2. FEATURES OF THE MARKET THAT MAKE SELF-REGULATION MORE OR LESS EFFECTIVE

Self-regulation covers a wide spectrum of possible activities that will vary in their effectiveness. At one end of the spectrum are those activities that would do little, if anything, to improve the welfare of consumers and the wider community. Indeed, in some cases, the monopoly power created by self-regulation could be used by firms as a restraint of trade to reduce competition — thereby acting against the interests of consumers and the wider community. At the other end of the spectrum are those self-regulatory activities that would not only improve the profitability of firms, but also the welfare of consumers and the wider community. The outcomes of most self-regulation activities fall somewhere in between these two extremes.

This chapter examines the features of markets that influence the likelihood that self-regulation will be effective. Section 2.1 outlines how the nature and extent of market failure can influence effectiveness. Section 2.2 discusses how product characteristics can have a bearing on effectiveness. Section 2.3 examines how the nature and extent of competition between firms can influence the effectiveness of self-regulation. Section 2.4 outlines how the similarity of producer and consumer interests can affect effectiveness. Concluding remarks are made in Section 2.5.

2.1 NATURE AND EXTENT OF MARKET FAILURE

As outlined in Chapter 1, most competitive markets will produce an outcome for the community that maximises society's income and future growth potential. But sometimes there are obstacles (impediments) that cause markets to fail to achieve these outcomes. The most commonly cited forms of market failure are information asymmetry, externality, public goods and imperfect competition. In some cases, some form of intervention (including self-regulation) may be warranted to assist a market to operate more efficiently and effectively. Ultimately, the effectiveness of any such intervention is dependent on the extent to which it reduces the potentially adverse effects that market failure has on the welfare of consumers and the wider community.

The precise nature and extent of that market failure has important implications for regulatory design. It influences not only the need for some form of regulation, such as self-regulation, to protect the interests of consumers and the wider community, but also the incentive and ability

of firms to develop, implement and operate effective and sustainable systems of self-regulation. Although the existence of market failure can provide an incentive for firms to self-regulate, the precise nature and extent of that market failure can also limit the effectiveness of that self-regulation by constraining the ability of firms to self-regulate.

This section discusses how the nature and extent of market failure influences the effectiveness of self-regulation, with particular reference to the types of market failures identified in the case studies analysed in Chapters 3 to 9. The nature and extent of those market failures is influenced, of course, by a wide range of other features of the market including the nature of the product, the nature and extent of competition between suppliers of the product, and the commonality of consumer and producer interests. Those market features, and their implications for the effectiveness of self-regulation, are discussed in sections 2.2 to 2.4.

2.1.1 Information related market failure

An important source of potential market failure in all of the industry case studies examined is the existence of asymmetric information between the various participants in those markets, including individual firms, consumers, and their respective associations. As outlined below, the nature and extent of those information asymmetries influences both the incentive and ability of firms to engage in effective self-regulation.

Consumer uncertainty regarding their preferences and the prices, performance and availability of products

An objective of many self-regulation regimes is to set standards in relation to the nature and quality of the information supplied to consumers about the prices, performance and availability of products. In particular, those regimes seek to either reduce the extent to which firms provide incomplete, misleading or offensive information to consumers, or make the information which is available to consumers more readily understood. For example, the self-regulation regimes for advertising and direct marketing seek to reduce the extent to which firms can mislead consumers about product prices and performance. The supermarket scanning code was also introduced to allay concerns that the introduction of bar code scanning might result in differences between displayed prices and prices charged at the checkout. Self-regulation of pharmaceutical manufacturers seeks to ensure that manufacturers give accurate information to medical practitioners. The code also contains rules regarding product inducements, so that a practitioner’s choice of medication is influenced more by product quality rather than the generosity of inducements. Self-

regulation of the accounting profession seeks to provide clients with information so as to allow them to differentiate between “reputable”/qualified practitioners and disreputable or unqualified practitioners. General insurance self-regulation requires insurers to write contracts in plain English so those insured are better able to understand the risks they are insuring against, the risks that are not covered by the contract and their duty to disclose relevant information to insurance companies.

The scope for firms to provide misleading information to consumers or their agents arises due to the information asymmetry that exists between firms and consumers. That is, firms tend to have better information on the prices, performance and availability of their products than consumers.

