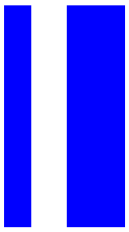

TASMAN ASIA PACIFIC

Economic, Management
and Policy Consultants

ANALYSIS OF MARKET CIRCUMSTANCES WHERE INDUSTRY SELF-REGULATION IS LIKELY TO BE MOST AND LEAST EFFECTIVE

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Key Findings

The effectiveness of self-regulation as a means of reducing market failure depends on the extent to which firms have both the incentive and ability to group together to reduce the welfare losses arising from that market failure. This is most likely to be the case if:

- any external costs arising from the market failure are borne predominantly by other firms in the same market;
- firms recognise their future viability depends not only on their relationship with their current customers and shareholders, but also on their relationship with the wider community;
- any social welfare objectives are clearly defined by Government;
- there is no constraint on firms grouping together to self-regulate their activities;
- markets are competitive and products are homogeneous;
- there are no constraints on imposing effective sanctions on firms that breach self-regulation;
- there is limited scope for adversely affected individuals and firms to 'free ride' on the benefits of self-regulation;
- there is no significant divergence of views between consumers and the community as to the merits of reducing a particular type of market failure;
- the product supplied is not essential to the welfare of individuals; and
- if the product supplied is essential to the welfare of individuals:
    - the government was involved in the development of the self-regulation;
    - the self-regulatory authority comprises representatives of all key stakeholders;
    - the administration and operation of the self-regulation is transparent; and
    - the self-regulatory authority is regarded by the community as being independent.

Self-regulation is likely to be less effective in markets where:

- there is little competition between firms;
- firms have a relatively short-term view of the factors influencing their viability;
- firms concentrate predominantly on the interest of their current customers and shareholders;
- firms have not invested heavily in the development of their reputations;
- external costs arising from the activities of a member firm are borne predominantly by sections of the community other than that firm's customers and other member firms;
- products are complex, heterogeneous in the eyes of consumers, and some of those products are essential to the welfare of individuals;
- firms, consumers and the wider community do not share a common interest in reducing the market failure; and
- any social welfare objectives of the self-regulation are not clearly defined in legislation.

EXECUTIVE SUMMARY

Purpose of the report

The Minister for Financial Services and Regulation has established the Taskforce on Industry Self-regulation to inquire into how the Government can encourage *effective* industry self-regulation. The Taskforce is focusing on self-regulation in consumer markets where the Commonwealth Government has constitutional responsibility or where there is a national scheme in place.

The Commonwealth Treasury has engaged Tasman Asia Pacific to identify and report on the characteristics of markets where various forms of self-regulation are likely to operate effectively and the circumstances where self-regulation is likely to be inappropriate. This work is intended to assist policymakers to avoid the promotion of self-regulatory schemes that are likely to fail.

Tasman was asked to analyse a sample of consumer markets that are principally the policy responsibility of the Commonwealth (rather than state or territory governments) and have self-regulatory schemes that are integrated into the regulatory framework and administered by industry. The seven chosen self-regulation case studies are:

- the Advertiser Code of Ethics;
- the Direct Marketing Code of Practice;
- the Code of Practice for Computerised Checkout Systems in Supermarkets (hereafter referred to as the Supermarket Scanning Code);
- the Code of Conduct of the Australian Pharmaceutical Manufacturers Association Inc;
- the Proprietary Medicines Association of Australia Inc Code of Practice;
- the Code of Professional Conduct of the Institute of Chartered Accountants in Australia and CPA Australia; and
- the General Insurance Code of Practice.

The results of that analysis are drawn together in Chapter 2 of the report, which identifies features of the market that make self-regulation more or less effective.

What determines the effectiveness of self-regulation?

The effectiveness of any form of regulation, including self-regulation, depends on the extent to which it achieves its objectives. From a government perspective, an important objective is to reduce the potentially adverse effects that market failure has on the welfare of consumers and the wider community. From a firm perspective, however, the objective of self-regulation is to improve the firm's profitability which, in some circumstances, will also improve consumer welfare and bring benefits to the wider community.

