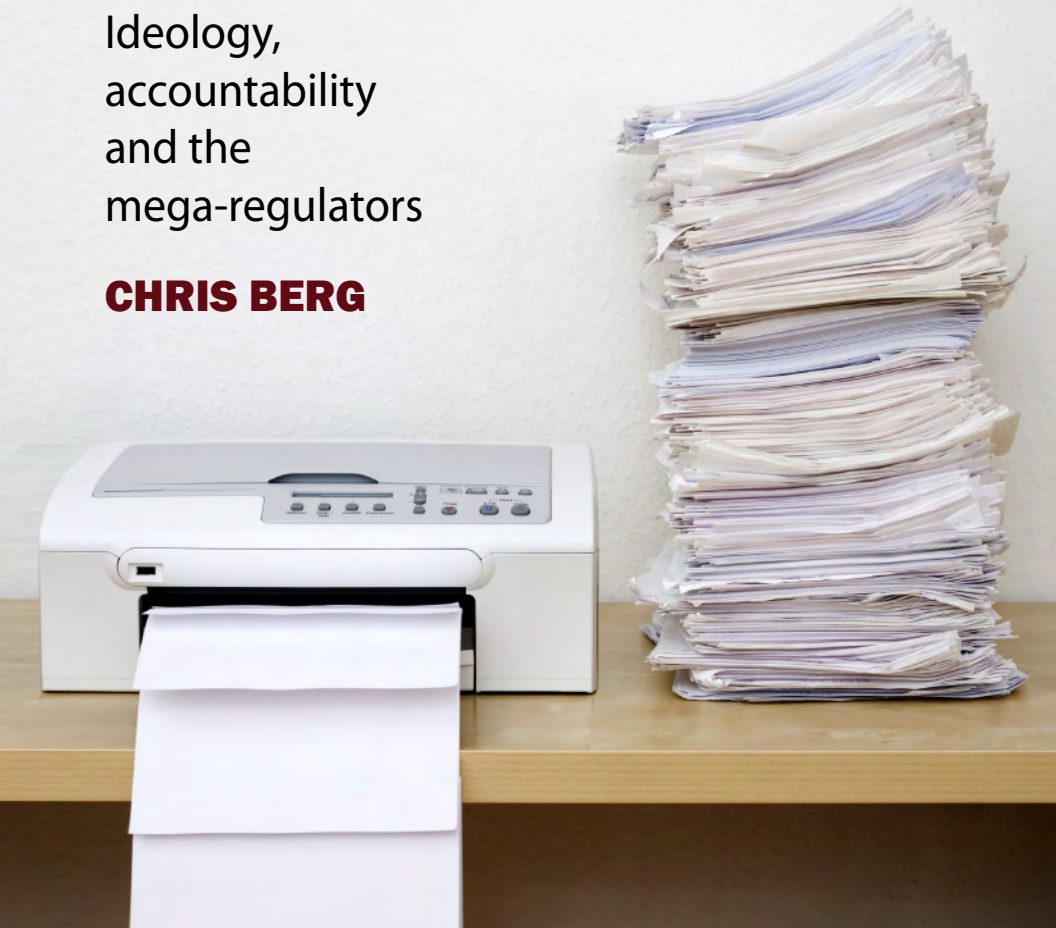
THE GROWTH OF AUSTRALIA'S REGULATORY STATE

Ideology, accountability and the mega-regulators

CHRIS BERG



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Ideology, Accountability, and the Mega-regulators

Chris Berg
Research Fellow
Institute of Public Affairs

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Head Office:
Level 2, 410 Collins St.
Melbourne Victoria 3000, Australia

Phone: (03) 9600 4744
Fax: (03) 9602 4989
Email: ipa@ipa.org.au
Website: www.ipa.org.au

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About the author

Chris Berg is a Research Fellow with the Institute of Public Affairs and the Editor of the *IPA Review*, Australia's longest running magazine dedicated to exploring free market ideas and public policy. He specialises in media, telecommunications and information technology policy.

His columns on regulatory policy and technological change have appeared in *The Australian*, *The Age*, *The Courier-Mail* and *The Australian Financial Review*. He is a regular columnist with *The Sunday Age*, writing about cultural and political issues. He is the author of a number of papers and government submissions, and gave evidence to the 2006 Senate Inquiry into Broadcasting Services Amendments.

Parts of this monograph are drawn from the paper, 'Policy without Parliament: the growth of regulation in Australia', which was published by the Institute of Public Affairs in November 2007. The author would like to thank Andrew Kemp for his invaluable help with the research for this work.

Foreword

John Roskam
Executive Director
Institute of Public Affairs

Regulations have more than just economic consequences. As Chris Berg reveals in this monograph, the explosion of regulation over the last few decades has precipitated a change in the structure of government itself. Our big three regulatory agencies, the Australian Competition and Consumer Commission, the Australian Prudential Regulatory Authority, and the Australian Securities and Investments Commission have been placed at the forefront of Australia's political system.

This monograph looks closely at these institutions, the discretionary power they have been granted, their levels of accountability, and their philosophical approach to regulating firms. Importantly, this monograph reveals the magnitude of the changes in regulatory practice and structures since the reform period, and raises questions about the future of regulation in Australia.

With a new commonwealth government, there is no better time to examine the power and influence of the major federal regulatory agencies.

Introduction

Regulation is a political activity. It sets the framework for the market economy by defining the boundaries between private action and government action. It is, since the failure of socialist methods of state ownership and control, the primary method by which the state relates to individuals and communities.

Appropriately, regulation has been deeply scrutinised to discern its impact on economic activity. Non-economic regulation has been analysed, to a lesser extent, from the perspective of political and human rights, as well as social and environmental impacts.

This monograph approaches the study of regulation from a different angle. Much study of regulation pays insufficient attention to the *institutions* which pursue regulatory goals. What is the proper role of regulatory agencies in a liberal democracy? What level of delegation to these agencies is appropriate? How accountable are these agencies?

This is not an economic analysis of regulation. Rather, it is an analysis of the structures and institutions that implement regulation, the way these have changed over time, and the implications of those changes. A number of major concurrent shifts in the form, development and conduct of regulation over the last two decades demand the reassessment of regulatory structures and processes.

- The volume of regulation and pace of regulation-making is increasing rapidly, and regulatory agencies have been consolidated into 'mega-regulators'.

- The method by which regulations are administered and policed has changed from a 'black-letter' approach to a 'responsive regulation' approach. Furthermore, the reliance on negotiation to ensure regulatory compliance brought about by this approach is increasing the discretionary power of regulatory agencies.
- Regulatory agencies have been deliberately separated from the traditional democratic chains of accountability.

The effect of these changes to the manner in which regulation is applied has worrying implications for the structure and form of Australian democracy. Regulators are increasingly political actors, using their statutory powers to influence and conduct public policy, which, in a democratic society, should be the domain of elected representatives.

The first part of this monograph looks at the recent institutional changes in Australia's regulatory agencies. It first charts the dramatic increase in legislation and regulation over just a few decades. It goes on to describe the consolidation and rapid growth of the three major economic regulators, the Australian Competition and Consumer Commission, the Australian Prudential Regulatory Authority and the Australian Securities and Investment Commission, as well as describing the changes in regulation-making and regulatory governance that has occurred over the last twenty years.

The second part looks at the place regulatory agencies have in the modern democratic state, the extent to which parliament has delegated authority, and even policy-making responsibility, to independent bodies, and the inbuilt mechanisms for accountability. It also looks at the new focus on the ideology of 'responsive regulation', and what implications these approaches have for the accountability of the agencies themselves.

1 Towards the regulatory state

W.K Hancock wrote in 1930 that 'Australian democracy has come to look upon the State as a vast public utility whose duty it is to provide the greatest happiness for the greatest number.'[1] Supported by a great deal of political consensus, this conception of the role of government buttressed Australia's welfare state for the majority of the 20th century. The Australian state had committed itself to the doctrines of full-employment, state enterprise ownership, protectionism, a highly regulated labour market, restricted capital markets, and marketing monopolies.

Under this model, public ownership of utilities and other industries, at least in theory, made economic regulation superfluous. Social and consumer focused regulations were largely insignificant.

In 2007, after two decades of nearly continuous economic reform, privatisation and trade liberalisation, the state which has succeeded the Australian welfare state is a radically different beast. Hancock's 'vast public utility' has lost its own vast public utilities. State and Commonwealth governments have systematically privatised a list of small and large-scale enterprises traditionally operated by government—banks, airports, telecommunications and energy utilities, laboratories, even radio stations.[2] Labour market reform, in a general direction of deregulation, has been a recurrent feature of the last two decades. Financial deregulation provided the reform period with its opening gambit.

Australia's reform movement has not been conducted in isolation, although it has been one of the more ambitious projects around the world. It joins the United Kingdom and New Zealand as the most extensive, although liberalisation has been a feature of almost all western democracies during the last two decades.

In Australia, to the extent that this ambitious program has been carried out, it has been largely successful in reversing the slow economic decline of the second half of the twentieth century. But contrary to the belief held by many on both the left and right of the political spectrum, this dramatic change in systems of political economy has not been as didactic as a shift from the welfare state to a liberal state. Leviathan has certainly not faded away—instead, amongst the reforms, liberalisations and privatisations of the last few decades, government has increased its expenditure and taxation.[3]

The modern state forges a compromise between Robert Nozick's 'nightwatchman state' and the welfare state by matching privatisations and liberalisations with regulatory *expansion*, rather than retreat.[4] Governments have shifted away from the provision of services, to the regulation of those services.

Institutions have been adapted to managing this change. When public utilities have been sold to the private sector, they have been concurrently placed under the jurisdiction of specialised statutory authorities whose role it is to direct and regulate those industries for public, rather than private, purposes. Often these measures have been matched by the development of regulatory mechanisms designed to introduce competition into industries where the cost of entry is seen to be prohibitively high—the mandatory third party access provisions of the *Trade Practices Act* and allied legislation allow firms to access the infrastructure of their competitor.

Protectionist or 'infant industry' legal structures, such as monopoly marketing boards and government cartelisation, are now subject to economy-wide competition regulation. Indeed, competition regulation has developed into its modern form parallel to the reform period.

A great deal of the growth in regulation under the modern regulatory state is social, rather than economic. Environmental regulation has a long history—Solon the Law-giver proposed in the sixth century that Greek agriculture be banned from steep slopes to prevent soil erosion—but its marked rise from the early 1970s was encouraged by the 1972 Stockholm Conference on the Human Environment. This resulted in the establishment of national environmental agencies in many developing nations, including Australia.[5] Consumer product safety, particularly in the transport sector,[6] and occupational health and safety regulations have also increased.

Financial regulation has followed an uneven path, but here too recent decades have seen significant re-regulation. The 'four revolutions' of financial deregulation in the early 1980s—the end of official control of the exchange rate, and of exchange control over capital flows, the entry of foreign banks and interest rate deregulation— precipitated the broader reform movement in Australia, and resulted in a far greater Australian participation in the global financial markets. These reforms rapidly changed Australia's banking sector from one of the most regulated in the world, to one of the least.[7] But this deregulation was closely followed by an increase in financial and securities regulation after a number of corporate failures, loans crises and much public criticism of the perceived excesses of the 'corporate cowboys'[8] of the time.

In the late 1990's, the Wallis Inquiry into the financial system increased the regulatory burden across many sectors, and a number of prominent corporate collapses in the first years of the 21st century provided the impetus for more again. Furthermore, participation in global financial markets has been accompanied by participation in global regulatory regimes, such as the G10's Basel II Framework.

It is perhaps not too much of a stretch to say that for industries which prior to the reform period were relatively free of government intervention, many of the developments under the aegis of the regulatory state consist of an encroachment of government into the private sphere, rather than the other way around.

This remarkable increase in government regulation has had a significant impact on the efficiency of the Australian economy and general levels of prosperity. However, the focus on the economic and social impact of regulation masks its full significance: there has been a fundamental shift in the relationship between government and society; in the mechanisms by which policy is conducted; and the institutions where political power resides.

2 Regulation and regulators in Australia

Regulation is a loose but convenient term. From a legal perspective, a regulation is a rule created by a delegated body—a clarification of existing primary legislation. This is, however, an insufficiently broad definition. For our purposes, regulation is the attempt to define the boundaries of economic activity for economic, social, or environmental reasons. Regulation is designed to modify or limit economic behaviour, but not to outlaw it.

It can be produced by explicit legislation, by subordinate legislation, by a wide variety of class orders, instruments, codes of conduct or guidelines. Where the government restricts economic activity, regulation can be found.

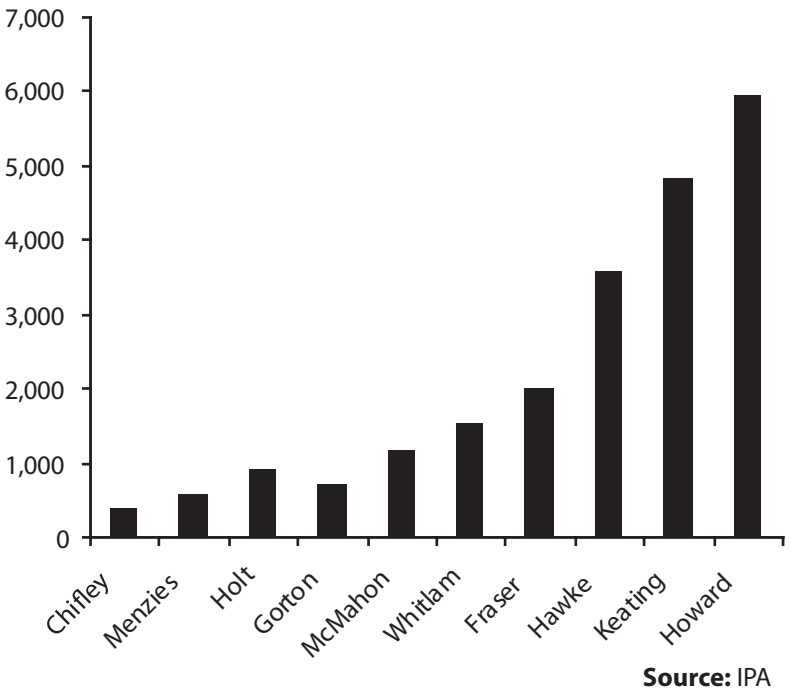
There are two conflicting models of regulation. The 'public interest' model argues that regulation is constructed and applied to solve economic and social problems which affect the community as a whole. These problems can be inefficiencies derived from market failures, or non-economic problems, such as welfare or equity. Carefully drafted regulation, judiciously and objectively applied, can, at least in part, mitigate these problems. Regulation is therefore a complement to the market, a mechanism governments use to improve market outcomes for economic or social goals, or divert market outcomes away from negative consequences.

A major impetus for regulation is the potential inefficiencies caused

by market failures. These inefficiencies can be not only economic, but also social or environmental. Regulation can act to replicate the alleged benefits of the state provision of services, for instance, by ensuring universal access to utilities. It can also replicate direct government redistribution techniques, for example, by capping prices on goods or services.

The public interest model of regulation assumes that regulators and legislators act in accordance to the best interest of the society at large. By contrast, the 'public choice' model of regulation treats regulators and legislators as self interested and flawed actors like any other within an economic system. As George Hilton has described

Chart 1: Average pages of Commonwealth Acts of Parliament passed per year, by government



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it, 'regulators are not automatons, but men and women who go to baseball games, advocate their political philosophies, have their gall bladders removed, take their cats to the veterinarian, and otherwise behave like the rest of us'.[9]

Regulation is the result of self-interested pressure groups competing to mold the legal framework for their own gain. The theory of regulatory capture—in which a regulator is 'captured' by the industry it regulates, and is therefore manipulated for private, not public, gain—is derived from the public choice model of regulation.

This monograph derives its model of regulation and political activity from the public choice school. The emphasis is, however, not on the self-interested actions of the regulated firm, or even on the politician. Instead, we focus on the actions and incentives of the regulatory agencies themselves. Furthermore, this monograph attempts to contextualise the regulatory agency within the formal structures of democratic legitimacy, looking specifically at the 'independent' nature of the regulatory agency within a framework of accountability.

This is not to disparage the character of the individuals who are employed in these agencies. Instead, the focus is on the *incentives* faced by those who are in a position to regulate firms. The behaviors described below are systemic; a function of the situation, not of the integrity of the regulators themselves.

Regulation is increasing

The most striking feature of the overall level of regulation and of the regulatory burden in Australia is its growth over time.