If all consumers knew their preferences, as well as the prices, performance and availability of all goods and services that were capable of satisfying those preferences, there would be little scope for firms to provide misleading information and the process of consumption would be relatively straightforward. Consumers would simply choose to purchase that combination of goods and services that meet their particular needs and budgets. In reality, however, such ‘perfect information’ does not exist. Consumers are often uncertain not only about their own preferences, but also about the prices, performance and availability of the various goods and services that might satisfy those preferences. In the presence of this uncertainty, the process of consumption becomes much more complex since consumers need to:

- clarify their preferences;
- search for goods and services that potentially meet those preferences;
- determine the prices and availability of those goods and services;
- select and purchase those goods and services that best meet their preferences and budgets;
- use those goods and services in such a manner as to extract the maximum possible benefit and minimise any potential costs;
- evaluate the extent to which those goods and services are actually satisfying their preferences; and
- decide when to stop using those goods and services and replace them with new and improved goods and services.

Much of this uncertainty is due to significant transactions costs that consumers would have to incur in order to acquire the information necessary to perform the consumption-related activities outlined above. In some instances, the necessary information may be so complex that it may be difficult if not impossible for the average consumer to interpret. For example,

in the case of prescription-only pharmaceutical products a patient cannot be expected to keep abreast of the continual developments in medications as well as their effectiveness and side effects. Thus, to a large extent, patients rely heavily on their medical practitioner to act as their agent and prescribe the most appropriate prescription-only medication. In some cases it is difficult for consumers to access all the information needed to gain a full appreciation of the risks associated with a particular product. For example, in the case of proprietary and complementary medicines, consumers may be aware that a product is available but may not be aware of the risks associated with overuse or inappropriate use. Similarly, in the case of general insurance consumers may be aware of various insurance products that are available, but are not likely to know the probability that they will make a claim under each type of insurance cover.

In view of the large number of decisions that consumers make everyday, it is simply not feasible for them to attempt to acquire all of the information they would require to make fully rational decisions. Rather, the high costs associated with acquiring all of that information places bounds on the extent to which it is feasible for consumers to act in a fully rational manner. The existence of this phenomenon, which is commonly called ‘bounded rationality’, means that consumers often have to rely on less informationally demanding, and more intuitive, approaches to formulating their decisions (Nagler 1993, pp 362-3). For example, as discussed in Chapter 3, rather than seek to obtain all of the information they need to clarify their preferences and evaluate the performance of alternative products, consumers may rely instead on persuasive advertising to provide that information. In addition, consumers also tend to rely on the reputation of the firm supplying the product as a guide to the quality of its products. The extent of ‘bounded rationality’ also tends to vary across consumers. For example, it can be particularly high for new immigrants who may have difficulty understanding English, for children, and in some instances for the aged and the infirm.

Similarly, in view of the considerable variation in the prices and performance of different products and services, consumers can incur significant costs when searching for products and services that are likely to satisfy their preferences and budgets. These costs, which are commonly referred to as ‘search costs’, tend to vary across products and services. For example, the search costs associated with trying to find a relatively uncommon product that is only available from a small number of suppliers are much higher than those associated with finding a relatively homogeneous good that is available from a large number of suppliers (Stigler 1961, p216).

Once a product has been purchased, consumers also incur costs associated with evaluating the performance of that product and determining when to replace that product. Indeed, the

quality and performance of certain ‘experience’ goods and services can really only be determined after those products have been purchased and used. Once again, the costs of such experimentation can vary considerably over different types of goods and services. For example, the costs of experimentation tend to be higher for products that are either essential to the consumer’s health and wellbeing (ie ‘non-discretionary’), or comprise a high proportion of their budget. These can include financial services such as some types of general insurance products, certain accountancy services and health related products such as proprietary medicines. For such products and services, the financial and non-pecuniary costs to the consumer from an inappropriate product choice may be high. By contrast, the costs of experimentation tend to be much lower for lower cost products and services that are ‘discretionary’ purchases.

The existence of this information asymmetry also has important implications for firms. In particular, it means that firms have to provide consumers with information about the prices, performance and availability of their products. Firms, particularly new firms, and firms selling new and improved products, cannot rely on consumers to be aware of their existence and the prices and performance of the products they are able to supply.

As noted earlier, the existence of this information asymmetry also provides firms with both the incentive and ability to mislead consumers as to the prices, performance and availability of their products or services. This imposes external costs not only on the consumers of those products, but also other firms in the industry producing substitutable products. These external costs are discussed further in Section 2.1.2.