A wide range of market features combine to influence the effectiveness of self-regulation. It is unlikely that all of these features will be found in any one market. In some markets, the prevailing market conditions will mean that self-regulation will be totally ineffective from a community welfare perspective.

As a consequence, any assessment of whether a particular market's characteristics are conducive to achieving effective self-regulation needs to be considered on a case by case basis. Even if the market's characteristics indicate it may be a suitable candidate, the effectiveness of the self-regulation can be influenced by the nature of the self-regulation arrangements themselves.

The extent to which self-regulation is effective in simultaneously achieving the objectives of both the government and firms depends, in turn, on the precise nature and extent of that market failure, since this influences both:

- the need for some form of regulation, such as self-regulation; and
- the incentive and ability of firms to develop, implement and operate effective and sustainable systems of self-regulation.

When will firms have the incentive to engage in effective self-regulation?

Self-regulation is likely to be more effective in reducing market failure in those circumstances where firms share a strong common incentive to reduce that market failure. That is, it must be in the interests of their overall profitability to reduce that market failure.

Firms in a market will have a greater incentive to group together to engage in self-regulation the greater:

- the magnitude of the external costs arising from market failure; and
- the proportion of those costs that are borne by that group of firms.

As a result, self-regulation is likely to be more effective in those cases where any external costs arising from a firm's activities fall predominantly on the other firms within that group, and the customers of that group. For example, self-regulation is likely to be more effective in those cases where the market failure is due to the existence of:

- information asymmetries between firms and consumers as to the prices, performance and availability of products, and that information asymmetry has an adverse effect on the sales of other firms in the group. This is most likely to occur when the firms in question are producing products that are relatively close substitutes in consumption;
- negative externalities produced by some of the firms in a market, and those external costs fall predominantly on other firms in the market and their consumers; and
- imperfect competition, where that imperfect competition is the result of the activities of some of the firms in the market, and the costs arising from those activities fall predominantly on other firms in the market.

By contrast, self-regulation is less likely to be effective where:

- the market is failing because the activities of firms are compromising a particular social welfare objective that has little significance for consumers of the product and those firms, but is important to the wider community. In such cases, the costs arising from the activities of these firms are being predominantly borne by other sections of the community, and firms will have little common interest in reducing those costs; or
- there is a significant divergence of views between consumers as to the merits of reducing a particular type of market failure. For example, this is more likely to occur where the products produced are heterogeneous, or where there is considerable difference of views between consumers as to the merits of achieving a particular social objective; or
- there is a significant divergence in producer interests in reducing the market failure. This is more likely to be the case where the products produced by those firms are not close substitutes in production or consumption; or
- there is little overlap between the interests of firms and consumers. For example, this can occur when there are only a few firms dominating a market due to the existence of economies of scale in production and/or barriers to entry. In such cases, those firms are more likely to have a strong common interest in retaining their market dominance. In these market circumstances firms have an incentive to use self-regulation to reduce competition even further.

When will firms have the ability to develop and operate effective codes of self-regulation?

The effectiveness of self-regulation also depends on the ability of firms to group together to self-regulate their activities. Even if firms have a strong incentive to reduce market failure, their ability to self-regulate effectively can be constrained by the precise nature and extent of that market failure.

In order to develop effective systems of self-regulation, firms, and the self-regulatory authority, need to know the extent to which their activities adversely affect other firms in the market, and their consumers.

As a result, self-regulation is more likely to be effective in those markets where:

- consumers share a common interest in reducing the market failure, since this will improve the ability of firms to determine the interests of consumers, as the views of one consumer will be representative of the views of all other consumers and, potentially, the community as a whole. This is more likely to be the case where the products of the firms are close substitutes in consumption, or where consumers and all other individuals share common views as to the merits of regulating the activities of firms to achieve a particular social welfare objective.
- firms share a common interest in reducing the market failure, since this improves the ability of the self-regulatory authority to develop and operate an effective code that meets the interests of producers. Self-regulation will tend to be more effective when there is sufficient commonality of interest between firms to encourage those firms to comply with the self-regulation. It will be difficult to provide effective sanctions if there are large numbers of firms that decide not to comply, or are able to free-ride on the benefits of those firms that do comply. Firms are more likely to have a common interest in reducing market failure where their products are close substitutes in production and/or consumption, or where there are other difficulties in differentiating their business from other firms. In addition, the threat of potential government legislation or regulation can also give firms a strong common incentive to implement effective self-regulation.
- consumer interests diverge, but there is either a strong consumer organisation that is able to reconcile those different interests, or the Government has introduced legislation that outlines the rights of consumers.
- firm interests diverge, but there is a strong self-regulatory authority that is able to reconcile those different interests, or the Government has introduced legislation that outlines the responsibilities of firms.