Legislation is wider in scope and content than regulation, but it can serve as a useful proxy. Chart 1 depicts the growth in Commonwealth legislation since Federation, by looking at the number of pages of Acts of Parliament passed per year.

While the growth in legislative activity has been sustained over time, it is interesting to note the dramatic increase over the past few decades. For instance, if we mark the year 1980 as the beginning of

Chart 2: Pages of Commonwealth Acts of Parliament passed per year, 1901-2006

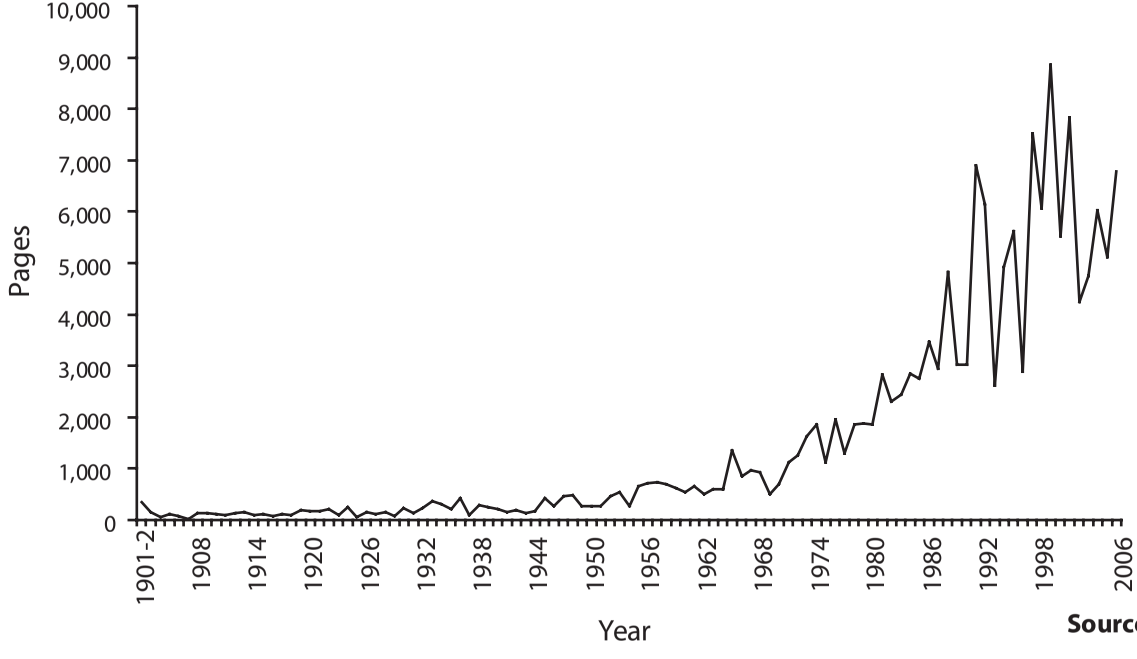

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Chart 3: Pages of legislation passed per year, Victoria, 1958-2006

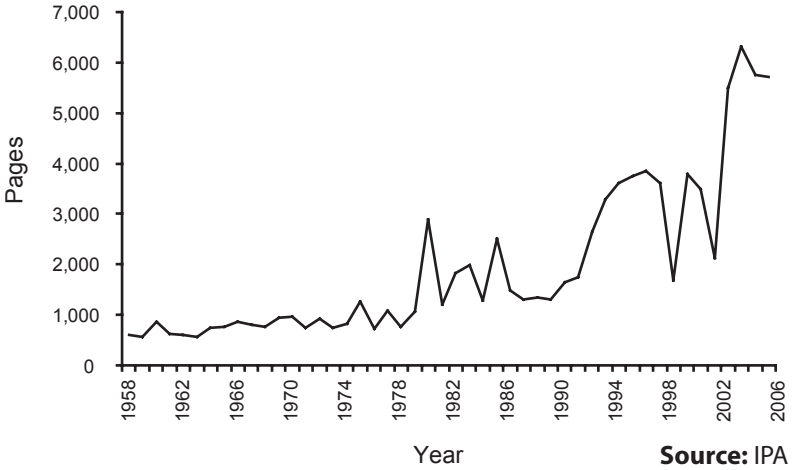

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Chart 4: Pages of legislation passed per year, New South Wales, 1959-2006

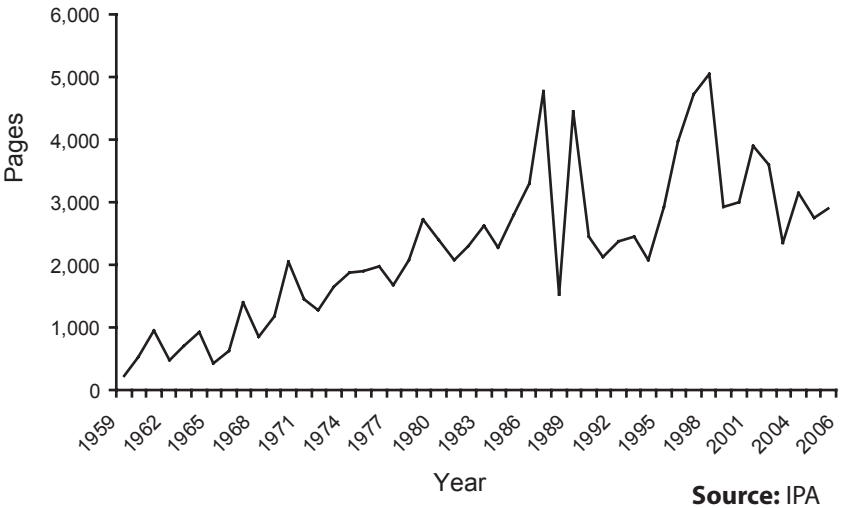

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Chart 5: Pages of legislation passed per year, Queensland, 1962-2006

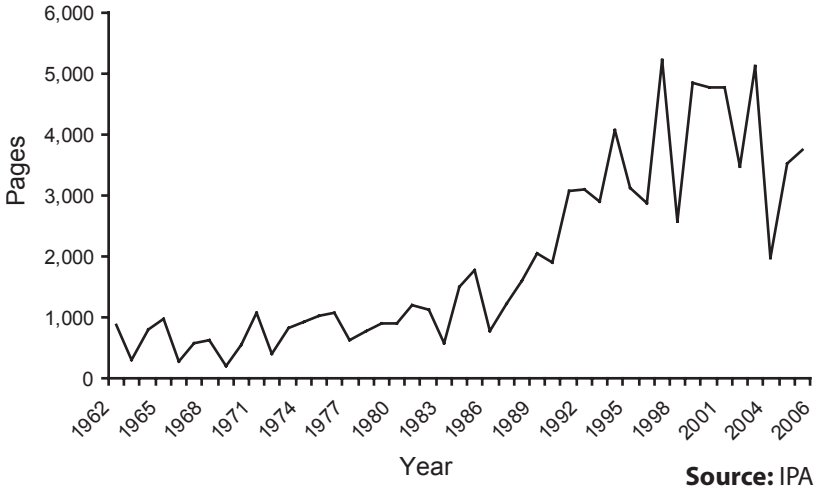

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Chart 6: Pages of legislation passed per year, Tasmania, 1968-2006

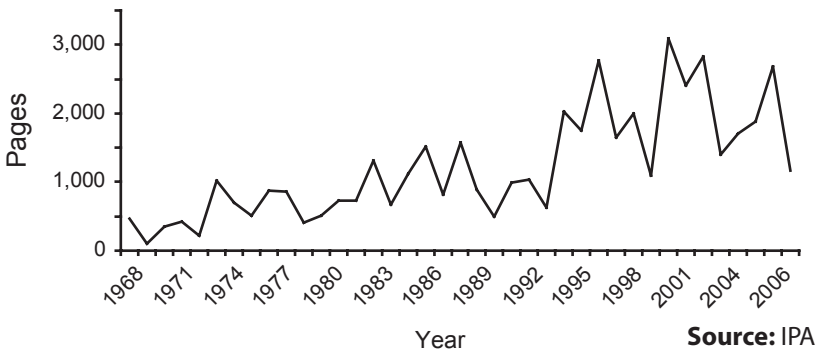

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Chart 7: Pages of legislation passed per year, Western Australia, 1959-2006

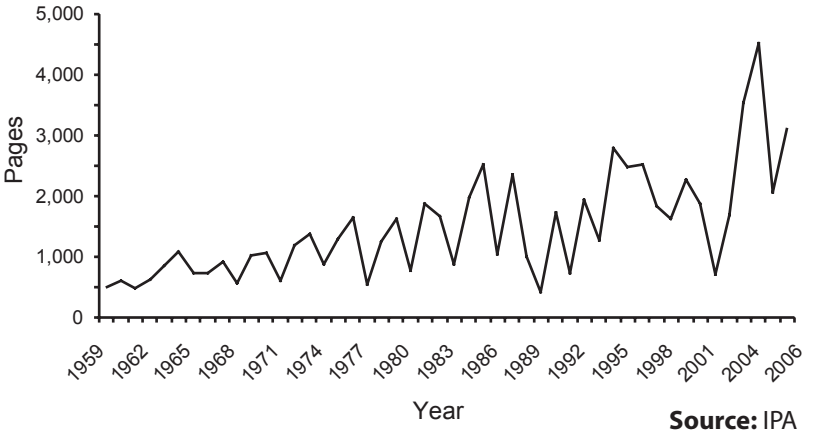

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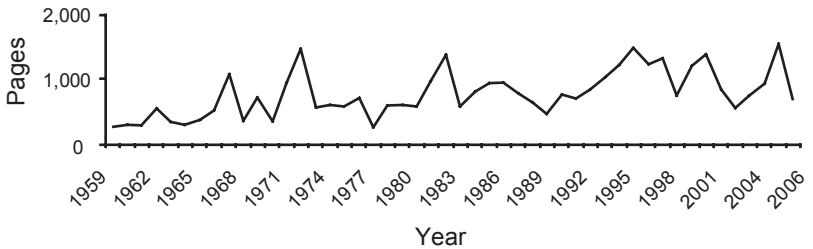
Chart 8: Pages of legislation passed per year, South Australia, 1959-2006



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the reform period in Australia, through to 2006, there was more than five times the number of pages of legislation passed than there had been in the eight decades before this period.

Furthermore, as Chart 2 reveals, it is striking how little legislative activity was required at the time of federation to unify the country—358 pages, spread over two years—compared with how much it took to manage the Commonwealth in 2006—a massive 6,786 pages.

Certainly, the changing nature of Australia's federal structure has significantly expanded the jurisdiction of the Commonwealth legislature, but there have been similar increases in state legislative activity—not decreases, as would be expected if there had simply been a shift in responsibility from the states to the federal government.

Indeed, state legislation has been marked by significant growth. Charts 3–8 illustrate legislative activity over the past forty years in Victoria, New South Wales, Queensland, Tasmania, Western Australia and South Australia respectively.

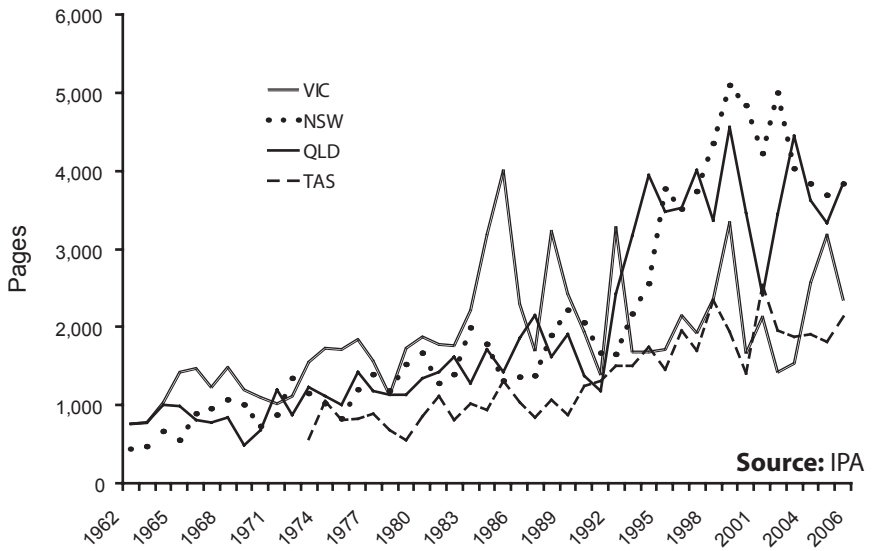
What data is available indicates that subordinate legislation—regulation—is growing at a similar pace as legislation. Charts 9 and 10 show how the increase in subordinate legislation in the Commonwealth and the states parallels the increase in total legislation over the last four decades.

Chart 1 reveals an interesting aspect of this increase. Legislative activity is government independent—changes in government have little effect on the rate of legislation. For this reason, Chart 2 illustrates how the coalition government under Prime Minister John Howard has been the highest legislating government in Australia's history. A similar analysis is possible with data on regulation cited in Chart 9—the Howard government oversaw the largest regulatory expansion since federation.

For the firms and individuals affected by regulatory and legislative increases, the impact is cumulative. Individuals not only have to act in accordance with the legislation and subordinate legislation passed in any given year—they also have to contend with the entire body of law as amended. Some of this legislation and regulation replaces existent

Chart 9: Pages of new Commonwealth subordinate legislation, 1962-2006

Chart 10: Pages of new state subordinate legislation, 1962-2006



law; but it is clear that it is growing—if not at the same heady pace that legislation and regulation in general is being passed.

One potential cause of the increase in pages of legislation is the move during the 1980s to plain-English drafting—as opposed to the traditional legislative language inherited from England in the nineteenth century—as well as the use of double-spacing.[10] Formatting changes can also alter the words-to-page ratio. Tasmanian legislation in its consolidated form has been published from 1996 on a larger paper format, but with an increase in white space. Similar changes have occurred in South Australia and Queensland.

Nevertheless, there is little to suggest that the plain-English drafting reform or formatting changes are the sole, or even primary, cause of increasing legislation pages—the increased activity both preceded these changes and continued after they had filtered through the various tiers of government. Technical changes in the manner in which legislation is drafted cannot explain modern legislative and regulatory excess.

Anecdotal evidence supports the empirical evidence for the growth in regulation. The federal government's 2006 Taskforce on Reducing the Regulatory Burden on Business noted that a particularly striking example of the level of regulation was the 24,000 different types of licenses administered by three levels of government.[11]

Telstra notes that the amount of regulatory instruments applicable to their business has grown since 1997 from 20 to 348,[12] and that the number of reports required by the ACCC have been increasing by 2-3 a year.[13]

Much of the increased regulatory burden is not sector specific, but is related to workplace law. The Australian Construction Industry Forum nominates recent changes to industrial relations and occupational health and safety law as a significant addition to the regulation facing their industry, as well as taxation changes.[14] Indeed, the *Incomes Tax Assessment Act* is often used as a barometer of legislative and regulatory growth, and has grown from 120 pages in 1936 to a bookshelf-crushing 7,000 pages.

The Insurance Council of Australia attempts to describe the level of

regulation affecting its industry by noting its effects on business structure and practice. Regulatory compliance now compromises between 10-25 per cent of board and senior management workload. One large insurer estimated a much higher workload, at least 40 per cent of senior executive time, and up to 60 per cent of board time.[15] One small insurer estimated that that this had grown five times since the amount five years ago, and ten times since ten years ago. Another insurer estimated that compliance expenses as a percentage of operating income had more than doubled in the last five years. Another estimated that the staff numbers in regulatory compliance committees had grown 20-30 per cent in the last two years up to 2005.[16] A PricewaterhouseCoopers analyst has noted that for the insurance industry over the last five years the cost of complying with the prudential regulatory framework has increased significantly.[17]

The Credit Union Industry Association notes that the burden on both their credit union membership and other banks and building societies has increased since the Wallis Inquiry, and attributes this to the mandatory implementation of Basel II, recent Financial Services reforms, changes to prudential standards, and the adoption of international accounting standards.[18] A practical example of this increase is provided by the Business Council of Australia: a total of 227 pages of documentation needs to be given to a customer before they can open a simple cheque account with an overdraft limit and a home loan, roughly five times the amount in 1985.[19] The Australian Bankers Association reports that one bank has doubled its annual compliance expenditure levels every five years since 1994-95, with a similar growth in staff dedicated to regulatory compliance.[20]

There has been little quantification of the extent of local government regulatory activity, but, there are indications that it is increasing. The Australian Chamber of Commerce and Industry writes that there has been a marked upswing of local government regulation as a constraint to investment between 2003-05.[21]

Some of these anecdotal impressions of the regulatory burden may even understate the economic impact of regulation by focusing in-

ordinately on the paperburden cost rather than the total regulatory cost. The paperburden cost includes the cost of employees dedicated to regulatory compliance, and external legal, economic and financial consultants, and they typically constitute one-third of the total cost of regulation.[22]

Thus, the contemporary political focus on 'red tape' presents the problem of over-regulation in a narrow light. The structure of regulation is so central to the business models and profitability of some firms that regulatory governance and compliance is an 'all-of-firm' question. For these firms, it is not necessarily possible to separate regulatory compliance costs from business costs.[23] The anecdotal estimates above, which focus predominantly on easy to measure paperburden costs, are, likely to be underestimations for many industries.