The market for accounting services is an instance where both consumers and accounting firms suffer external costs from an information asymmetry. A lack of information about the business attributes and competencies of particular accountants can lead to an inappropriate choice of service provider by clients. This, in turn, can lead to a loss of income and, at worst, insolvency for the client. The provision of inadequate accountancy services can have much wider effects. For example, they can adversely impact on company shareholders, creditors and investors. Further, because it is difficult to identify which accountants have, and which do not have, the necessary skills and competencies to undertake accounting services, the negative feedback associated with poor service can have a deleterious effect on the whole profession.

As a result, firms have an incentive to engage in collective self-regulation with a view to reducing the extent of the information asymmetry, for example by improving the quality of information supplied. Such action will also reduce the risk of each firm’s sales being affected adversely by the false claims or the malpractice of a competitor.

However, as discussed further below, the ability of firms to group together to reduce the extent of misleading information, and other potential sources of market failure, is also affected by a number of other information asymmetries between key market participants.

In addition, the effectiveness of self-regulation as a means of reducing the extent of or the impact of an information asymmetry is influenced by a number of other factors including:

- the nature of the product, which is discussed further in Section 2.2;
- the nature and extent of competition between firms, which is discussed further in Section 2.3; and
- the extent to which producers and consumers share a common interest in reducing such market failure, which is discussed further in Section 2.4.

Producer uncertainty regarding the nature and extent of market failure

The effectiveness of self-regulation as a means of reducing market failure depends on the extent to which firms, and the authority responsible for developing and administering self-regulation (hereafter referred to as the self-regulatory authority), have accurate information on the nature and extent of that market failure. To develop, implement and operate effective self-regulatory scheme, firms and self-regulatory authorities need to know how the activities of firms affect consumers, other firms, and the wider community.

Although a firm might have accurate information on the prices, performance and availability of its own products, it is likely to be more uncertain about:

- the prices, performance and availability of the factors of production and intermediate goods and services it uses in its production processes;
- the preferences of consumers and other individuals in the community, and the manner in which the firm's activities affect the welfare of those individuals; and
- the activities of other firms, and the manner in which those activities might adversely affect their profitability.

This uncertainty of firms about the nature and extent of market failure tends to reduce the effectiveness of self-regulation. In general, the more complex the nature of the market failure, the greater the potential information asymmetry between firms, consumers and the wider the community, the more difficult it is for firms to self-regulate.

The main sources of information available to firms and the self-regulatory authority on the potential welfare costs arising from their activities include:

- the complaints process, which can provide information on the nature and extent of costs arising from their activities;
- the views provided by representatives of consumer and community organisations;
- surveys of consumer and community satisfaction; and
- previous industry studies by government (eg by the ACCC and the Productivity Commission).

Self-regulation therefore tends to be more effective in those circumstances where the self-regulatory authority:

- has the widespread support of industry;
- comprises representatives of the other key stakeholders that are likely to be affected by the firm's activities, including consumers, consumer associations, the government, and the wider community;
- maintains good relationships with key stakeholders including consumers, consumer associations, the government and other community groups; and
- operates an effective system of handling complaints.

As discussed in Chapter 9, the two tier dispute resolution mechanism that accompanies the General Insurance Code of Practice provides for significant consumer representation and is held in relatively high regard by many consumer organisations for this reason.

In addition, as discussed further in Section 2.4, even if firms do have access to accurate information on the nature and extent of market failure, their incentive and ability to reduce that market failure will depend on the extent of commonality between the interests of those firms, as well as their consumers, and the wider community.

Self-regulatory authority uncertainty concerning the interests and activities of firms

Self-regulatory authorities can also be uncertain about the precise interests and activities of those firms that have agreed to abide by self-regulation. Individual firms may have much better information on the nature of their activities, and the effects that those activities have on consumers, other firms and the wider community, than does the self-regulatory authority. This is less of an issue where the self-regulatory authority has significant industry representation.