- there is an independent self-regulatory authority which has the widespread support of industry and comprises representatives of all other key stakeholders that are affected by the activities of the firms (including consumer organisations, the government and the wider community), and that authority maintains a good working relationships with those key stakeholders.

Achieving the best regulatory mix

It is important to note that the market features identified above influence not only the effectiveness of self-regulation, but also the effectiveness of government legislation and regulation. This means that the development of effective regulation involves a careful analysis and comparison of the relative merits of alternative forms of self-regulation, government regulation, and legislation, and mixes of those regulations.

The most effective system of regulation is the one that is the result of careful analysis of the nature and extent of the market failure, and the allocation of regulatory functions to those entities that have the have the best incentives and ability to perform those functions. Often, the most effective form of regulation will involve some mix of self-regulation, government legislation and regulation. As noted above, the effectiveness of self-regulation can be improved by government legislation and regulation that clarifies the property rights of individuals. Similarly, successful government legislation and regulation relies heavily on individual firms having both the incentive and ability to individually, or collectively, self-regulate their activities to achieve 'voluntary compliance' with that legislation.

It is also important to note that the process of developing effective self-regulation, government legislation and regulation, does not stop once that regulation has been implemented. Rather, a successful regulatory design process involves regular monitoring and reviews of the effectiveness of those regulations after they have been implemented with a view to identifying possible options for reform. It is unrealistic to expect that the first version of a particular self-regulatory regime will succeed in eliminating market failure. Inevitably, even the most effective forms of self-regulation, government legislation and regulation involve some degree of inefficiency and inequity, and it takes time to improve the effectiveness of those regimes.

In order to develop more effective systems of self-regulation, it is essential for firms, consumers, and the government to work together to develop a much better understanding of the nature and extent of market failure in a particular industry. Once the nature and extent of market failure is understood, both firms and the government will be in a much better position

to identify and evaluate alternative regulatory options, and to assign regulatory functions to those entities that are in the best position to perform those functions.

1. INTRODUCTION

1.1 BACKGROUND TO THE CONSULTANCY

The Minister for Financial Services and Regulation has established the Taskforce on Industry Self-regulation to inquire into how the Government can encourage *effective* industry self-regulation. The Taskforce is focusing on self-regulation in consumer markets where the Commonwealth Government has constitutional responsibility or where there is a national scheme in place.

Self-regulation is most effective when, from an economy wide perspective, it has the highest benefit-cost ratio of all alternate regulatory solutions (including market deregulation). From the producer's perspective, self-regulation can be low cost relative to other forms of regulation or intervention such as statutory controls and mandates, licensing, quotas, minimum standards, product labelling, taxes, statutory limits on resource use, direct government provision, and price controls. It can help producers to raise quality and reduce costs. For example, by reducing uncertainty and establishing joint arrangements for the resolution of disputes. From the consumer's perspective, self-regulation can improve market outcomes by allowing them to make more informed choices and reducing the risk that they will inadvertently purchase poor quality goods or services. It can also provide a low cost means for consumers to resolve their disputes with producers directly. In the absence of self-regulation the transaction costs associated with a legal recourse could be high relative to the benefits that consumers do not pursue their complaint.

However, self-regulation is not always effective. There are many factors which influence the effectiveness of self-regulatory schemes in reducing costs on business and improving market outcomes for consumers. For instance, the characteristics of the market in which the scheme applies can influence effectiveness. So too can scheme design and the nature and extent of government involvement.