The full cost of regulation is much greater than the visible cost of compliance. Certainly, the distribution of costs caused by regulation varies by industry. In the food sector, the primary cost of regulation is a paperburden cost. But for much of the economy, the paperburden cost is dwarfed by the restrictions imposed by the regulations. For instance, the 'chilling effect' of access regulation dwarfs the paperburden cost of those regulations by holding back infrastructure investment.

As Gary Banks argues, 'regulations not only create paperwork, they can distort decisions about inputs, stifle entrepreneurship and innovation, divert managers from their core business, prolong decision-making and reduce flexibility.'[24] These effects are, on average, far more significant than the red-tape which is required by regulators to assess compliance. Focusing only on paperburden costs is like focusing on the time spent filling out a tax return rather than the amount of tax paid. Political platitudes to lower the red-tape burden offer little promise if they are not part of a general push to decrease overall regulatory intervention in the economy.

It would be a mistake to limit the analysis of regulation to the regulatory paperburden. Nevertheless, the increases in the compliance cost of regulations can provide a rough proxy of the increases in the regulatory burden across the economy.

Regulatory agencies are growing

Another method by which we attempt to measure regulatory growth is by looking at the structure and size of the regulatory agencies themselves.

There are approximately sixty Commonwealth regulators and national standard setting bodies.[25] There are a further forty federal ministerial councils setting and administering regulations. While hard to estimate, the federal regulatory agencies employ over 34,000 people, with a combined budget of well over $4.5billion.

The Victorian Competition and Efficiency Commission identified sixty-nine regulatory bodies in that state, with a combined budget (excluding the Metropolitan Fire Brigade, Country Fire Authority and Parks Victoria) of over one billion, and a staff of 6,895.[26] The Productivity Commission extrapolates these figures to come up with an estimation of 600 regulatory agencies across the country. Extrapolating that figure, and taking into account government departments with regulatory functions, ministerial councils, inter-governmental bodies, and the range of quasi-official agencies and boards, it is easy to imagine that nationwide, at least $10billion is spent on regulating the Australian economy annually.

Using numbers of staff as a proxy of agency size, many of the agencies have seen significant recent growth. For instance, the Australian Fisheries Management Authority has nearly doubled in size in the last decade, from a staff of 100 to 186. Food Standards Australia New Zealand has increased by 50 per cent, from 100 in June 2000 to 146 in 2006. The Australian Pesticides and Veterinary Medicines Authority has increased in that same period from 113 to 133.

In Victoria, the Office of the Chief Electrical Inspector had grown from a staff of 35 in 1999 to 59 in 2005, when it was merged with the Office of Gas Safety to become Energy Safe Victoria with a staff of 89. The Victorian Building Commission has increased its staff to 111 from 81 in 2002. The Essential Services Commission has increased from 34 to 62 since 2001. In New South Wales, the Independent Pricing and Regulatory Tribunal has doubled in size in the past decade, from 32 in 1997 to 73 in 2006.[27]

Agency consolidation and the mega-regulators

There are a large variety of regulatory agencies dedicated to regulating specific industries, like the federal Civil Aviation and Safety Authority or the Australian Fisheries Management Authority. But occupying a central role in Australia's regulatory system are a few key economic regulators with economy-wide scope. Rather than being confined to narrow jurisdictions, these agencies typically do

Table 1: Resources of selected Australian Government regulatory agencies in 2004-05

Agency	$'000	Staff
Australian Customs Service	1,026,351	5,572
Australian Maritime Authority	71,925	247
Food Standards Australia New Zealand	18,967	146
Australian Prudential Regulation Authority	95,052	570
Australian Securities and Investments Commission	217,967	1,471
Civil Aviation Safety Authority	120,547	672
Australian Pesticides and Veterinary Medicines Authority	21,263	133
Australian Taxation Office	2,525,935	21,511
Australian Competition and Consumer Commission	84,168	596
Australian Communications and Media Authority	73,799	500
Australian Fisheries Management Authority	43,162	186
Australian Quarantine and Inspection Service*	290,000	2,800
Total	**4,589,136**	**34,410**

*Data from 2003-04

Source: Annual reports. Adopted from Productivity Commission, *Regulation and its Review, 2004-05*

not only regulate a wide variety of industries, but are also multi-dimensional in scope. That is, Australia's major economic regulators regulate for both economic and social outcomes, as well as technical regulation like standards setting. These regulators are not built around the institutions that they administer, but are rather built around 'functional' lines.[28]

For example:

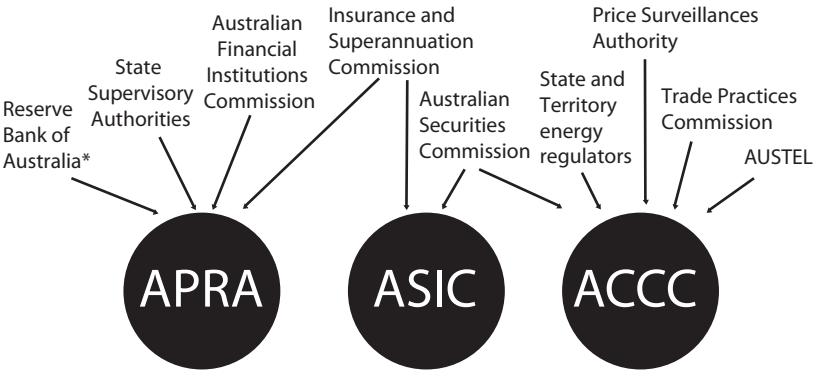
- the Australian Securities and Investment Commission (ASIC) is responsible for consumer and investor protection;
- the Australian Prudential Regulatory Authority (APRA) is responsible for prudential regulation; that is, market failure associated with information asymmetries in financial contracts; and
- the Australian Competition and Consumer Commission (ACCC) is responsible for policing anti-competitive behavior economy-wide.

Functional regulation is said to be more suitable for economic systems that are highly complex, and when the boundaries between industries are blurred. With jurisdiction across the economy, functional regulators are able to identify similar characteristics in firms from different sectors and regulate appropriately.[29] By contrast, in an 'institutional' or 'industry-centric' regulatory system, firms may avoid ther regulator's attention by engaging in activities in which-regulator may not have specialist expertise. Similarly, one regulator may develop standards which contradict other regulators.

Some academics have argued that institutional regulation, by 'siloing' off industries into distinct and separate categories, is more resistant to possible 'runs' of risk across industry sectors,[30] although there has been some evidence to suggest that adopting a functional approach to financial regulation in Australia has not been harmful in this way.[31]

The following sections look specifically at the three major functional economic regulators, the ACCC, ASIC and APRA. However it is worth noting that the Australian Communications and Media Authority, and

Chart 9: Agency consolidation



* The Reserve Bank of Australia has retained some of its regulatory functions.

Source: IPA

the Reserve Bank of Australia are also major economic regulators. Furthermore, both the Australian Taxation Office and the Australian Customs Service both also have substantial regulatory powers.

The Wallis Inquiry

The 1997 Financial System Inquiry ('Wallis Inquiry') was only the third major inquiry into the Australian financial system since federation, after the 1936 Royal Commission and the Campbell Inquiry in 1981. After the 'four revolutions' which followed the Campbell Inquiry, the financial market and its structure went through a dramatic overhaul, with the introduction of new institutions such as foreign exchange firms, recognised bond dealers and new types of trusts and management funds, as well as entrance into foreign exchange markets and new secondary mortgage markets.[32] In the decade between 1985 and 1995, the number of commercial banks in Australia increased from 13 to 49.[33]

The purpose of the Wallis Inquiry was to assess the appropriate-

ness of the regulatory framework which had been constructed during the period of financial deregulation in the light of these changes. The 'modest trend' towards agency consolidation internationally was noted in the inquiry's discussion paper—the inquiry predated the now prototypical example of an 'all-in-one' regulator, or 'mega-regulator', the United Kingdom's Financial Services Authority (FSA).

Governance and power concentration was a factor for the participants of the inquiry when recommending the ideal regulatory structure. The inquiry rejected a proposal to amalgamate existing financial regulators into a 'mega regulator' due to the need for efficiency and specialisation. The inquiry was concerned with regulatory governance; writing that the single regulator may become 'excessively powerful'.[34]

But nevertheless, the Wallis Inquiry's final recommendations as adopted by the government consisted of major agency consolidation into two main organisations, the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investment Commission (ASIC). This model was popularly known as the 'twin peaks' model, from a 1995 article which recommended delineating financial regulation according to function—prudential (APRA) and disclosure (ASIC).[35] Advocating this agency consolidation, Treasurer Peter Costello said ahead of the Wallis Inquiry:

> The regulatory framework is hopelessly out of date. You have superannuation funds that are now in home lending and are essentially running banks and you have banks coming into superannuation—you have got different institutions offering the same product, different regulators regulating the same product because they are offered by different institutions. Why do not we cut all that away and say whatever the nature of the financial institution we will have a regulator covering prudential and a regulator covering consumer protection and we can sweep a whole lot of that away?[36]

While the 'twin peaks' model amalgamates regulatory functions in a less extreme manner than the United Kingdom's FSA, it was, nevertheless a significant consolidation. By drawing the vast bulk of regu-

latory functions away from the Reserve Bank of Australia (the bank did gain some roles of the Australian Payments System Council), the new model eclipsed the international consolidations described in the inquiry's discussion paper. It is not inaccurate to refer to the new tri-regulator model as a system of 'mega-regulators', even if the FSA provides a more 'pure' example of such an institution. In both the Australian and international context, the result of the Wallis Inquiry was the creation of two functionally-structured mega-regulators with economy-wide jurisdiction.

Australian Prudential Regulatory Authority

Before the Wallis Inquiry, prudential regulation was structured institutionally—a framework which emphasised the differences between the regulated institutions rather than the similarities. The Insurance and Superannuation Commission (ISC) regulated insurers and superannuation funds. The RBA regulated the banking sector. The constitutional division between the Commonwealth and the states had resulted in regulatory authority for building societies, friendly societies and credit unions residing in the eight State-based 'State Supervisory Authorities'[37] and the federal Australian Financial Institutions Commission. (AFIC).

Under the post-Wallis Inquiry reforms, APRA, as a functional regulatory agency, has assumed prudential regulation of finance-based industries. It required eleven pieces of legislation, which constituted over 4000 pages, including four new acts and two omnibus acts. In total, APRA's foundation amended and repealed more than seventy existing acts.[38]

APRA absorbed the entire ISC, as well as roughly seventy staff from the RBA who had bank regulation roles. APRA has since experienced rapid growth, from a staff of roughly 400 at the time of transition to 570 in 2006. The annual federal appropriation for APRA has grown fifty-five per cent in that time, to a budgeted $90,058 in 2006-07.

On top of the legislation which founded APRA, the prudential

regulator has overseen more than 66 major regulatory changes since 2000.[39] In 2007, APRA regulates more than 1,900 entities (excluding small APRA funds).[30]

For the insurance industry, the creation of APRA represented a significant increase in regulatory activity covering the sector. Under the ISC, the insurance industry had been regulated relatively lightly. In the view of the new consolidated regulator, this light-handed regulation was unsatisfactory. APRA's Executive General Manager of Policy, Chris Littrell, argued that:

> Until 2001 the Australian general insurance industry was characterised by an unsatisfactory culture of reluctant regulatory compliance by some entities, even among our largest companies.[41]

Indeed, following the HIH insurance collapse, Littrell argued that eliminating this cultural clash was one of the early tasks that the regulator faced:

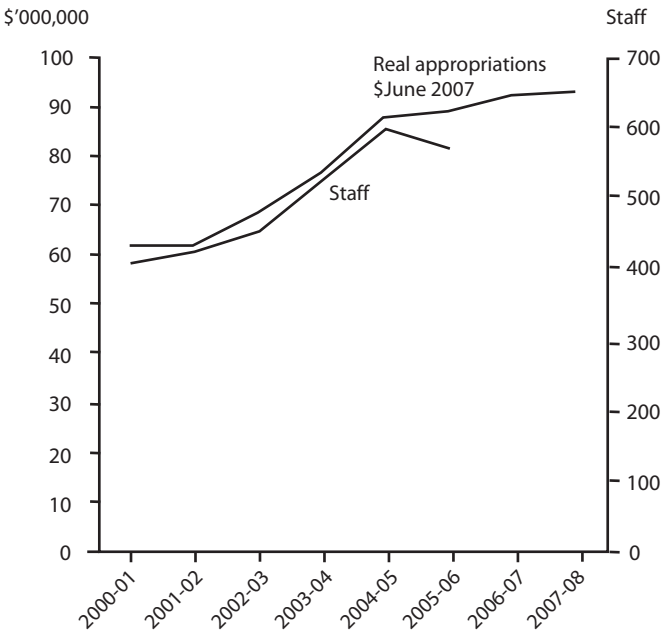
> As an integrated supervisor, APRA is in a position to observe the managerial differences between our regulated sectors. Banks in general are run by people who are or have been risk managers, and by people who understand that regulation has its good points. In Australia at any rate, many insurance companies have been dominated by salesmen, who often viewed regulation as something to be avoided. Having come up the career ladder by dealing with actuarial restrictions, they tended to treat regulatory requirements as another annoyance to overcome, rather than a guide to good practice.[42]

While HIH's collapse and the subsequent Royal Commission heralded the beginning of a major wave of regulatory increases in the insurance industry, its genesis was the foundation of APRA itself, which coupled the insurance industry with the much more highly regulated banking industry. Indeed, plans to increase regulation of the general insurance industry preceded the 2001 collapse of HIH. The *Financial Services Reform Act 2001* classified most insurance as a 'financial service'—with the notable exceptions of reinsurance, health insurance and government insurance—and required an Australian financial services license. Financial product advice, dispensed by in-

termediaries not directly providing insurance, also required licenses under the 2001 act to do so. The act also imposed significantly increased product disclosure requirements, and capital and corporate governance requirements.[43]

The industry has implemented a second wave of HIH inspired reforms, APRA Stage II, which, among other things, require new business plans to meet future capital liabilities, annual financial condition reports, and regular external reviews.

Chart 10: APRA, Staff and Annual Appropriations, 2000-01 to 2007-08



Source: Staff: APRA Annual Reports. Appropriations: Commonwealth Budget Papers

The Association of Superannuation Funds of Australia, in its submission to the Reducing Regulation Taskforce, stated that since the establishment of ASIC and APRA, supervisory levies paid by superannuation funds had increased dramatically. Indeed, APRA's expenses relating to superannuation have grown, even though the number of superannuation funds themselves have decreased significantly.[44]

For the banking sector, a great deal of the regulatory change after the foundation of APRA was concerned with the transfer of regulatory authority from the still-existent RBA towards the new prudential regulator.[45] But the most significant regulatory change has been adopting the Basel II Capital accords. As a non-member of the G10's Basel Committee on Banking Supervision, Australia is under no obligation to do so. Australia's authorised deposit taking institutions (ADIs) began to adopt the Basel II Framework in January 2008.

The implementation of Basel II under the auspices of a mega prudential regulator has, for many organisations, had the effect of a dramatic increase in regulatory burdens. Basel II constructs an internationally consistent framework for banking capital requirements and accounting standards. For large, internationally active, banks, implementing Basel II has much important significance. However, for smaller domestically based ADIs, Basel II provides little benefit. For credit unions, whose involvement in international markets is low, the cost of implementing the framework is precipitously high. Similarly questionable benefits have accompanied APRA's uniform adoption of the International Financial Reporting Standards, which affects major, internationally active, Australian banks and small domestic cooperatives like the St Mary's Swan Hill Co-operative Credit Society alike.[46] APRA's activities illustrate clearly the perils of uniformly applying regulations that are designed for a specific class of institution.