The existence of this information asymmetry between individual firms and the self-regulatory authority means that there is scope for each firm to understate the potential impact that their activities are likely to have on consumers, other firms, and the wider community. In particular, the existence of industry self-regulation may encourage some firms to seek 'membership' in order to continue their disreputable practices. The scope for such 'adverse selection' can be reduced to some extent by:

- vetting firms prior to granting 'membership' and monitoring the practices of members closely (for example, the accountants professional bodies rely extensively on mandating minimum qualifications and experience for membership and undertake periodic quality reviews to help overcome adverse selection); and
- imposing effective sanctions on those firms that breach self-regulation. In particular, it is important to ensure that individual firms not only bear the costs of their activities, but also a suitable additional penalty for breaches. In this regard Barkenbus (1983) argued that the success of self-regulation by nuclear utilities would be largely dependent on the creation of an incentives structure which included the threat of large, but not punitive, financial losses should an accident occur. The threat of such a sanction creates an incentive for utilities to build and operate facilities in the safest possible manner.

In addition, once a firm has agreed to abide by industry self-regulation, it may reduce its own internal self-regulatory activities. As discussed in Section 2.3, this can reduce the extent of competition between firms as well as the effectiveness of self-regulation. This risk can be reduced to some extent by ensuring that complaints received by the self-regulatory authority about the practices of a particular firm are referred in the first instance to that firm for them to deal with through their own internal self-regulation procedures.

Information asymmetry between the self-regulatory authority and the firms covered by self-regulation also makes it difficult for the authority to be certain that it is acting in the interests of all member firms. As discussed further in Section 2.4, where the interests of firms diverge considerably, and some firms have much stronger views than others, it can be difficult for the authority to ensure that it provides a balanced overview of the overall interests of all of the firms engaged in self-regulation.

Consumer association uncertainty concerning the interests and activities of consumers

The problems outlined above are not unique to self-regulatory authorities. Rather, they are common problems facing all organisations formed to represent the interests of individual members. Consumer associations, for example, may face similar problems. Individual

consumers often have a much better understanding of their interests, and the manner in which they are adversely affected by the activities of firms, than consumer associations.

This information asymmetry provides consumers with an incentive and opportunity to overstate the extent to which they have been adversely affected by a firm's activities in their representations to the consumer organisation. In addition, the presence of an effective consumer organisation may reduce the incentive for individual consumers to reduce the risk of disputes with firms. For example, it could encourage consumers to be more unreasonable in their dealings with firms, or refer relatively minor cases to the consumer association that could have been dealt with more efficiently had the consumer approached the firm directly themselves. This can limit the effectiveness of self-regulation. It can be dealt with through industry dispute resolution mechanisms that discourage frivolous or vexatious complaints, like the one operating in the general insurance industry.

In other instances, the consumer association can have better information about the extent of the economy-wide impact of a firm's actions than individual consumers. For example, a consumer in isolation may view a firm's 'mistake' in over charging for a product or service by a small amount is as an isolated incident, which justifies no action. However, a consumer association through their extensive network may be aware that the over charging practice is widespread and requires consumer redress.

2.1.2 Externality market failure

Another important source of market failure is the existence of 'external' costs and benefits that are not taken into account by firms and consumers when determining how much they should produce and consume. For example, as discussed in Chapter 3, misleading and offensive advertising can impose external costs on consumers and the wider community.

In the case of externalities, the effectiveness of self-regulation depends on the extent to which firms have the incentive and the ability to 'avoid' external costs or 'internalise' external benefits and costs. The incentive for firms to group together to self-regulate the external costs they impose on consumers and the wider community will depend on:

- the magnitude of the external costs and benefits arising from the activities of those firms; and
- the proportion of those external costs and benefits that are borne by other firms subject to self-regulation.

For example, as discussed in Chapter 5, supermarkets shared a strong common interest in allaying consumer concerns that the use of bar code scanning would result in discrepancies between displayed prices and prices charged at the checkout. In the case of accounting services, as discussed in Chapter 8, there is no legal constraint to prevent an unqualified or even a dishonest person from setting themselves up as an accountant in public practice. This has created an incentive for professionals to associate and operate under Codes of Conduct, which set down standards of professional practice and ethical rulings which allow them to differentiate themselves from less reputable practitioners.

By contrast, the incentive to self-regulate tends to be much lower in those cases where most of the external costs or benefits are borne by other sections of the community. In this case, there is little incentive for those firms to group together to internalise those externalities. For example, unless other adversely affected sections of the community are able to bring pressure to bear on advertisers via the legal system or by encouraging consumer boycotts of the product they will be unlikely to effectively self-regulate their advertising products.