The Commonwealth Treasury has engaged Tasman Asia Pacific to identify and report on the characteristics of markets where various forms of self-regulation are likely to operate effectively and the circumstances where self-regulation is likely to be inappropriate. This work is intended to assist policymakers to avoid the promotion of self-regulatory schemes that are likely to fail.

The consultant was required to adopt a case study methodology as the basis for researching and reporting on market conditions that are conducive to effective self-regulation. Tasman was asked to analyse a sample of consumer markets that are principally the responsibility of the Commonwealth (rather than state or territory governments) and have self-regulatory schemes that are integrated into the regulatory framework and administered by industry. The seven chosen self-regulation case studies are:

- the Advertiser Code of Ethics;
- the Direct Marketing Code of Practice;
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- the Code of Conduct of the Australian Pharmaceutical Manufacturers Association Inc;
- the Proprietary Medicines Association of Australia Inc Code of Practice;
- the Code of Professional conduct of the Institute of Chartered Accountants in Australia and CPA Australia; and
- the General Insurance Code of Practice.

The case study material presented in this report provides information on the development and operation of these seven self-regulatory schemes and an analysis of prevailing market conditions. Importantly, the consultant does not seek to make judgements about the success of each scheme. Rather, the case study material is intended to highlight features of markets (including market failures as well as supply and demand characteristics) that are likely to have a direct bearing on the effectiveness of the self-regulatory schemes.

The consultant was required to draw together the results across the case study markets to identify, in general terms, features of markets that have contributed to the success of self-regulatory schemes and discuss market features that have militated against the success of self-regulation.

This report presents the consultant's findings and advice on market characteristics that are conducive to effective self-regulation. Chapter 2 identifies the features of markets that have contributed to the success of self-regulatory schemes and discusses market features that have limited the success of such schemes. These determinations are based on case study material and the consultants' general experience. Chapters 3 to 9 provide background material on each of the case study self-regulatory schemes and analyse market circumstances which have influenced the effectiveness of each scheme.

1.2 WHY DOES THE NEED FOR SELF-REGULATION ARISE?

In most cases, the provision of goods and services in the economy is carried out by the private sector operating under minimal levels of regulation, including self-regulation. This is because the unfettered operation of the market is generally the most efficient means of allocating society's resources. However, for a variety of reasons, the unfettered operation of markets can result in them failing to produce efficient and equitable outcomes. The most common sources of market failure are information asymmetry, externality, public good and imperfect competition (see Box 1).

Box 1: **Forms of Market Failure**

Information asymmetry

Information asymmetries occur where one party to a transaction has more information available about the good or service than others. The traditional example of this is the market for used cars where the buyer is often not able to tell whether the car is a 'lemon' or not, whereas the seller usually knows more about the car's true quality. In this type of market, bad products tend to force out good ones, as buyers discount the price they are prepared to pay in case the product they buy is defective. Sellers of good quality products are often not prepared to sell at that lower price. Solutions to this market problem include dealers issuing warranties on their products and the establishment of supplier accreditation schemes.

Externalities

Externalities arise if an activity undertaken by a firm, government, or household, provides spillover benefits, or imposes spillover costs, on third parties. For example, negative externalities can arise if one firm supplies a faulty or inferior quality good or service to a customer at the same price that other firms provide a sound quality good or service. The consumer, after discovering the quality is sub-standard, may infer that other firms also provide a faulty or inferior quality good. Thus, the actions of one firm adversely affects the reputation of all firms operating in the market. Responses for dealing with negative externalities include the creation of tradeable property rights, prohibition of an activity, compulsion of minimum standards, and imposing a tax on the offending activity.

Continued over page

Box 1: **Forms of Market Failure** (continued)

Public Goods

Public goods have two important characteristics. First, once the good or service is produced it is difficult or impossible to exclude those who do not pay from enjoying its benefits. This is known as the 'non-excludability' characteristic. People who benefit from the provision of the good but do not contribute to the cost of its provision are known as 'free-riders'. The second characteristic of public goods is the fact that consumption of the good or service by an individual does not reduce the amount of that goods or service available for others. This is known as 'non-rivalry' in consumption.