Australian Securities and Investments Commission

Under the twin peaks model of financial regulation, the Australian Securities and Investment Commission (ASIC) regulates company and financial services law for consumer, investor and creditor pro-

tection. Where APRA regulates for the viability of financial institutions, ASIC's many briefs include regulating conduct and disclosure, administering the corporations law and consumer protection. To do so, it administers eight separate laws, including the *Corporations Act 2001, Australian Securities and Investments Commission Act 2001*, and the *Insurance Contracts Act 1984*.

ASIC was drawn from the Australian Securities Commission, and in 1998 absorbed the consumer protection responsibilities in insurance and superannuation of the ISC. It also drew consumer protection responsibilities in finance from the Australian Competition and Consumer Commission, replicating Section 52 of the *Trade Practices Act* in the ASIC Act. Further, ASIC absorbed the consumer protection responsibilities of the Australian Payments Systems Council and financial sector industry codes of conduct.[47] In 2005-06, ASIC had regulatory responsibility for 1.5 million corporations and 4,415 financial services businesses.[48]

ASIC's growth has been the most marked of the economic regulators. Since 1999, the regulator's annual real appropriations have increased by 76 per cent. In that time, it has hired more than 200 extra staff; going from 1,221 to 1,471.

Regulatory agencies tend to be reluctant to divulge the resources dedicated to different aspects of their operations, but the 2005-06 annual report provides a breakdown of ASIC's staff operations.

According to publicly available data, regulation and enforcement consumes between 50-60 per cent of the employees and finances of ASIC, a proportion which has increased since its founding.[49] The categories ASIC use to class their activities could be misleading—nevertheless, it is notable that the development of regulatory policy, that is, changes in regulatory policy, employs more than 100 full time staff.

ASIC has overseen a rapid and comprehensive overhall of corporate governance law under the Corporate Law Economic Reform Program (CLERP). Changes to Australian's corporate law under CLERP have spanned nearly a decade, so far comprising of:

- CLERP 1-5: Corporate Law Economic Reform Act 1999 covering fundraising, director's duties, takeovers and accounting standards
- CLERP 6: Financial Services Reform Act 2001 covering Wallis Commission reforms
- CLERP 7: Corporations Legislation Amendment Act 2003 covering lodgement and compliance procedures
- CLERP 9: Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 covering the regulation of corporate governance.[50]

The continuous reform of the CLERP decade is set to continue: The Federal Government released three discussion papers on corporate law and compliance in March 2007.[51]

The rapid, comprehensive change in corporate law under the continuous process of CLERP, as well as the Wallis Inquiry-era reforms which inaugurated ASIC, have been matched by the regulators use of legal instruments to modify the *Corporations Act* 2001. Since 2002, ASIC has issued more than 380 class orders, which materially alter the terrain of corporate law.[52] Indeed, the Association of Superannuation Funds of Australia argues that ASIC's reliance on instruments like class orders has been a major cause of the increased complexity of corporate regulation in the last decade.[53]

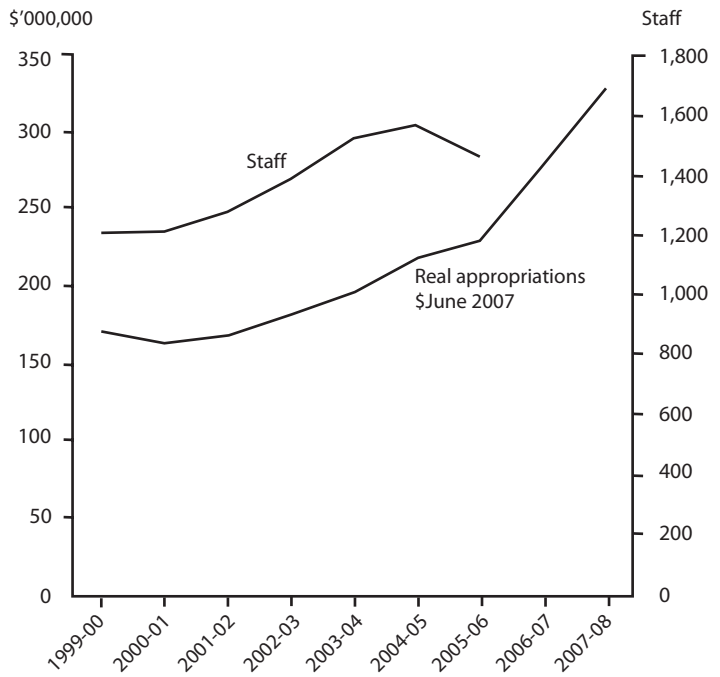
The gains from the expanding reach of regulatory intervention in the structure of the firm are uncertain. Prominent corporate collapses have been a regular feature of Australian economic history since before federation.[54] There is, however, little evidence to suggest that the dramatic increase in corporate, securities, financial and banking regulation that followed the wave of corporate collapses in the late 1980s has had any significant impact on subsequent collapses.

There is a very real likelihood that the excessive restraints placed upon corporate form and function, particularly at the executive and upper management level, can have a detrimental effect on entrepreneurial activity. Regulatory micromanagement places a sig-

nificant burden upon innovative practices and structures. It also induces substantial costs upon firms. For instance, regulatory measures which attempt to foster 'compliance culture' by imposing personal legal liability for business decisions upon executives reduce the incentive to take up those senior management positions, and raise the salaries of those who do.[55]

As with all tax and regulatory burdens, firms try as far as possible to pass these costs onto the consumer. It is indicative that an

Chart 11: ASIC, Staff and Annual Appropriations, 1999-00 to 2007-08



Source: Staff: ASIC Annual Reports. Appropriations: Commonwealth Budget Papers

Table 2: ASIC staff by team, 2005-06

Team	Role	Number
Enforcing the law	Investigate and act against misconduct	373
Protecting consumers	Protect consumers	100
Promoting compliance	Ensure companies and licencees comply with the law	187
Regulatory work	Set ASIC policy on regulating markets and business	137
Operations	Company data, insolvency, IT and HR	480
Finance	Finance, risk, knowledge management, corporate services	117

Source: ASIC Annual Report, 2005-06

August 2006 CPA Australia survey found the perception that the overwhelming beneficiaries of CLERP 9 auditing processes reforms were regulators and auditors.[56]

Australian Competition and Consumer Commission

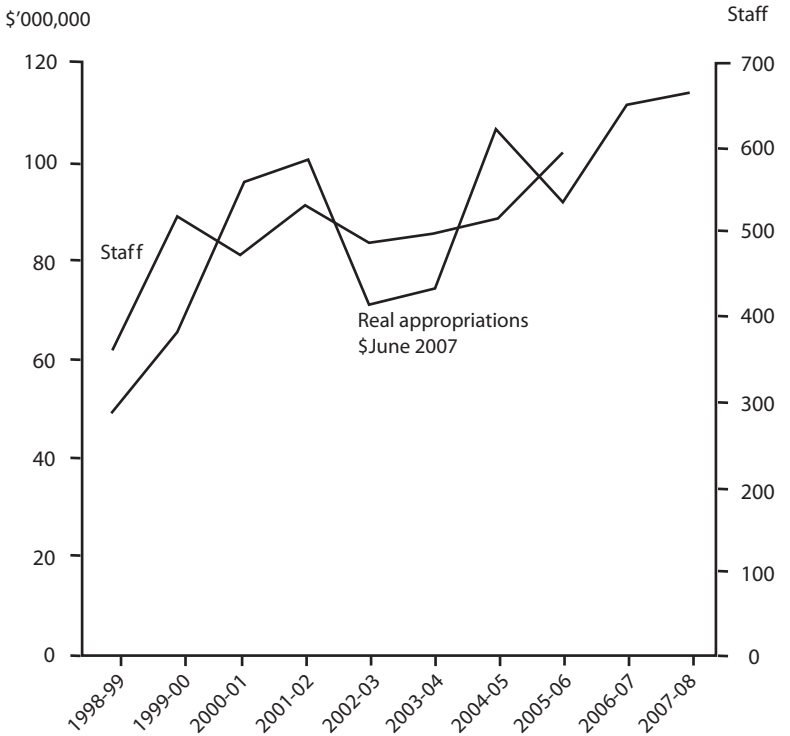
The Australian Competition and Consumer Commission (ACCC) was also conceived as a national, functional regulator for Australian competition and consumer regulation. The 1993 Hilmer Committee wrote that it:

> …started from the proposition that competition policy across all Australian industries should be desirably administered by a single body… As well as the administrative savings involved,

> there are undoubtedly advantages in ensuring regulators take an economy-wide perspective and have sufficient distance from particular industries to form objective views on often difficult issues.[57]

Prior to the creation of the ACCC, the Australian Trade Practices Commission (TPC) monitored and enforced competition regulation under the 1974 *Trade Practices Act*. The Prices Surveillance Authority administered the *Prices Surveillance Act 1983*, focus-

Chart 12: ACCC, Staff and Annual Appropriations, 1998-99 to 2007-08



Source: Staff: ACCC Annual Reports.
Appropriations: Commonwealth Budget Papers

ing on the abuse of market power.[58] In 1995 the Trade Practices Commission and the Prices Surveillance Authority were folded into the newly-created ACCC to administer the *Trade Practices Act*. In 1997, the telecommunications regulator, AUSTEL, was abolished, and responsibility for telecommunications-specific competition regulation transferred to the ACCC. (The responsibility for technical and standards regulation for the telecommunications industry was moved to the Australian Communications Authority, now the Australian Communications and Media Authority.)

In 2005, the Australian Energy Regulator (AER) was established, as an independent, but constituent part of the ACCC. In practice, the AER will operate largely as a section within the ACCC.[59]

After its assumption of telecommunications regulation, the ACCC has grown from a staff of 359 in 1999 to 596 in 2006; a 66 per cent increase. The agency's budget has doubled in real terms.

In 2005-06, the ACCC was involved in 53 litigation proceedings, and accepted 54 enforceable undertakings from firms.[60]

Compared to APRA and ASIC, the ACCC has overseen a relatively stable regulatory environment, at least since 1997. Some changes are, however, worth noting. In 1998, the regulator lost some jurisdiction after the financial services reforms transferred responsibility for misleading and deceptive conduct in financial services to ASIC. However, ASIC has since referred the responsibility for health insurance back to the competition regulator. The ACCC was given responsibility for price monitoring and price 'exploitation' during the transition to the New Tax System, which may account for the sharp increase in growth of staff in the 1998-2000 period. This increase in agency size has, tellingly, been sustained since those powers expired.

Warren Pengilley has described the omnibus role of the ACCC as 'educator, policymaker, prosecutor, advocate, adjudicator, executioner and arbitrator'.[61]

[Regulatory activity] …resembles the attitude of the Soviet Navy to the North Sea. When the Soviet Navy does not know what to do with its submarines' spent nuclear fuel, it simply throws it into the North Sea without much consideration for the long-term effects of its action. We have done much the same in this country in relation to regulation. When we have some sort of an economic or pricing problem, we simply throw it to a regulator to fix without much consideration of the long term effects of what we are doing.[62]

3 Explaining agency growth

Bureaucracies grow

The growth of regulatory agencies can be explained in a number of ways. As the volume and complexity of regulation grows, the cost and expertise required to administer it grows similarly. The public interest model of regulation also indicates another source of agency expansion—the political desire to provide extra resources for increased regulatory activity.

These explanations are external—that is, they locate the cause of agency expansion outside the agencies themselves. However, the public choice model helps flesh out some other sources of agency growth. Regulatory agencies differ in many important respects from traditional bureaucracies, but they are influenced by many of the same incentives, and the model of bureaucratic growth provided by public choice theory can be usefully applied to independent regulatory agencies. Regulators are, like bureaucracies, non-profit organisations financed by appropriations, rather than the sales of output. Bureaucracies are motivated, not by the profit-maximisation that characterises private industry, but by budget maximisation, or, more accurately, *discretionary* budget maximisation.[63] Regardless of any increase in the regulations that an agency administers, we should expect regulators, acting as bureaucracies, to expand their discretionary budgets accordingly.

Such a desire to maximise the budget of an agency does not have to

be the consequence of conscious self-interest. Regulators may be convinced that increased budgets will help them improve outcomes and detect non-compliance in regulated firms. Furthermore the existence of 'cat-and-mouse' games between firms and regulators (described below) may convince regulators that they require higher budgets to match firms' activities. As the importance of regulation to the financial viability of private firms increase, firms correspondingly increase the resources dedicated to manipulating or avoiding those regulations. A common complaint about regulatory activity in Australia from those who favour the public interest model is that the resources used by firms to challenge regulations dwarf the resources available to regulators. As a regulatory framework increases in complexity, the resources dedicated to managing that framework—from both the regulator and the firm—also increase.

Furthermore, budget maximisation can be encouraged by institutional, administrative and structural changes in the public sector. Empirical evidence exists to suggest that bureaucratic budget maximisation is partly dependent in the size of the jurisdiction administered. In small jurisdictions, it is difficult to conduct public policy that favors a minority, as voters are able to inform themselves about that policy at a lower cost. In larger jurisdictions however, voters are constrained by both the costs of acquiring information, and the possibility that doing so could materially affect the policy.[64] Larger jurisdictions also increase the cost of moving away from the jurisdiction—the bureaucracy effectively asserts a monopoly power over those it administers.

Two major drivers have led to a jurisdictional expansion of regulatory agencies in Australia. The first is the centralisation of regulatory agencies. Agency consolidation has been made possible by moving regulatory jurisdictions from the states to the commonwealth—seen, for example, in the Wallis era reforms eradication of the state based State Supervisory Authorities. The second is the transition from institutional regulation to functional regulation. Functional regulation can be usefully seen as a jurisdictional expansion, as regulators focus not on single industries, but on broad categories of marketplace activ-

ity. This expansion in regulatory scope is just as much a jurisdictional expansion as a geographic one. As a consequence, the jurisdictional expansion of Australia's regulatory agencies has created an environment conducive to budgetary expansion.

These patterns of agency behavior—that is, behaviors which encourage the growth of the regulatory agencies independent of any increase in regulation—are particularly important in the Australian context. While all three mega-regulators have seen roughly comparable increases in budgets and staff, regulatory changes themselves have been disproportionately distributed between the agencies. ASIC and APRA have been subject to dramatic regulatory reforms, whereas the ACCC has overseen a comparatively stable regulatory environment. The model of bureaucratic budget maximisation therefore helps illuminate one factor in the growth of the ACCC.

Regulation expands

Nevertheless, the major source of agency growth is the growth in regulation itself. One explanation for this increase is cultural—regulation may be symptomatic of a changing attitude towards risk, and the political reliance on regulation as a form of governance is a reflection of that. The former British Prime Minister Tony Blair nominated a tendency towards greater risk-aversion, by regulators, legislators, and the general public, as a source of regulation.

> In my view, we are in danger of having a wholly disproportionate attitude to the risks we should expect to see as a normal part of life. This is putting pressure on policymaking [and] regulatory bodies … to act to eliminate risk in a way that is out of all proportion to the potential damage. The result is a plethora of rules, guidelines, responses to 'scandals' of one nature or another that ends up having utterly perverse consequences.[65]

The 'risk society' that Blair draws upon describes a society 'increasingly obsessed with the future (and also with safety), which generates the notion of risk.'[66] A risk society is not necessarily a society that is more hazardous—rather, it reflects a preoccupation with potential hazards,

and a desire to manage them. Anthony Giddens attributes the preoccupation with risk to popular uncertainty about high technology. Technologies like genetically modified foods and cellular networks are both ubiquitous and complex—few individuals using these technologies fully understand how they work, and are as a consequence likely to overestimate their potential risk.[67]

This focus on risk translates, at least in a democratic system, to a political class similarly preoccupied with managing risk—a phenomenon more poignant when considering that an ordinary person lacks the necessary expertise to assess fully the relative risk of their own behaviour. The risk society is a society dependent on a growing body of regulation, and a corresponding array of unintended consequences. This is compounded by a general perception in the voting population that regulation is the primary role of government;[68] a belief not discouraged by the reduction of government owned businesses, and, of course, the growth in regulation. The 'there oughta be a law' attitude is hard for democratically elected politicians to avoid.

However, this attribution of regulatory expansion solely to external factors is incomplete. Democratic pressures to increase regulation are only one side of the equation—the regulators themselves are able to encourage regulatory expansion.