The nature and extent of the external costs and benefits produced by firms also influences their ability to set up and operate an effective system of self-regulation.

Although the incentive for effective self-regulation increases as the external costs arising from market failure become greater and more widespread across the community, so too does:

- the magnitude of the administrative costs that the self-regulatory body will have to incur to internalise those external costs;
- the scope for adversely affected individuals and firms to ‘free ride’ on the benefits of self-regulation (Gunningham and Rees 1997, pp 392-396); and
- the risk that the failure of self-regulation will impose significant welfare costs on the community.

2.1.3 Public good market failure

Many of the externalities arising in the markets examined in the case studies also exhibit the features of a public good. That is, it is often difficult to prevent individuals from being adversely affected by a firm’s activities (non-excludability), and the amount of external cost borne by one individual that is adversely affected by a firm’s activities may not reduce the amount of external cost (‘non-rivalry’, or ‘jointness’ in consumption).

In such cases, any system of self-regulation designed to reduce external costs is also likely to exhibit the features of a public good. That is, it may be difficult for firms to exclude other

firms and individuals in the community from enjoying the benefits of that self-regulation. In addition, the benefits of self-regulation enjoyed by one individual may not reduce the benefits that self-regulation provides to other individuals in the community. For example, as discussed in Chapter 3, self-regulation designed to reduce the external costs arising from misleading and offensive advertising exhibits the features of a public good. That is, it is difficult to exclude individuals from enjoying the benefits of more informative and less offensive advertising, and one individual's enjoyment of those benefits does not reduce the potential benefits available to other individuals.

Where public good attributes are present, firms engaged in self-regulation may have significant difficulties raising sufficient revenue and attracting the resources necessary to provide an optimal level of self-regulation. Similarly, consumer associations may have difficulty attracting the finances and resources they need to effectively represent the interests of their members.

In addition, a self-regulation authority is likely to experience difficulty developing efficient and equitable means of charging their members and the consumers of their products for the costs of self-regulation due to the authority's lack of information on the social costs arising from the activities of each firm.

2.1.4 Market failure due to imperfect competition

Another potential source of market failure is imperfect competition between firms in either the markets for the products they sell, or in the markets for the factors of production and intermediate goods and services they use. Such imperfect competition can arise for a variety of reasons including the existence of barriers to the entry of new firms, economies of scale, the provision of misleading information by firms, and other 'unfair' trading practices. For example, as discussed in Chapter 3, the efficiency with which the market for advertising operates is reduced to some extent by the fact that the main media markets that disseminate that advertising are dominated by a small number of large firms. The features of the market that influence the nature and extent of competition between firms, and the implications of those market conditions for the effectiveness of self-regulation, are discussed in greater detail in Section 2.3.

In a market with imperfect competition, self-regulation can either increase or further decrease the existing level of competition.

Self-regulation provides an important mechanism for firms to increase competition within the industry, thereby improving the efficiency and equity of market outcomes. For example, as discussed in Section 2.1.1, self-regulation has the potential to reduce the information

asymmetries that exist between firms and consumers concerning product prices, performance and availability. This increases competition between firms by reducing their ability to create artificial differences between their products in the minds of consumers.

On the other hand self-regulation can often involve a restraint of trade (see Abolafia 1985). In some instances this self-regulated restraint of trade is in the public interest. For example, in some markets firms may choose to self-regulate product standards but compete in all other respects. Such regulation may lower costs and may be in the public interest, particularly if the standards relate to safety of the product. In this situation the restraint of trade created by self-regulation maintains the competitive structure in the longer term. In other cases, the restraint may be purely in the interests of firms and to the detriment of the community as a whole. For example, if businesses' self-regulate to operate as a cartel which restricts production or collaborates to increase prices or the value of bids competition will be reduced.

Any form of regulation, including self-regulation, operates by restricting certain activities of firms and therefore has the capacity to restrict competition. The effectiveness of that regulation therefore depends on the extent to which it succeeds in restricting only those types of activities that are 'unfair' and/or reduce the overall efficiency and equity with which the market operates.

In reality, no form of regulation can be expected to operate as a perfect 'screen' that reduces only unfair competition. In the course of screening out 'unfair' competition, it is inevitable that self-regulation will also decrease the amount of 'fair' competition between firms (Breton and Wintrobe 1992). In some circumstances this may reduce the effectiveness of self-regulation as a means of improving economic efficiency and equity.