Imperfect Competition

Unequal power on the supply or demand side of a market can lead to non-competitive behaviour which can produce an outcome that does not maximise welfare or growth. Excessive power in a market can arise due to regulation, for example regulation which prohibits entry, however, it can also arise 'naturally' due to technology or particular characteristics in a market. Natural monopoly, where a single firm can supply the only market, is one extreme case of imperfect competition.

There is widespread recognition that self-regulation (such as product or advertising standards, codes of practice or ethics, and codes of professional conduct) can be a very low cost regulatory option to deal with some instances of market failure. Generally regulatory costs tend to be higher for more heavy-handed forms of government regulation. It is for this reason that the Office of Regulation Review (1998) and the Commonwealth Interdepartmental Committee on Quasi-regulation (1999) recommend that, where appropriate, industry should take increased ownership and responsibility for developing efficient and effective regulation, having regard to minimum feasible compliance costs.

Self-regulation can also be superior to alternative forms of regulation because it directly involves the parties who generally have the best institutional knowledge about the need for action and about the relative merits of alternative types of action. Miller (1985) notes that governments can hire the technical expertise needed to draft regulations, but this method is slower in perceiving the need for action than where parties are directly involved in the relevant market action.

Self-regulation also has the advantage of being more flexible than other types of regulation. Consequently it may be less likely to stifle innovation or excessively limit consumer choice.

When self-regulation becomes redundant, firms will tend not to follow it. If one code promotes inefficient practices, it is likely that firms will form a new organisation to develop a substitute code. The same often does not apply to government regulation, which tends to be more permanent. If rules become outdated and promote inefficiency, producers may still be forced to comply. The bureaucratic process can be slow to effect necessary changes to regulation.

However, while it can be least cost, involve knowledgeable parties and be flexible, self-regulation is not a panacea. For instance, it may not be sufficient to produce appropriate market outcomes from the point of view of consumers. As discussed in Chapter 2, some types of market failures are more likely to be addressed effectively through self-regulation than others.

1.3 FACTORS INFLUENCING THE EFFECTIVENESS OF INDUSTRY SELF-REGULATION

As noted earlier, there are many factors which influence the effectiveness of self-regulatory schemes. This report focuses on the characteristics of markets which influence effectiveness, however it is important to understand how non-market factors such as scheme design and government involvement also can influence effectiveness. Policymakers must be aware that, even though a market may have characteristics that are conducive to effective self-regulation, it does not follow that self-regulation will automatically be effective. Poor scheme design or inappropriate government involvement may detract from the scheme's effectiveness. On the other hand, even where a market is dominated by characteristics that are not conducive to self-regulation, self-regulation may be relatively successful due to clever scheme design and appropriate government involvement.

1.3.1 Market factors

Sometimes the characteristics of the market to which self-regulation applies is the key determinant of the effectiveness of the scheme. Market characteristics generally can be categorised as demand-side or supply-side characteristics.

Demand side market characteristics are market factors that affect the level and nature of consumer demand for a good or service such as:

- the price of the product;
- the extent to which a consumer purchase is discretionary;

- the extent to which consumers can and do quickly switch between products and services in response to changes in quality or price;
- the complexity of product information;
- the level and nature of consumer complaints;
- the quantum of compensation sought in dispute; and
- the impact of globalisation and technological change on consumer choice.

Supply side market characteristics are market factors that affect producers' behaviour such as:

- the number and size of sellers in the market;
- the cohesiveness of the industry;
- the level of participation in any industry association;
- the degree of competitive pressure in domestic market;
- the degree of competitive pressure from overseas suppliers;
- the impact of globalisation and technological change on supplier behaviour; and
- the degree of pressure on suppliers in the market to grow their customer base to achieve a competitive scale of operations.

Chapter 2 examines in detail how these various demand and supply conditions influence the effectiveness of self-regulation.