Inherent in regulatory activity is its tendency to expand into new areas. Poorly made or conceived regulation can encourage more regulation to resolve the original flaws. Similarly, the complexities of implementation can necessitate further burdens upon regulated entities, or definitional ambiguities created by changing markets can force regulatory expansion. (For example, the challenge of pinning down what should be considered a 'financial service' has led to an expansive definition of the term.)

Increased regulation is often a consequence of a systemic bias towards increased regulatory activity. Regulators tend towards expansive interpretations of their jurisdiction; conservative estimates of what activities might be 'excessively' risky; a low threshold for the 'immorality' of certain forms of corporate conduct, and so on. Regulation

expands deeper into the affairs of the regulated firms, as the regulator attempts to gauge how compliant firms are, or ascertain whether there are new opportunities for regulation. As firms and individuals deal with the introduction of regulation, they gain knowledge about its nature. And as profit-maximising entities, they endeavor to avoid the costs of the regulation by technological, process, or structural innovation. In response, the regulator, seeing these actions as a failure of the regulatory framework, endeavors to expand their jurisdiction to cope.

Edward Kane views the relationship between regulator and firm as a continuous game of cat and mouse:

> Market institutions and politically imposed restraints reshape themselves in a Hegelian manner, simultaneously resolving and renewing an endless series of conflicts between economic and political power. The approach envisions repeating stages of regulatory avoidance (or 'loophole mining') and re-regulation, with stationary equilibrium virtually impossible.[69]

The result of this game is a spiraling volume of regulation and a diversion of activity away from economically beneficial innovation to regulation avoiding innovation. In a complicated regulatory framework, there is just as much scope for entrepreneurial activity focused on regulatory gamesmanship as entrepreneurial activity focused on satisfying consumer preferences. Firms cannot passively accept the increased costs caused by regulation, and so engage in strategies to avoid the regulatory costs. Regulators are reluctant to let the avoidance slide because avoidance threatens their bureaucratic turf. As a consequence, and frustrated by their seemingly ineffectiveness, regulators are tempted to 'shore up' the existing suite of regulations with further regulation. Furthermore, regulators have an incentive to act quickly, rather than effectively. As Tony Blair noted, 'A civil servant or regulator who fails to regulate a risk that materialises will be castigated. How many are rewarded when they refuse to regulate and take the risk?'[70] This political imperative can bias them towards over-regulation or over-enforcement.

Regulation also expands horizontally, to encompass a broader array of firms whose activities might parallel the activities of those in the original jurisdiction. Certainly, such expansion is often the consequence of similar expansion in the economy. For example, competition law is now applied to digital services, a market not envisioned by the policy-makers who drafted the original *Trade Practices Act*. But it is just as often a deliberate regulatory expansion by a self-interested agency.

As Clyde Wayne Crews argues,

> Agencies face overwhelming incentives to expand their turf by regulating even in the absence of demonstrated need, since the only measure of agency productivity—other than growth in its budget and number of employees—is the number of regulations.[71]

So in many cases, it is likely that the regulatory agencies themselves are, at least in part, responsible for the expansion of regulation across the economy—a conclusion perhaps borne out by the regular appeals by regulators for expanded power and jurisdiction.[72] Regulators act as stakeholders within their own jurisdiction just as much as any firm, consumer group or non-government organisation does. A range of other factors can influence the regulator towards lobbying for increased regulation, including ideological preference, or a hostile relationship to regulated firms.

Furthermore, their 'independence' from the political process and from the economic interests of those they regulate gives them substantial public authority to comment and recommend legislative change. A warning may perhaps be sounded here about the possibilities of a *reverse* regulatory capture; that is, capture of the legislator by a regulator determined to expand their jurisdiction or scope. The expertise claimed by regulators in their jurisdiction provides them with a strong platform to recommend regulatory changes which increase their own powers.

The phenomenon of spreading regulation should be seen as distinct from the increase in regulation making. Increased regulation is an activity of the legislator, often produced by political imperatives.[73]

Regulatory spread is, by contrast, often the result of a concerted effort by the regulator itself to expand its powers in order to fulfill its original purpose, or at least what it considers as its original purpose. The legislative imposition of greater regulation can be easily tracked through published indices of consolidated legislation and subordinate legislation—the creeping expansion of a regulator's jurisdiction and power is more obscure.

Both the legislator and the regulator, for different but often overlapping reasons, add to the burden of regulation upon the economy.

4 Modern regulating: Major changes in the content and conduct of economic regulation

Writing about the parallel developments in the United Kingdom in regulation and privatisation, Michael Moran has characterised the last two decades as a period of 'hyper-innovation'.[74] This characterisation is just as apt for Australia. The institutional certainty of Australia's mid-twentieth century political economy has been replaced by a continuous process of regulatory and legislative reform.

The remarkable growth of social and environmental regulation has its basis in a general shift to risk as the primary target of regulation. As Julia Black writes, risk-based regulation 'involves the development of decision-making frameworks and procedures to prioritise regulatory activities, organised around an assessment of the risks that regulated firms and others pose to the regulator's objectives.'[75] A focus on risk, legitimised by economic tools such as cost-benefit analysis, has allowed governments to regulate in the absence of direct control.[76]

In the most obvious example, the construction of a functional prudential regulator has brought risk-based regulation to the financial sector. APRA's adoption of a risk-based framework preceded the HIH collapse, but, in its aftermath, the regulator developed two primary frameworks for risk: the Probability and Impact Rating System (PAIRS) which assesses how risky a financial entity is, and the Supervisory Oversight and Response System (SOARS) which assesses how the entity copes with that risk. Under PAIRS and SOARS, APRA's

risk assessments necessarily focus on the internal structure of the regulated firm. The regulator second-guesses the firms own risk assessments and internal management controls, and acts when it feels those assessments are wanting. This focus on the internal operation of the regulated firm has been described as a key attribute of the modern approach to regulation, and is common to many financial regulators internationally.[77] It is, as we have seen above, also an indicator of vertical regulatory expansion.

One of the most significant innovations in economic regulation has been the implementation of incentive regulation onto privatised public utilities. Typically targeted at network industries like gas, electricity or telecommunications, incentive regulation regulates a now-privatised natural monopoly in order to induce competition where otherwise there would be none. This approach to economic regulation views assets in a vertically integrated firm as potentially separable. The 'unbundled' assets are then shared with third-parties at prices set by the regulator. In this way, regulators attempt to induce competition where no facilities based—that is, rival infrastructure—competition is likely to occur.

Mandatory third party access to a firm's assets is not a new phenomenon, having its genesis in eighteenth century common law.[78] However, with the exception of the *Queensland Wire* case in 1987, third-party access requirements were largely absent from Australian regulatory policy before the 1993 Hilmer Report. The National Access Regime, which comprises of Part IIIA of the *Trade Practices Act 1974* and a variety of state and territory industry-specific regimes has been a major change to Australia's property rights framework. Continuing controversy regarding the efficacy of this regulatory approach has left its scope uncertain—as a result, regulatory innovation in this case is controlled by the courts, rather than legislators or regulators.

Regardless of the causes of this 'hyper-innovation' in regulation, firms now operate in a much more uncertain regulatory environment than before the reform period. This is particularly concerning because investment decisions are contingent not only on the regulatory environment in which they are made, but on an estimate of the regulatory

environment of the future. If that future environment is plagued by uncertainty—investors do not know what 'reform' their industry can look forward to in the future—it will be factored into the decision to invest or not. Firms can delay investments, and, through political activity, try to influence future regulatory frameworks in which that investment might be more profitable. Where investments are irreversible, investors face two options: invest now, or defer investment until the uncertainty is resolved.

This is not merely a consequence of uncertainty about what actions legislators may take in the future—it can also be because of uncertainty about the actions of the regulators agencies. For instance, ambiguous statements about the manner in which, or extent to which, regulations will be applied can exacerbate this uncertainty.[79]

A 2001 study into the relationship between American antitrust law and investment has found strong links between levels of regulatory uncertainty and lower levels of investment—the much cited measures of 'business confidence' may be partly proxies for regulatory certainty.[80] Illustrating how investment suffers under uncertainty, Pipe Networks, a telecommunications backhaul provider, argued in April 2007 that regulatory uncertainty in the telecommunications industry meant that investment in backhaul had been, at least for the moment, effectively shut down.[81] Many submissions to the federal government's Taskforce on Reducing the Regulatory Burden on Business cited uncertainty about future regulations, and uncertainty about how laws and regulations would be interpreted by the judiciary as a major impediment to business operation.

Political regimes which have broad uncertainty about potential government intervention across the economy experience concrete effects. And uncertainty scales with dramatic effect. The historian Robert Higgs has found that 'regime uncertainty'—of which uncertainty about possible future regulatory decisions is a key part—was the major factor in prolonging the Great Depression. The anti-business rhetoric of President Roosevelt and his supporters concerned investors enough to withhold investment, even when the actual investment climate was not particularly punitive.[82]

Regulatory hyper-innovation, regardless of the character or nature of the regulatory change, can, in and of itself, discourage productive activity. Recognition of this effect should compel caution before pursing continuous rapid economic reform—particularly if the economic reform in question is of a *re*regulatory rather than *de*regulatory nature. Regulatory uncertainty in economy-wide areas like corporate governance has the potential to be massively disruptive for economic development. The effect of uncertainty on economic activity is even more concerning when the nature of what is considered proper compliance to those regulations is vague.

The evolution of regulatory ideology

A significant major change in the content and conduct of regulation in Australia has been the shift from 'command and control' regulatory enforcement to 'responsive regulation'.

Regulation has a long history. The economy of Tudor and Stuart England, for instance, was subject to a vast array of interventionist controls on the economy. The majority of these regulations can be succinctly described as prohibitions on certain conduct or activities, with penal sanctions for non-compliance. Attempts by the government to manipulate the economy in a positive fashion were, by necessity, formulated as a series of prohibitions, rather than mandatory activities.[83] This 'command and control' method, where legislators define the range of prohibited and permissible behaviour, and use coercive sanctions to punish breaches, has been the most commonly used form of government regulation throughout history.

This simple model of prescription and enforcement has been replaced by an array of compliance and enforcement techniques which give governments and regulatory bodies a greater flexibility to apply regulation. 'Responsive regulation' is a philosophical approach to regulatory practice and compliance that, when applied, constitutes a major change in the relationship between government and firms. It has, as we shall see, also significantly increased the power and influence of regulatory agencies in the Australian economy. Responsive

regulation may appeal to theorists and, indeed, regulators as a more 'friendly' approach, but it has distinct, and not necessarily positive, political consequences.

The concept of responsive regulation provides modern agencies with an enforcement ideology to match their adoption of risk-based regulation. One of the ideas behind responsive regulation is that governments should be responsive to the conduct of the regulated firm and vary their enforcement measures accordingly.[84] Rather than producing a binary distinction between a compliant and a non-compliant firm, the regulator assesses the *extent* to which the firm is compliant, and the level of enforcement necessary to ensure ideal compliance. According to its proponents, responsive regulation seeks to resolve questions of compliance through negotiation rather than coercion. The regulatory theorist John Braithwaite compares responsive regulation to traditional criminal sentencing practice:

> The formalist might say, for example, that armed robbery is a very serious evil. Therefore it should always be dealt with by taking it to court, and if guilt is proven, the offender must go to jail. Responsive regulation requires us to challenge such a presumption; if the offender is responding to the detection of her wrongdoing by turning around her life, kicking a heroin habit, helping victims, and voluntarily working for a community group 'to make up for the harm she has done to the community,' then the responsive regulator of armed robbery will say no to the jail option.[85]

The command and control method under a responsive regulation regime is rarely used. Instead, it appears at the top of Braithwaite's influential 'regulatory pyramid'.[86] An example regulatory pyramid for an industry which requires government licence appears in Chart 13.

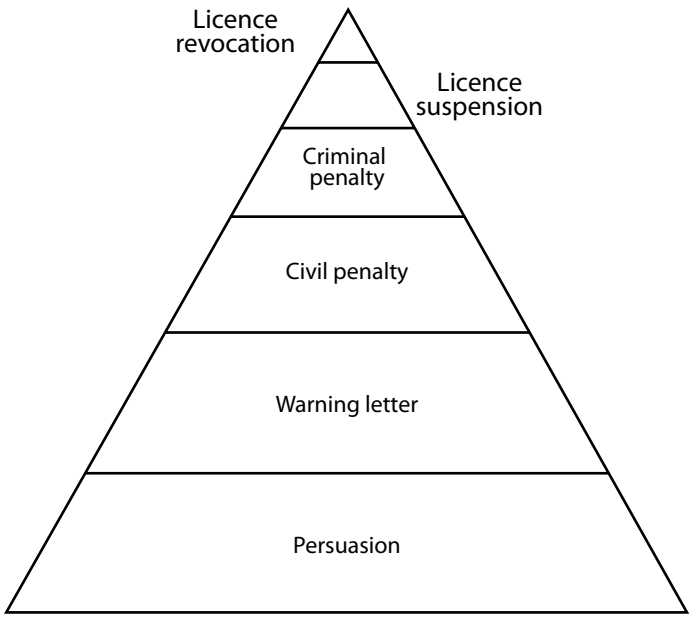
In this regulatory pyramid, license revocation, in this case the most coercive sanction available, is only applied after more 'gentle' enforcement techniques, from persuasion to license suspension, have proven inadequate. The most commonly used technique, persuasion, is given force by the existence of the coercive techniques at the top.

The responsive regulation model provides governments and regulators with a more 'harmonious' approach to regulation, rather than the uni-

formly coercive command and control techniques. Responsive regulation speaks of incentives, voluntary and self-regulation, and tries to forge a cooperative rather than hostile relationship between firm and regulator. It is also designed to help regulators cope with a paradox common in command and control regulatory regimes; that of extremely stringent regulation resulting in under-enforcement. For instance, if the only sanction available to regulators when faced with a minor regulatory breach was license revocation, the pressure not to enforce the law would be high. In a responsive regime, minor breaches are treated with minor punishments.

How does this emphasis on responsive regulation mesh with the consolidation of regulators into functional agencies? Grabosky and Braithwaite found in 1986 that the cooperative approach to regulation was more likely in regulatory agencies that administered a small, single in-

Chart 13: Example regulatory pyramid



dustry, range of firms, and where there are close personnel interactions between regulators and firms.[87] These small agencies clearly exhibit the characteristics of 'regulatory capture', right down to the archetypal steady traffic of personnel between both the firm and the regulator. There is an implication in this study that the cooperative model of regulation increases that risk.

The graduated approach to compliance and enforcement is widely used in Australian regulatory activity. Many regulatory agencies have explicitly adopted the responsive regulation approach. APRA's Jeffrey Carmichael's description of the procedures to achieve compliance mimics closely the terminology and descriptions of responsive regulatory activity used by its advocates:

> First, regulatory intervention is usually graduated. Unlike other forms of regulation—where a breach of legislation is usually a legal offence thereby warranting a legal response—breaches of prudential standards are primarily warning signals.
>
> The usual response to a prudential breach includes a period of cooperation between the regulator and the financial institution, during which a remedy is sought that is capable of returning the institution to full prudential compliance. Only when the problem becomes intractable, or the institution recalcitrant, does the regulator need to resort to more extreme measures.[88]

Similarly, APRA argues that where its statutory powers are limited, 'moral suasion' is applied to pressure regulatory compliance.[89]

A wide acceptance of the responsive regulation model should be seen as a partner of other major developments of modern regulation. The regulatory pyramid, for instance, is a key tool of risk-focused regulating, as the assessment of the firms internal processes and its regulation requires flexible enforcement tools.[90] ASIC, for example, has described their new approach as 'principles' focused, arguing that 'the regulatory emphasis has moved away from black letter enforcement to setting high industry standards and leaving it to industry to comply with the legislative requirements'.[91] Certainly, if ASIC is not satisfied with this compliance, they can move their way up the regulatory pyramid to more coercive techniques.

Trying to bridge the gap between coercive regulation and purely voluntary compliance by following a pyramid model of regulation has encouraged regulators and legislators to pursue much loftier, but also much woollier, goals. The regulation scholars Bachdach and Kagan, reflect the high-minded, but ultimately unclear priorities of this approach:

> …the social responsibility of regulators, in the end, must not be to impose controls, but to activate and draw upon the conscience and the talents of those they seek to regulate.[92]

Braithwaite himself argues that 'at the base of the pyramid, regulators assume and nurture virtue.'[93] The adoption of the regulatory pyramid model encourages this fuzzy approach to regulation, which, by focusing on relative levels of compliance, directs regulators to assess the 'virtue' of a regulated firm.