Similarly, self-regulation can also have the unintended effect of reducing the incentive that firms have to strive to improve their own internal systems of self-regulation as a means of attracting more consumers. This risk can be reduced to some extent by ensuring that the self-regulatory authority provides appropriate incentives and opportunities for individual firms to improve their own internal self-regulation practices. In this regard, it is important for the self-regulatory authority to continually strive to 'raise the bar' by encouraging firms to adopt best practice techniques of self-regulation, rather than simply set a base standard. Similarly, when developing legislation and regulations, the government needs to be careful that it does not undermine the incentive that firms have to develop better self-regulatory practices. For example, there is a risk that a government mandate of prescriptive 'minimum' standards will reduce the ability of the self-regulatory authority to raise the standard of self-regulation above those minimum standards. This risk can be reduced to some extent through the use of performance-based standards.

2.1.5 Property right market failure

The absence of well-defined and enforced property rights is another important source of market failure. Poorly defined and enforced property rights often result in the failure of firms to take into account the external costs that their activities impose on consumers, other producers, and the wider community. Similarly, the practical problems associated with defining and enforcing property rights are partly responsible for the existence of public goods, and can reduce the extent of competition between firms.

Some rights of consumers and the wider community are relatively well-defined and enforced, whereas others are not. For example, certain basic consumer rights are relatively well defined in Commonwealth and State ‘fair trading’ legislation and enforced through the courts. By contrast, individual rights in relation to the physical and social environment are relatively poorly defined and are difficult to enforce.

Property right problems are not only a potential source of market failure, but they also have important implications for both the incentive and ability of firms to engage in self-regulation. In general, self-regulation will be a more effective means of dealing with property right problems when either:

- consumer rights are not well defined in legislation, but firms have the incentive and ability to develop, monitor and enforce a better system of consumer rights; or
- consumer rights are already well defined in legislation, but firms are better placed than the government to monitor and enforce those rights.

Consider first the case where the rights of the consumer are not well defined in legislation. In these cases, the effectiveness of self-regulation depends on both the incentive and ability for firms to develop, implement and enforce an improved system of consumer rights.

In general, the incentive for firms to develop, monitor and enforce better consumer rights will be greater:

- the greater the extent to which consumers consider that the activities of those firms are infringing upon their rights;
- the stronger the bargaining power of consumers, and consumer associations, in relation to firms and their associations;
- the greater the potential costs that firms have to bear as a result of consumer concerns that their rights will not, or are not, being upheld by firms (eg the loss of sales due to concerns about the treatment of consumers, the costs of dealing with complaints, and the litigation costs associated with resolving disputes through the courts); and

- the greater the potential cost savings to be derived from grouping together with other firms to develop and operate an improved system of consumer rights (eg due to economies of scale in complaints handing and dispute resolution).

Similarly, in general, the ability of firms to create, monitor and enforce more effective systems of consumer rights will be greater when they:

- have a good understanding of consumer and community views as to what constitutes a fair system of consumer rights;
- are able to translate those views into a consistent set of consumer rights that they are prepared to uphold (this will depend on the extent to which firms, consumers, and other individuals in the community share similar views on what those rights should be);
- are able to monitor the extent to which firms uphold those rights; and
- hold members accountable for their failure to uphold those rights, and ensure individual members bear the costs of their failure to enforce those rights, plus appropriate penalties.

As outlined in Chapter 4, the development of the direct marketing code provides an illustration of a situation where initially consumer rights were poorly defined. In this case, firms engaged in direct marketing recognised that it was in their mutual interests to develop, implement and operate an improved system of rights for consumers in order to improve consumer acceptance of such marketing practices.

Now consider the case where the rights of consumers and other individuals in the community are relatively well defined. In such cases, self-regulation can still be effective in reducing the net social costs associated with monitoring and enforcing compliance with those rights. This is because firms can face better incentives, and may be in a better position, to be able to monitor and enforce those rights than the government.

For example, consider the development of the supermarket scanning code, which is discussed in Chapter 5. In this case, the rights of consumers were well defined in both Commonwealth and State trade practices and fair trading legislation prior to the introduction of the supermarket scanning code. It was clearly illegal to advertise goods at one price, and then charge customers a higher price at the checkout. However, it was also impractical for consumers to enforce those rights through the courts in view of the potentially small sums of money involved. Development of the supermarket scanning code, and implementation of its 'item free' policy not only restored consumer confidence in the use of scanning equipment, but it also provided supermarkets with much better incentives to monitor and enforce consumer rights than the threat of legal action. In addition, it created a far more efficient

system of dealing with consumer complaints, and providing compensation for instances of overcharging, than were available to consumers through the courts.