1.3.2 Scheme design

Scheme design is an important determinant of scheme effectiveness. There is a relatively well-developed literature listing the characteristics of well designed self-regulation (see for example IC 1995, ACCC 1999). Based on this literature, well designed self-regulation is usually characterised by:

- transparency and extensive consultation in scheme development;
- independence of operation;
- transparency in scheme operation;
- appropriate representation of consumer interests;
- in the case of dispute resolution schemes, ease of access for consumers;

- widespread industry participation in the scheme;
- provision for sanctions against firms in the event of non-compliance; and
- provision for regular review to improve the self-regulatory regime as consumer preferences and expectations, product range, technology (etc) change over time.

If the majority of these aspects of scheme design are missing, the overall effectiveness of a self-regulatory scheme may be compromised. In particular, effectiveness can be compromised when consumers do not have confidence that their interests are represented fairly by the scheme, or when producers do not have "ownership" of the scheme.

The effectiveness of a scheme may be influenced significantly during its initial development. Extensive consultation is important during the development of any self-regulatory scheme to ensure that all relevant stakeholders (including consumers and producers and, where appropriate, government) have an opportunity to present their views on what the scheme's objectives should be, and how those objectives can best be achieved. If there is not extensive consultation during the development of a self-regulatory scheme, there is a risk that the scheme will adopt inappropriate objectives or fail to include appropriate objectives. It also is important that debate over scheme design is as transparent as possible so that stakeholders, including the general public, can have confidence that proper attention is paid to their views. Failure to do this may undermine consumer or producer confidence in the scheme.

Achieving independence of operation can be difficult for self-regulatory schemes since, by definition, they are administered by industry and may be (or be perceived to be) biased in favour of the producer's interests. Notwithstanding this, self-regulatory schemes can achieve a degree of independence. For instance, firms can make their in-house complaints resolution schemes more independent by creating an autonomous complaints resolution unit within the organisation so that the process becomes independent from parties within the firm who are directly involved in the dispute. A greater degree of independence can be achieved by making provision for arbiters outside the firm to mediate in a dispute or by providing consumers with recourse to an independent industry complaints organisation with consumer representation.

Transparency of operation can be achieved through regular reporting of how well the scheme is achieving its objectives and the public dissemination of verifiable or independently audited performance indicators. Where the processes involved under which self-regulatory schemes operate are not well understood by stakeholders, the scheme may be considered as a "black-box". In this situation, it can be difficult for stakeholders to have confidence in scheme outcomes.

Similarly, if a self-regulatory scheme does not actively make provision for consumer interests to be represented, provide for ease of access by consumers, or apply sanctions against producers who do not comply with the scheme, it will be difficult for the industry to foster consumer confidence in the scheme.

Often the most effective schemes in terms of scheme design are those that make provision for regular independent reviews of the scheme's objectives, scope of operation and outcomes. This means that even if a scheme is not fully effective initially on the grounds of scheme design, it may be improved as stakeholders gain experience.

1.3.3 Government involvement

Governments can influence the effectiveness of self-regulation through the threat (or perceived threat) of direct regulation. Among several of the case studies considered, the threat of more heavy-handed regulation led the industry to band together to consider self-regulatory options. The threat of direct government regulation also provides a powerful incentive for producers to maintain self-regulation and even expand its charter to continually meet the needs of consumers.

While the threat of government involvement can encourage industry to develop effective forms of self-regulation, there also is potential for it to detract from effectiveness. If a self-regulatory scheme has been developed by industry and administered by industry, producer "ownership" of the scheme can be high. This sense of ownership can motivate producers to find better ways of achieving scheme objectives. If the industry and consumers are generally satisfied with the operation of a scheme, and there is evidence that the effectiveness of the scheme is improving over time, the threat of government intervention (such as formal monitoring by a regulatory authority or transfer of self-regulatory provision into government regulation) can undermine producer ownership of the scheme and, thereby, reduce scheme effectiveness.

This suggests that where there is a market failure or social objective that needs to be addressed the threat of government regulation or formal monitoring can provide a powerful incentive for industry to come together to develop an effective self-regulatory scheme to minimise compliance costs. However, when a scheme is up and running and considered to be working effectively by the majority of producers and consumers, any attempt by government to impose more heavy handed regulatory options on the industry may be counterproductive.