But the devil, as always, is in the detail—in this case, sitting on the middle rung of the regulatory pyramid. Braithwaite's example pyramid, which has been replicated widely, omits a number of steps. What bridges the gap between a relatively modest measure like issuing a warning letter, and a relatively significant measure like pursuing a civil penalty? This omission is crucial, as the difference between these measures would seem to reflect the difference between a firm which is cooperating with a regulator, and one which is not. The responsive regulator needs to bridge that gap.

In practice, this gap is bridged by a process of negotiation between the regulator and the regulated firm. Negotiation is used by regulatory agencies as a medium-level compliance technique, avoiding the inflexibility and hostility of 'command and control', but to be used when simple persuasion and letter writing is not deemed sufficient. Neil Gunningham describes this approach's relation to traditional coercive regulation:

> The threat of enforcement remains, so far as possible, in the background. It is there to be employed mainly as a tactic, as a bluff, only to be actually invoked where all else fails, in extreme cases where the regulated remains uncooperative and intransigent.

Negotiation is a useful tool for the regulator, including flexibility and timeliness in regulation. In the process of negotiation, the regulator can bridge the gaps in knowledge between itself and the firm, which the

World Bank has called the 'basic problem' in regulation.[94]

However, agencies which adopt a negotiation strategy to ensure compliance in regulated firms are more likely to overstep. The compliance approach to regulation has accompanied the institutional consolidation of regulators into functional agencies.

The regulatory technique of bargaining and negotiation has its antecedents in the long established legal processes of dispute resolution,[95] but has been given an official place in compliance by the institution of Section 87B of the *Trade Practices Act* which allows the ACCC to accept enforceable undertakings from regulated firms. The financial services reforms gave ASIC and APRA[96] similar powers to accept enforceable undertakings.

Enforceable undertakings allow the regulator to accept a wide-range of remedies for potential regulatory breaches. These can include, for instance, corrective advertising, community service orders, and participation in education and compliance programs. The regulator's power to accept such undertakings is only constrained by constitutional law—specifically the prohibition on executive agencies imposing punishment. Agencies are therefore prohibited from including in undertakings fines or other 'penal' penalties.

Nevertheless, Karen Yeung has written that the scope and content of these undertakings may still consist of a constitutional breach. Yeung also argues that the power imbalance between the agency and the regulated firm may undermine the extent to which negotiated compliance settlements, and the enforceable undertakings which give them legal force, can be considered genuine consensual agreements.[97] The theoretical underpinnings of the compliance approach may emphasise the 'voluntaryness' of compliance enforcement, but, in practice, the agencies still have considerable power to compel compliance.

Additionally, the use of negotiation could constitute a breach of the basic tenets of the rule of law. Hayek described it in this manner:

> …government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge.[98]

Granting agencies the power to negotiate not just the level of compliance, but even the legal framework itself, violates this principle. The rule of law requires that state intervention in private manners is legitimised by legislative action. Conferring the power of negotiation on regulatory agencies undermines the certainty that the law provides. The consequence of enshrining negotiation at the base of regulatory practice is further regulatory uncertainty—negotiations, by their very nature, have unpredictable results.

The emphasis on negotiation, and the high levels of discretion this accords regulatory agencies, is a troubling aspect of the theory of responsive regulation. For all the rhetoric about the voluntary nature of responsive regulation and benefits of audited self-regulation, the theory provides only a partial guide to regulators who need to bring firms into compliance. Partly, this is an ideological flaw. The attention given by responsive regulatory theorists to the lower half of the regulatory pyramid, where little coercion is applied, reflects a corporatist desire for business-government cooperation.

Furthermore, the emphasis on education to 'nurture virtue' in a regulated firm is less about economic regulation and more about the desire to convince firms to adopt the non-market goals of the corporate social responsibility movement. Indeed, responsive regulation scholars talk of integration between the goals of consumer groups, the state, and the regulated firm. For these reasons, the movement towards responsive regulation is the regulatory wing of corporate social responsibility, and shares many of its parent's flaws.[99]

Braithwaite argues that for responsive regulation to be effective, the laws which it administers must be 'just'. Otherwise, without widespread acceptance of the law, the moral approach will not be effective—regulators cannot tug the heartstrings of firms if the ethical content of the law is debatable.[100] Again, this presents a critical problem for responsive regulatory theory. Much corporate law is of at least debatable content. Differing interpretations of the most effective forms of economic regulation—firms targeted by regulators will routinely challenge the necessity of regulatory burdens they face —mean that the 'justness'

of the law will always be up for grabs. Even when the necessity of the law is widely recognised, the degree to which it is applied, and the interpretation of what is considered compliant or non-compliant behaviour, will be the focus of much debate between the regulator and the firm. If regulators and firms are unable to resolve these issues at the lower rungs of the regulatory pyramid, then responsive regulatory practice dictates that either the enforcement measures escalate up the pyramid, or that a process of negotiation beings, leaving regulators in a position to prescribe compliance terms to the firm. There is good reason to suggest that the manner in which responsive regulation plays out encourages resentment by the firm at the heavy-handed and manipulative tactics of regulators, and results in under-compliance.[101] Both circumstances breach Hayekian rule of law principles—laws should be enforced in their entirely or not at all.

Similarly, assessments of the relative morality of corporate conduct should be left not to a regulator, but to democratically elected representatives. Morality and virtue are areas in which regulators hold no expertise, and in the absence of that expertise or an electoral mandate, they are in no position to make assessments of what might constitute 'moral' commercial conduct.

These flaws in the ideology of responsive regulation are significant problems for modern regulatory practice. The practice of regulating a firm that does not want to be regulated, while still following route proscribed by the regulatory pyramid, requires techniques which coerce the firm, whether openly or by implication. Responsive regulation encourages the regulator to view itself as a political actor in the economic system, rather than a dispassionate watchdog. In light of the consequences of a responsive approach to regulation, it is retrospectively clear that the 'command and control' approach was not solely a limitation on the activities of regulated firms, but also acted as a limitation on the activities of regulators. Contemporary debates about regulator's use of the media and the discretionary powers accorded to regulators can be traced back to this adoption of responsive regulatory ideology.

Quasi-regulation: Co-regulation, guidelines, voluntary approaches and so on

A related strand of modern regulatory ideology is designed to minimise government involvement, yet at the same time continue to mandate that firms pursue non-market outcomes. The term 'quasi regulation' encompasses rules, instruments and standards where the government influences business behaviour, but where the behaviour is not explicitly designed, enforced, or punished by government.[102]

It is difficult to determine the extent to which quasi-regulation is used in the Australian economy. When regulators operate under a compliance-focused regulatory pyramid, the distinction between what can be considered a 'genuine' regulation and what should be classed as a quasi-regulation is not clear. As there is no formal mechanism to identify and collate quasi-regulatory measures, their use, while widespread, is hard to quantify.

Under a typical co-regulatory scheme, the responsibility for regulation is shared between the government and the regulated industry. Typically, the industry and government develop a code of practice, which is then monitored by the industry itself. As the OECD notes,

> This approach allows industry to take the lead in the regulation of its members by setting standards and encouraging greater responsibility for performance. It also exploits the expertise and knowledge held within the industry or professional association.[103]

Co-regulation tries to emphasise the voluntary nature of the scheme, by encouraging firms to set their own standard and apply it.

For governments, quasi-regulatory measures offer significant benefits. They are cost-effective, as the government does not bear the burden of directly developing, monitoring and prosecuting the regulation. Governments are not directly responsible for the content of the regulation, minimising the potential political harm from misguided regulation. Furthermore, governments often prefer the use of quasi-regulatory measures because they can be introduced and amended without reference to Parliament.[104]

There are, however, questions about how voluntary these quasi-regulatory measures are. In many cases, codes of practices, standards, and industry guidelines are formulated specifically to ward off the threat of government regulation—a measure which aims to mitigate some of the uncertainty about potential government action described above, as well as avoid more aggressive regulation. The following, which lists some of the forms quasi-regulation can take, reveals the influence of government on these 'voluntary' regulations.

- Industry based code with endorsement by government agency
- Industry based code or standard developed in response to actual or perceived threat by government to regulate
- Substantial government involvement in the development and subsequent monitoring of a code or standard
- Industry code or standard required by legislation, but developed and implemented by industry, with reserve enforcement powers given to a regulatory authority
- Agreements negotiated between industry and government
- Government guidelines to assist business meet legislative requirements by suggesting actions not specified in law
- Standards and codes established by government, with compliance being achieved because it is a precondition for other benefits; and
- Use by the courts of voluntary standards and codes in determining what is reasonable in, for example, negligence cases.[105]

In all of these cases, the extent to which these regulations can be considered 'voluntary' are debatable. Industry standards, whether technical, ethical, or economic, develop in the absence of government intervention. Quasi-regulations disguise implicit government regulation with the rhetoric of voluntarism and cooperation—in many cases, they are as coercive as 'proper' regulation.

Quasi-regulations dramatically increase the likelihood of the adverse effects of regulatory capture. Quasi-regulatory bodies are typically comprised of the most influential firms in a given industry, and can work to protect these firms through the application of anti-com-

petitive co-regulation. Similarly codes of conduct can work in an anti-competitive fashion. Adverse affects of this nature in quasi-regulatory bodies are common.[106] Giving quasi-regulations a degree of legal sanctions runs the risk of causing the mandatory cartelisation of the regulated industries.[107]

The 1997 Commonwealth Interdepartmental Inquiry into Grey-Letter Law found a myriad of problems with what they saw as government's increasing reliance on quasi-regulation, including lack of government justification and risk-assessment, the discretionary power given to agencies with jurisdiction over quasi-regulations, the risk of regulatory creep, uncertainty about how strictly the regulation will be applied, its cost, and its legal status. There remains no formal requirement for Regulatory Impact Statements to be prepared for quasi-regulations, but the Office of Regulatory Review encourages it, and the level of response varies from year to year.

While governments may benefit strategically from relying on this form of regulation, those benefits do not necessarily translate to benefits for the economy or consumers. Outsourcing regulation in this manner may reduce the cost of regulating for the government but, as firms are required to administer such regulatory frameworks themselves, can increase the cost to firms.

All forms of quasi-regulation, while rhetorically-framed as voluntary or non-coercive measures are backed by the threat of direct government action. While the level of government involvement is low, it is a mistake to conceive the actions of firms as being purely voluntary; rather, quasi-regulation is a further example of gradated government action, given force by the coercive techniques available if the 'voluntary' ones fail.

5 The problem of regulatory governance

As we have seen above, regulatory agencies have consolidated into unified agencies structured around function, rather than institution. And these large, consolidated regulatory agencies inhabit an increasingly significant profile in Australian political and economic life. As economic management by the state has shifted from *direction*—the predominant approach typified in public ownership of utilities and government enterprises—to *adjustment*—economic, social and environmental regulation—these agencies become central.

In fact, it is arguable that it is now appropriate to consider regulation making and administering as the primary function of government. Richard Schultz's description of the administrative state in Canada is just as appropriate for Australian circumstances:

> Regulation, as a governmental activity, has come to rival, and in some respects eclipse, the traditional spending and taxing powers of government as a means by which government seeks to influence, direct and control economic and social behaviour.[108]

With regulatory agencies central to the processes of making, policing and administering regulation, the position of those agencies within the structures of liberal-democracy, and the means by which they are governed, are critical. If one was to chart the centres of state power in Australian history, the expansion and consolidation of regulatory agencies described above would indicate a key shift.

Regulatory agencies are a form of government institution with unique characteristics, and these characteristics are central to the manner in which they are governed. Modern regulatory agencies are statutorily independent, and are non-majoritarian. They are created by legislation, but are operationally separate from parliament and elected representatives. They frequently exercise executive, judicial and legislative power over their jurisdiction. They are restricted by the application of administrative law and judicial review, but hold significant discretionary power. They are delegated authority, but remain at 'arms-length' from those who delegated the authority to them.

The independent regulator has mushroomed since the 1980s and 1990s across the world, particularly in response to the widespread privatisation of public utilities. However, the emergence of this form of government department can be traced back to the United States' *Interstate Commerce Act 1887* which created the Interstate Commerce Commission (ICC). The ICC has now become the prototypical example of regulatory capture. Both the United States and Canada have, over the course of the twentieth century, developed and maintained a variety of independent regulatory agencies. The last few decades have seen these institutions adopted by the rest of the world.

This form of independence is intended to insulate the regulators from the political process, and therefore political pressure—both from party political interests, and lobbying interests. The doctrine of regulatory independence attempts to ensure that the regulator is impartial.

It is also possible that keeping regulatory agencies at arms-length, politicians are able to distance themselves from the sometimes unpopular actions of the regulator, as well as rely on the regulator to provide credibility for their own policies.[109] Agencies provide a buffer between politicians who are accountable to the voters, and the policies enacted by the government. For instance, regulators overseeing price controls who decline to systematically lower prices will not embarrass elected representatives. Politicians benefit from the perceived neutrality and objectivity provided by independent regulators with expertise, but do

not suffer from their adverse decisions.

This is not the only reason governments would delegate substantial power to an independent body. The creation of independent agencies may, in some cases, be merely symbolic gestures.[110] Political actors may not want the regulator to regulate at all, a phenomenon regularly observed in the history of regulation making since Tudor England.[111]

In a democratic system, the government derives its legitimacy from the democratic process. But regulatory agencies are headed by unelected officials delegated their powers by elected officials. Non-majoritarian institutions such as these derive their political legitimacy from two aspects of their form. 'Output' legitimacy implies that the non-majoritarian institution will produce better outcomes than an elected body. 'Input' legitimacy implies that the non-majoritarian institution will follow superior—read, transparent and impartial—decision making processes.[112] Nevertheless, the OECD has warned that the consequences of such institutions are not yet well understood—non-majoritarian institutions vested with considerable legal power are susceptible to becoming 'governments in miniature'.[113] The following sections will look further at the levels of accountability and discretion that the regulatory agencies possess, and how the uncertain position regulators that occupy in Australia's political system is of some concern.

Delegating authority

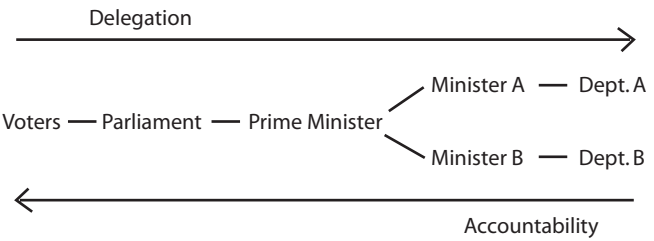
From a structural perspective, parliamentary democracies are a chain of delegation. This chain runs from the source of sovereignty—voters—through to a parliament of elected representatives, to a government formed from that parliament, to ministers, and eventually to civil servants. Civil servants derive their legitimacy solely from being at the end of this chain; their authority is ultimately drawn from the voting public.

This chain of delegation is necessary because in a large state it is impossible for elected representatives to pursue and administer all the functions of government. Delegation is a function of the size of gov-

ernment. Their legitimacy secured by this chain, delegated civil servants are able to bring technical skills to the area of policy that elected representatives may not possess. Similarly, they are able to give the area of policy a level of attention that representatives would not.

Delegation can be reconciled with representative democracy by ensuring that elected representatives are accountable for the actions of their delegated agents. In the traditional model of departmental responsibility, this chain of delegation is matched by a similar path of accountability in the reverse direction. The democratic precept is therefore the ultimate accountability of elected representatives to the voters they represent. Civil servants, through the chain of delegation, are similarly accountable to voters.

Chart 14: Departmental chain of accountability[114]



Appropriately, delegated authority in parliamentary democracies has been comprehensively analysed from the viewpoint of principle-agent theory. A principal—for instance, a minister—engages an agent—a department—to act on its behalf. Problems arise when the agent's self-interest does not align with the principal's. Principals, once made aware of this problem, can utilise a variety of mechanisms to harmonise interests. Mechanisms used down the chain of delegation in parliament include electoral laws which attempt to harmonise interests between voters and parliament; political parties and committee specialisations to harmonise interests between parliament and government; and oversight, ministerial responsibility and budget

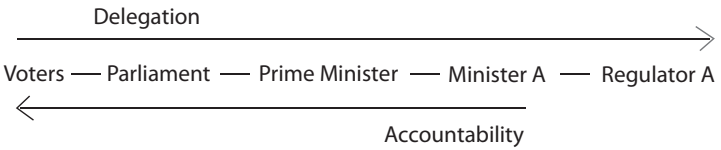
management to attempt to harmonise interest between ministers and departments.[115]

This is, admittedly, an ideal type. The countervailing forces of delegation and accountability rarely work this way in practice. Actors within the political system face incentives which encourage them to avoid both forces. Government ministers may avoid engaging their department on technical or implementation questions if they feel their preferred policy direction is not amenable to the desires of the department. Similarly, political expedience may cause them to shirk responsibility for the actions of that department. Conversely, the department may have its own agenda opposed to the minister, and may choose to avoid democratic accountability for its activities. Indeed, one English critic has called the chain of accountability a 'fiction', which is 'profoundly misleading, often absurd, frequently inconvenient and sometimes damaging in that it prevents genuine instruments of accountability being developed.'[116]

His criticism may be hyperbolic, but has a large degree of validity for the modern relationship between minister and department. However, it is even more trenchant when we study the governance structures of the independent regulatory agency. The creation of independent regulatory agencies does not conform to the model of delegation and accountability described above. Regulatory agencies are delegated a considerable degree of agency power. In the traditional principal-agent problem described above, the challenge for this principal is to control the agent. But when delegating authority to a regulatory agency, the principal designs the agent with the explicit intention of *not* trying to controlling it. The regulator operates at 'arms-length' from parliament.[117] In this manner, regulatory agencies are deliberately disconnected from the chain of accountability.

The Wallis Inquiry recommended that APRA and ASIC be established with 'substantial operational autonomy'. The premium placed upon political independence went so far as to recommend that the agencies not be located in the political capital, Canberra, but rather the main financial capitals. It recommended that the agencies' bud-

Chart 14: Regulatory chain of accountability



gets, one of the primary mechanisms by which ministers can control their departments, were to be funded separate to the Commonwealth budget—or at least insulated from the political budget balancing targets.[118] Agencies with high independence are often characterised by long terms of office for their heads, as dismissal on political grounds is made nearly impossible. ACCC head Allan Fels remained in his position from 1995-2003, despite a change of government and a controversial media profile.

The independence of regulatory agencies creates a new problem for governance and accountability. These agencies exist outside the structural restraints within which bureaucracies traditionally operate—that is, a direct chain of accountability to voters.

Administrative discretion

Ensuring that regulatory agencies are accountable is vital because, as we have seen, regulators have substantial discretionary power. Parliament delegates authority to regulators with broad non-specific briefs. Doing so, they provide little guidance about how best to allocate their resources, set regulatory priorities and distribute the gains and losses from regulatory activity. No matter how strict the administrative controls on an agency, the nature of the principal-agent relationship will grant the agency substantial power to exercise discretion in the manner in which it acts.

Discretion is, to an extent, inevitable.[119] Each level of government is vested with a measure of discretion in order to fulfill its tasks. Furthermore, discretion is necessary if entities are to utilise the specialty

skills that they (hopefully) have been vested with.[120] If discretionary action was only the preserve of those who had been elected as representatives, government would be crippled by legislative lag, as the political theorist John Locke wrote in 1689:

> The Power to act according to discretion, for the publick good, without the prescription of the Law, and sometimes even against it, is that which is called Prerogative. For since in some Governments the Lawmaking Power is not always in being, and is usually too numerous, and so too slow, for the dispatch requisite to Execution; and because also it is impossible to foresee, and so by laws to provide for, all Accidents and Necessities, that may concern the publick; or to make such Laws, as will do no harm, if they are Executed with an inflexible rigour, on all occasions, and upon all Persons, that may come in their way, therefore there is a latitude left to the Executive power, to do many things of choice, which the Laws do not describe.[121]

While discretion is necessary, the extent of discretionary power Locke grants the government is far more than would be commonly accepted today. It is, however, a level which the regulatory agencies themselves have advocated in the past. Desiring a Lockean amount of 'latitude', ACCC Chairman Allan Fels argued in 1995 that the competition regulator needed a 'carte blanche' level of regulatory discretion, and should be granted greater 'flexibility' to set prices.[122] More recently, the ACCC's submission to the 2002 *Trade Practices Act Review* argued that the regulator be granted substantially more discretion—being allowed to enact cease and desist orders itself.[123]

The extent of discretionary power vested in a bureaucratic agency, particularly in a regulatory agency intentionally set aside from the normal chains of accountability, has worrying implications. An example of significant discretionary power being granted to a regulator is ASIC's power to exempt individuals or groups from provisions of the *Corporations Act*. Between July and September 2006, ASIC granted 482 exemptions out of 578 applications to exempt.[124] This is on top of the policy-making function of ASIC's class orders mechanism.

The ACCC has considerable discretion in the application of ac-

cess regulations and merger reviews. Regulators face large information asymmetries which necessitate some estimation of investment and operational costs faced by regulated firms or levels of efficiency. The size and extent of the market under consideration requires definition by the regulator, as does what would be considered the exercise of undue market power. For instance, section 46 of the *Trade Practices Act* leaves the initial interpretation of market behaviour as anticompetitive to the regulator. This discretionary power provides the regulator with the ability to enforce as strict or lax a regulatory regime as it chooses, depending on its preferences. As the Productivity Commission has written,

> If significant administrative discretion is involved in the application of a regulation, there may be a tendency for regulators to bring their own values and predilections to the decision making process.[125]

The Sydney Airports Corporation in its submission to the Productivity Commission's 2001 Inquiry into the National Access Regime wrote,

> ...[T]he ACCC exercises immense discretion under Part IIIA and related regimes and that none of these provide definite guidance to the ACCC on how it is to balance what are often diametrically opposed public interest considerations. It would, for example, be only too easy for the ACCC to take individual decisions or settle upon a set of generally applicable pricing principles that the Government considered to be unduly focused on price reduction at the expense of investment promotion.[126]

There is reason to believe that regulatory agencies are biased towards an increasingly strict interpretation of regulation. In determining a price for regulated access regimes, regulators, given reign to do so, tend to cut prices to the minimum possible level to restrain what is seen as 'excess' profit making by the infrastructure owners.[127] Public perceptions of high-profiting firms who can be characterised as in some way 'monopolistic' can determine and influence the activities of the regulator. Furthermore, regulatory agencies have a tendency to cut

prices in order to satisfy the short-term preferences of consumers for lower prices, dismissing the long-term consequences of lower infrastructure investment.[128] This focus on the short-term consequences of regulation over the long term consequences has also been criticised by the Australian Banking Association in relation to the ACCC's merger assessments—arguing that the regulator gives little attention to the adjustments made by competitors and suppliers after a merger.[129]

Regulatory agencies can exercise discretion simply by prioritising resources. The agency determines what should be investigated, what can be considered a breach of regulation, what cases should be prosecuted and when—or whether—the cases reach the judicial system.[130] Regulatory agencies, or the staff that comprise them, may have certain preferences about how their agency should act. They may shirk challenging regulatory problems, in order to maximise their leisure. Or they may act in a manner which extends their power and budgets. These activities may not be consistent with the desires of the delegating principal, or the voting public which provides them with their legitimacy.[131]

Discretionary actions give the regulator enough leeway to negotiate with the regulated firms, or, to be less charitable, the power to manipulate the process in order to reach its goals.

Bureaucratic drift

Given a large enough level of discretion, it is possible for regulators to pursue public policy aims that are better pursued by elected representatives.

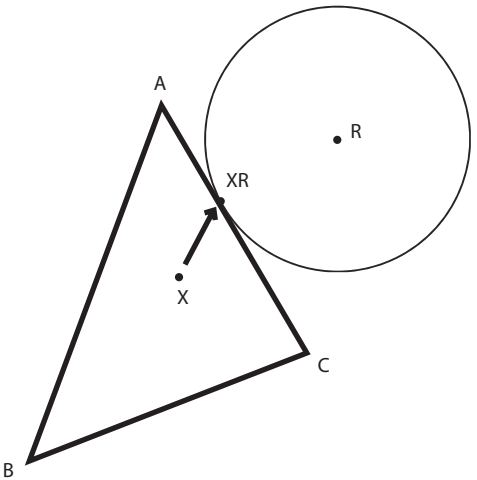
In Chart 15 below, policies are devised by a coalition of policymakers (A, B, and C) who define the parameters and conditions of the particular piece of policy. X is their agreed ideal policy, representing a compromise between the ideal policies of A, B, and C.

However, public policy is not implemented by itself. The process by which delegated agencies can enact outcomes different from those which are desired by those who originally delegated power is called 'bureaucratic drift'. Bureaucratic drift posits that the agency delegated

to implement X also has a preference, R. The agency will attempt to fulfill its own preferences within its institutional constraints. The only manner in which the agency may be disciplined is if there is unanimous disapproval from the policy-making coalition—unlikely if the agency remains within the ABC triangle.

The delegated agency is free to enact XR, rather than X.

Chart 15: Bureaucratic drift[132]



Bureaucratic drift is not always intentional. Like any organisation, regulatory agencies, either consciously or subconsciously, develop norms to guide decision-making processes. These norms are often beneficial—simplifying decisions, allowing the agency to establish a degree of precedent, learn from its previous experiences, and even provide industry with an unwritten degree of certainty. Relying on norms provides the regulator with a degree of efficiency. However, bureaucratic drift shifts these norms in a direction not predicted or desired by policy-makers. Furthermore, the unconscious nature of internal norms make this shift hard to detect, and even harder to control.[133]

Bureaucratic drift can affect all aspects of agency activity, not only the determination of policy and the application of discretion, but also the regulatory process itself. Bureaucratic drift can encourage deviation from judicious regulatory processes, particularly as regulators adopt compliance-focused regulating.

6 The regulator acting badly: Discretion in practice

Arm-twisting

The greater the regulatory and discretionary power, and the further removed from the chains of accountability, the more possible is activity which could be described as 'bullying' or 'arm-twisting' by the regulator. These inelegant terms describe 'a threat by an agency to impose a sanction or withhold a benefit in hopes of encouraging "voluntary" compliance with a request that the agency could not impose directly on a regulated entity'.[134]

As we have seen above, the process of negotiation is the 'flashpoint' of the regulatory pyramid—sitting in between persuasion and coercion. Arm-twisting describes the manipulation of the regulated firm by the regulator during the negotiation process, and is made possible by the power-imbalance between the two negotiating parties. (After all, arm-twisting would not be possible if the regulator could not escalate to more coercive compliance techniques.)

This form of regulatory activity is most concerning because it allows the regulator to act outside its brief; allowing it to manipulate the informal elements of the statutory regulatory process to follow a path not envisioned by the delegating authority. As Lars Noah writes of arm-twisting by American regulatory agencies, 'arm-twisting often saddles parties with more onerous regulatory burdens than Congress had authorised, accompanied by a diminished opportunity to pursue judicial challenges.'[135]

Warren Pengilley describes a range of circumstances when arm-twisting is apparent:

- The regulator threatens widespread legal action against a particular section of the community whereas the truth is that it is never likely to take such action, or at least not take action to the extent threatened. The threat aims to make a particular person believe that enforcement is widespread when it is not and thus to coerce compliance with the regulator's wishes.
- The regulator consistently 'talks up' penalty provisions in legislation with the effect that the community believes that even the most minor transgression of the law is likely to involve the maximum of penalties.
- The regulator may point *in terrorem* to powers which it has to serve notices which give *prima facie* validity to certain determinations it makes. These determinations may ultimately be court reviewable but the cards are stacked in favour of the regulator both because of presumptions running in its favour and because penalties may run from the date of the regulator's notice.
- The regulator actually misstates the true position—such as claiming that it has certain powers which it does not, in fact, possess. This claim can be backed up by the various other tactics referred to above. Alternatively the regulator may state a legal position in its 'Guidelines' which accords with its policy but is not the legal position at all. The regulator, by its position, convinces the party involved that the law is as it states and that it will enforce the law according to its view.
- The regulator actually issues court process but, because of doubts in the regulator's own case, then 'settles' the matter after lengthy pre-trial proceedings. The party proceeded against has little option but to settle. However, it will have incurred significant costs, legal and otherwise, which will not generally be recoverable. The threat of this action, and the knowledge that the regulator has engaged in such tactics in previous cases, may itself be enough for the regulator to win the day. Further the fact that legal proceedings are pending has a deterrent effect on the others who may believe that they can act lawfully but are concerned at the regulator's pending action. In this way, the

regulator can often achieve its objective but the legal correctness of its views is never tested.

- In litigation, a regulator may seek to obtain advantage by stonewalling, refusing to provide details of its case, details of its market analysis or details of its evidence whilst obtaining, over time, more evidence and information from a regulated entity which seeks, by divulging information to the regulator, to convince the regulator that no action should be taken against it.
- The regulator uses publicity which can often imply, if not specifically state, that a party has breached the law without this fact ever being finally demonstrated, or required to be demonstrated. Any threat of adverse publicity can be a formidable regulatory weapon. The credible threat of such publicity can often coerce acquiescence to the regulator's view.
- The regulator points to the fact that, in the ultimate, it has decision making powers which it will use and which are unreviewable—in some cases *de facto* so and in others legally so. This is a particular problem in cases where a regulator has a policy implementation role and also a quasi-judicial role in relation to the policy it implements. Should the regulator have a particular view or want to implement some particular theory, the citizen can be arm twisted because of the fact that ultimately the regulator is also the decision maker and there is no venue in which the citizen can, as a matter of commercial reality, have the regulator's theory independently evaluated, no matter how wrong the citizen may believe this theory to be.[136]

The circumstances in which regulators can utilise these methods are made possible by the ideological emphasis on responsive regulatory practice.

Arm-twisting is likely more common than is publicly acknowledged. Firms which are bullied by regulators have little incentive to publicise the fact, as it could impede on-going or future relationships and negotiations. The array of arm-twisting techniques available to regulators supplement their already considerable power when negotiating settlement. The negotiation strategy provides the regulatory agency with greater discretionary power than it would hold if it was restricted to the coercive 'command and control' technique. This illus-

trates the perhaps unintended consequences of the widespread adoption of the concept of the 'regulatory pyramid' and other cooperative compliance theories in both the literature and practice.

Fritz Morstein Marx wrote as far back as 1939 on the discretion of regulatory agencies noting that:

> …a well ordered society cannot afford to be indifferent to any legal uncertainty attending the exercise of administrative power. It is futile to eulogise the rule of law if it fails to offer practical safeguards of legality in the expanding realm of relationships between administrative authority and the individual.[137]

A deliberate emphasis on negotiation and the focus on the responsive regulatory approach provide an unstable framework for the conduct of a regulated firm; leaving the application of regulation to the relative skill and bargaining power of the negotiators. In this manner, negotiation and compliance may reduce the 'harshness' of command and control regulation, but encourage other negative attributes of regulation—the regulator's capacity to arm-twist and bully, unpredictable regulation and the investment uncertainty that creates, regulatory 'drift' as the parties to negotiation manipulate the process to reach agreement, and regulatory expansion as, in the course of negotiation, the regulated firm offers concessions beyond the regulator's original purview.

Furthermore, the flexibility which is provided by the gradations of responsive techniques now available to agencies is not an absolute good—flexibility also invests the regulator with greater power which should, perhaps, be held elsewhere in a parliamentary democracy. Flexibility may, merely, be a synonym for increased power.

Trial by media

The ideology of responsive regulation is nevertheless deeply embedded into modern regulatory practice. One of the most innovative techniques developed in recent years by regulatory agencies, in particular the ACCC, has been the systemic use of the media to leverage compliance out of firms.

The use of the media by the ACCC has been a major locus for criticism of Australian regulators. Some firms and industry organisations have described ACCC's use of the media as 'trial-by-press-release', 'reputational blackmail', and even compared it to the tactics used by the secret police in Nazi Germany.[138]

Widespread recognition of the publicity activities of the ACCC was encouraged by a minor 2002 scandal which attracted media attention. On 23 April 2002, the ACCC conducted a 'raid' of Caltex Australia's Sydney offices in order two seize documents, a power given to regulator by the *Trade Practices Act*. This raid was heavily publicised by the next day's *Daily Telegraph*, which featured a photography that, according to the caption, depicted ACCC staff exiting Caltex buildings carrying boxes of documents. Subsequent statements by the ACCC revealed that the boxes contained not Caltex documents, but ACCC documents and equipment. The only documents that were seized from Caltex were transported on a computer disc, hours after the photograph had been taken. This was no accidental confusion. The ACCC had worked closely with the *Daily Telegraph* and the newspaper organised a photographer to be present at the raid.[139]

The April 2002 Caltex raid starkly illuminated the publicity hunger of the ACCC. Acting on limited information, the ACCC conducted a high-profile entry and seizure. The end effect, whether by accident or design, was publicity which showed a corporation being raided in a manner reminiscent of a raid on a drug laboratory.

Indeed, criticism of the publicity tactics used by Australian competition regulators has been a periodical feature of its judicial review. In 1977 Justice Smithers cautioned the ACCC's predecessor, the Trade Practices Commission from overusing the media to affect regulatory outcomes:

> Adverse publicity is often one of the inevitable consequences of wrongdoing … But adverse publicity initiated by the prosecuting authority itself requires special consideration. If the matter is publicised ahead of trial, and widely, and in terms likely to induce public censure of the parties concerned and those parties are in day to day business relationships with the public, then there is obvious danger of injury to the lawful business of the parties which from a practi-

> cal point of view may have the effect of effectuating a cumulative punishment.[140]

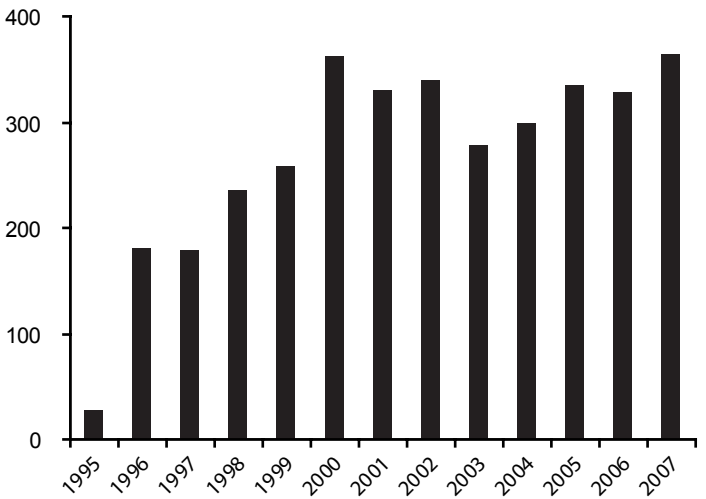
More recently, in 2001 Justice Finn criticised the ACCC's previous statements saying they

> … may constitute good public theatre. Whether they represent good public administration is another matter. There is a very real prospect that the view the ACCC has taken of [the relevant provision of the Act] will be found to be incorrect … there can be respectable opinions on both sides of the argument.[141]

Given the importance of reputation in business practice, the 2002 *Trade Practices Act* Review ('The Dawson Inquiry') had a focus on the reputational impact of ACCC activities. Submissions to the Dawson Inquiry are peppered with complaints from businesses and industry groups about what is seen as publicity mongering by the competition regulator.

The Dawson Inquiry recommended the regulator adopt a media code of conduct which limited its publicity for ongoing investigations, restricted its media releases to mere factual reporting, and reported the

Chart 16: ACCC media releases, 1995-2007



Source: ACCC website

outcome of its investigations in an 'accurate, balanced and consistent'[142] manner. Chart 16, which depicts the number of ACCC media releases between 1995 and 2007, reveal a regulator chastened by the adverse publicity concerning its use of the media. It has, in the years since the Dawson Inquiry, crept back to roughly the level of activity seen before 2002.

However, these criticisms of the ACCC's use of the media as an 'aberration' miss the mark. Modern regulatory ideology provides ample justification for the use of publicity as a mechanism to compel compliance. John Braithwaite and Brent Fisse wrote that the formal use of publicity is a sanction against non-compliant firms, without the regulator having to resort to more coercive measures. Telegraphing the full development of the responsive regulation ideology in 1983, they argued that the threat of adverse publicity is a key tool to bridge the gap between a purely voluntary regulatory system and a black-letter system:

> Publicity is hardly an interventionist sanction. It probes and prods, whereas a mandatory injunction dictates. At the same time, publicity is a far cry from the hands-off attitude of the fine. It can be used to direct the public spotlight into the black box of organisational control, and can highlight the need for particular disciplinary, structural, or other organisational action. The modus operandi of its intrusion into corporate internal affairs is thus exploratory and agitative, a combination which compliments intervention, addresses the weakness of non-intervention, and helps to keep corporations and regulators on their mettle.[143]

To Braithwaite and Fisse, the use of publicity is a form of regulatory agitation to pressure compliance, rather than to compel it. Not only are firms who are actively engaged in negotiations with regulators influenced by the threat of publicity, but also other firms as well. Indeed, Allan Fels made this point as recently as 2004, arguing that the ACCC's publicity campaigns 'had a powerful effect… in spreading the culture of competition'.[144]

Therefore, the widespread criticism which greeted the most significant publicity seeking actions of the ACCC in 2002 needs to be put into context. Active publicity and media manipulation is a key part of responsive regulatory theory and practice. It is a symptom, rather than the disease itself.

7 Australia's regulatory dilemma

Contemporary regulatory ideology insists that regulation should be 'voluntary', that regulators should pursue 'virtue' in the regulated firms, and that regulators need flexibility and discretion to regulate as circumstances require. This ideology encourages regulators to manipulate the regulatory process to expand their jurisdiction and powers, arm-twist firms into compliance, and, at the extreme, deviate public policy away from the desires of elected representatives. To appropriate a cliché from the computer industry, regulatory arm-twisting and manipulative publicity campaigns aren't bugs, they are features.

Lloyd N Cutler and David R Johnson aptly summarise the regulatory dilemma as follows:

> Regulatory agencies are deeply involved in the making of 'political decisions in the highest sense of that term—choice between competing social and economic values and competing alternatives for government action—decisions delegated to them by politically accountable officials… Agencies would be said to fail when they reach substantive policy decisions (including decisions not to act) that do not coincide with what the politically accountable branches of government would have done if they had possessed the time, the information and the will to make such decisions.[145]

This failure is difficult to detect while that expertise does not exist, and while regulatory agencies remain independent from the normal chain of accountability. Regulators possess political power but lack

political legitimacy. Elected representatives are unwilling to reduce their independence as it provides those representatives with a 'buffer' between policy and politics. And the steady accumulation of responsibility caused by regulation growth gives these non-majoritarian institutions ever increasing power.

Cutler and Johnson go on to recommend enabling the politically accountable branches of government to selectively intervene into the regulatory process, allowing the executive to modify or direct certain agency actions.

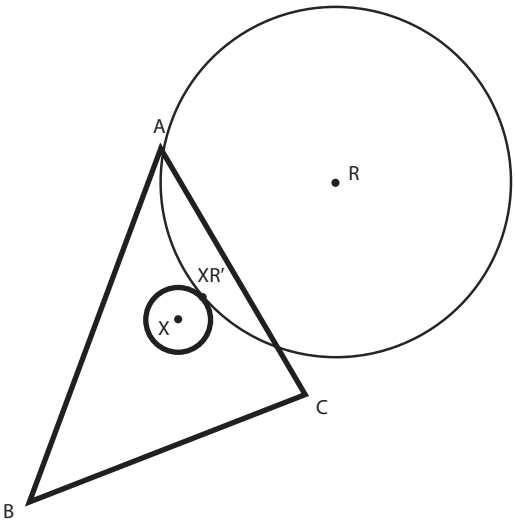
Selective interventionism would, however, undermine the regulatory neutrality that governments have tried to encourage by building independent agencies in the first place. Regardless of whether the policy-maker is democratically selected or not, introducing selective interventionism subjects would make regulatory decision-making more, rather than less, arbitrary.

Such a mechanism would encourage politically-motivated regulatory activity. Indeed, nakedly political regulations would increase regulatory uncertainty as not just regulatory negotiation, but also political negotiation, becomes central to administrative decisions, as well as increasing the potential gains from political corruption. Regulators may then be secure in their democratic legitimacy, but the increased risk of corruption and general uncertainty created by political imperatives would have deleterious consequences.

Agency independence is designed to insulate regulators from political interests on one side, and economic interests (firms, consumers, etc.) on the other. Selective interventionism is no solution to the problem of regulatory governance. To re-introduce the political process by allowing political actors to influence the decisions of the regulator would have unfortunate consequences.

Partial accountability is provided by two systematic attributes of the regulatory agencies. Internal control mechanisms, for instance internal review procedures, legislative restrictions on discretion, mandatory public consultation, and external legal appeal processes.

Chart 17: Controlling bureaucratic drift by limiting agency discretion[147]



Control mechanisms

Control mechanisms aim to restrict the behaviour of the agency to fit the desires of the delegating principal. These mechanisms can include procedural requirements, legislative oversight and judicial review, as well stakeholder involvement measures like hearings and accepting submissions.[146]

Institutional design and the implementation of restrictive administrative procedures can be used to minimise bureaucratic drift. Chart 17 illustrates the manner in which limiting agency discretion, for example, minimises the extent of bureaucratic drift. By restricting the distance from which the agency may drift from X, what is finally implemented, XR, is closer to the policy-makers original intent.

Limiting discretionary power in this manner is, however, fraught with difficulty. Part of the justification for delegating the practice of regulation down from parliament is to utilise the expertise that comes

with specialisation. The degree to which legislators can limit the authority of an agency is constrained by the legislator's knowledge of the regulated industry, and the activities of the regulator. Legislators delegate authority precisely because they lack this knowledge.

Furthermore, parliament, even if we ignore its political imperatives, lacks the ability to react quickly to changing circumstances. Legislation making is a slow, highly political process, and, if faced with rapidly changing circumstances in the regulated industry, a sluggish response by legislators may be harmful. Parliament may have democratic legitimacy to exercise discretion, but it has limited capacity to exercise that discretion in a timely manner. Agencies are restricted by the bounds of administrative law and legal norms, but the extent to which their boundaries can be narrowly defined is limited, even if parliament had the desire to do so.

Limiting discretion by prescribing in great detail what an agency may or may not do is at best only a partial solution to the problem of regulatory governance. As long as agencies administer vast and far-reaching bodies of legislation and regulation, it is inevitable that they will be delegated the authority to interpret it. Many of the pitfalls concerning regulatory activity described above—for instance, bureaucratic drift and regulatory expansion—are found in Australia despite the existence of administrative control mechanisms. Other pitfalls, such as the use of arm-twisting in regulatory negotiation, exist outside their scope.

Measures to ensure the quality of regulation are another mechanism to control regulatory activity. The Australian government requires regulatory agencies to produce a Regulation Impact Statement (RIS) when considering a new regulation, following a consistent process. (Some regulations are exempt.) However, the adequacy of the RIS process has been in doubt. While in 2004-05, 84 per cent of required RISs were produced, the RIS process is relatively easily sidestepped when inconvenient. In particular, the highest-impact regulation is also the regulation which tends slip through the RIS process.[148]

Accountability through the courts

Judicial review restricts the exercise of power by regulatory agencies. Judicial review acts as a final bulwark against abuse of administrative power, as courts presume that agencies are unable to make proper judgments about the limits of their own power.[149] For this reason, judicial review is concerned not with the final regulatory conclusion, but with the process by which that decision is arrived at. Judicial review provides a useful restraint upon discretionary power.

The statutory framework governing regulatory agencies provides regulated firms the right of appeal. The Australian Appeals Tribunal exists to adjudicate appeals of government administrative decisions, including regulatory decisions. Furthermore, many regulatory activities require the consent of a court to be enforced. For instance, firms accused of breaching enforceable undertakings must be taken to court before they can be ordered to comply. While the prosecutor does not prosecute the underlying breach, Christine Parker has noted that the court often considers the merits of the original undertaking.[150] She argues that the formal review process provided by the courts is sufficient to mitigate and subdue the possibility that the regulator could act in the bullying manner described in chapter six.

However, while the regulators recognise that administrative law places limits on their action, the exact nature of those limits are uncertain.[151] The high costs, both financial and to the disruption of the activity of both the firm and the regulator mean that the parties avoid testing their claims in court where possible. This encourages negotiation and settlement outside of court. As Parker notes, when the ACCC was vested with the power to accept enforceable undertakings, up until 2004, the regulator took only three to court. One of them was dropped.[152] Despite the concerns about arm-twisting and bullying in the negotiation of enforceable undertakings, few of them are subjected to full judicial scrutiny.

Court procedures provide a 'last resort' to businesses who both feel they have been aggrieved by improper administrative procedures, and, crucially, who also calculate that challenging the action of the regula-

tor would be in their long term interest. Robert Baldwin and Martin Cave argue that these appeal processes are not without cost.

- Appeal mechanisms may increase delays and costs and may weaken the capacity of the first instance decision maker to make sustainable policies.
- To allow government-instituted appeals might expose regulators to political interference and undermine their authority.
- A divergence between policies adopted at first instance and on appeal may be produced and lead to confusion, in addition to the delays and uncertainties of a two-tier process.
- Appeals involving legalistic arguments before generalist decision makers may prove less timely and less expert than decisions by specialists.
- An appeal and review procedure may not always provide a second opportunity for a fair decision. It may offer an avenue to the 'real' decision maker that is delayed by a kind of mock examination before the first-instance body. This is especially the case where appeals proliferate.[153]

Both accountability through the courts, and accountability through internal agency appeal and review processes can fall victim to 'appeal fatigue', an effect which ironically increases as formal review mechanisms increase.[154] Furthermore, judicial review cannot mitigate the effects of negative publicity campaigns or regulatory arm-twisting, which have, non-legal but nevertheless significant, impacts on the business of a firm.

As an *ex post* measure, judicial review does not, and cannot, provide a day-to-day oversight of the application and conduct of the regulator's discretionary powers.

Reversing the trend

Regulation is not only a drain on economic efficiency and activity. The increase in regulatory activity and the consolidation of regulatory responsibility into 'mega-regulators' raise a number of political governance questions—as regulators hold increasing power over the economy, their activity takes on a political dimension. Ronald Rea-

gan's 1976 criticism of the undemocratic power of regulatory and bureaucratic agencies in the United States applies just as well to Australia in 2007 when he argued that:

> We are governed more and more by people we never elected, and who can't be turned out of office by our votes and who want more power than they ever have.[155]

Regulatory agencies have presided over the most intense period of regulatory and legislative activity in Australian history. This position gives them enormous influence—for which they are largely separate from the traditional chains of democratic accountability. Furthermore, as we have seen, this independence has the capacity to encourage regulatory growth and expansion, increasing the burden on the economy.

To mitigate these problems in the short term, legislation needs to be more carefully drafted to be clear about its objectives, the type of behaviour that the regulation is intended to target, and, importantly, the objective principles guiding the need for, and conduct of, the regulation. These may be obvious requirements, but they are not always met. The Productivity Commission found that the National Access Regime, as innovative and imposing a regulatory mechanism as could be imagined, failed on all of these counts.[156]

To stem the increase in regulation making, new regulations should be subjected to more rigour. Alan Moran has recommended a set of standards for regulation which include the following:

1. Require a review to ensure the new regulation is fully consistent with the letter and spirit of the freedom of inter-state commerce provisions of the Constitution.
2. Introduce the regulation under a two stage process approach: the first simply setting out the issues in a dispassionate and non-committal manner and the second seeking comment on the agency's preferred approach.
3. Require an independent analysis to verify that the regulation is merited. This might be a scientific review in the case of measures mooted that guard against health or environmental externalities. And it may use formalised and independent economic analysis

to review alleged economic benefits from an externality.

4. Establish disciplines that ensure the regulatory burden does not increase. In this respect a useful approach would be that of the UK Prime Minister's direction to the Better Regulation Task Force to look at:
    - First measuring the administrative burden then setting a target to reduce them (the Dutch approach); and
    - A 'one in, one out' approach to new regulation, which forces a prioritisation of regulation and its simplification and removal.[157]

But while regulation dominates economic life, it is nonetheless a specific problem with a larger cause—the extended reach of government into the economy. Concerns about the manipulation of firms by regulators or the growth of regulatory power are more generally symptoms of interventionist government.

Unfortunately, on this ultimate point, there can be no 'silver bullet' solution. The 'one in, one out' approach may slow the growth in regulation, but achieve no overall reduction of the burden and the costs. Independent analysis, greater and more structured consultation processes and increased rigour to ensure that new regulations are constitutional will similarly do little to increase economic freedom. As regulation is first and foremost a political act, the problem of regulatory expansion ultimately requires a political solution. A reduction of regulation and regulatory activity is a challenge which requires a concerted effort from regulators and legislators alike.

Elected representatives need to be cognizant not only of the economic and social impact of the vastly expanding body of regulation, but also of the impact it has on political governance and the dispersion of power in Australia's democracy.

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