2.1.6 Failure to meet social welfare objectives

Social welfare can be reduced not only by the failure of markets to operate in an economically efficient manner, but also by the failure of those markets to produce outcomes that are considered to be desirable by society.

As a result, some self-regulatory codes not only try to improve market efficiency, but they also seek to achieve a number of social welfare objectives. For example, the self-regulatory code governing advertising seeks to improve economic efficiency by reducing the extent of misleading advertising, but it also seeks to ensure that advertisements are not offensive to the community.

Similarly, the Accountants Code of Professional Conduct places significant weight on the public interest. It requires that members safeguard the interests of their clients and employers. But in safeguarding these interests they must not be in conflict with duties owed the community and its laws.

The effectiveness of self-regulation as a means of achieving such social welfare objectives depends on the extent to which firms have both the incentive and ability to achieve those objectives. In general, the incentive for firms to self-regulate to achieve a particular social policy objective will be greater, the greater the extent to which those firms stand to benefit from those self-regulatory activities. It is unrealistic to expect private firms to be prepared to incur the costs associated with such self-regulation unless they expect to benefit in some way from such activities. As explained below, however, this does not mean that firms do not have commercial incentives to act in the interests of the wider community.

At first, it is difficult to see why firms should be interested in the welfare of any individuals in the community other than their current customers. On closer inspection, however, it is apparent that there are a number of circumstances in which it will be in the interests of firms to group together to self-regulate their activities in order to achieve those social objectives.

Consider first the case of firms who are only interested in the welfare of their current consumers. Even such short sighted firms, may find it beneficial to act in interest of the wider community in those cases where the interests of their consumers and the wider community coincide. This case is discussed further in Section 2.4.1.

Now consider the more realistic case where firms recognise that their key stakeholders extend much further than their current customers and shareholders. Many medium to larger firms now recognise that their longer term profitability and viability, and their potential to attract new customers and investors, does not depend solely on how they are viewed by their current customers and shareholders. It also depends on how their activities are viewed by the wider community and the government, who may have a significant influence on their future sales, sources of funds, profitability and the (black-letter law) regulatory environment. As a result, those firms are investing considerable amounts of time and money in developing their reputations as socially responsible corporations. Introducing self-regulation can be an important factor in improving their corporate image.

Some sections of the community criticise such activities as little more than 'window dressing', designed to head off the introduction of more effective government regulation that would have far more detrimental effects on those firms. There is little doubt that the potential threat of more onerous government regulation has been one of the factors that have encouraged firms to set up systems of self-regulation.

However, it is also important to recognise that the failure of firms to act in a manner consistent with society's broad social objectives can have a damaging effect on their overall reputation and profitability. That is, the money that a firm has invested in developing its reputation to increase the sales of its products can act as a significant financial incentive to self-regulate its activities to ensure they are consistent with social welfare objectives.

In general, self-regulation is likely to be more effective in achieving a particular social welfare objective in those circumstances where:

- that particular social welfare objective is well specified either in legislation, or in government policy statements;
- the firms involved in the self-regulation individually and collectively have made significant investments in building their reputations for ensuring their activities do not compromise the community's ability to achieve that particular social welfare objective;
- firms are in a better position than the government to judge the extent to which their activities adversely affect society's ability to achieve that social objective and to regulate the activities of other firms; and
- firms provide consumers and the wider community with regular information on disputes and their resolution so they are better able to monitor their performance.

By contrast, self-regulation is likely to be less effective as a means of achieving a particular social welfare objective in those circumstances where:

- that particular social welfare objective is not well defined;
- there is a significant divergence of views between individuals in the community in relation to that social policy issue (this is discussed further in Section 2.4); and
- individual firms tend to focus on the short term interests of their present customers, and have not invested in developing their reputations.

2.2 NATURE OF THE PRODUCT

2.2.1 Importance of the product to consumers

The self-regulatory codes examined in Chapters 3 to 9 cover a wider range of different goods and services, which vary significantly in their importance to consumers and the wider community. Some of those goods and services are essential to the health and well-being of most consumers and the wider community (for example, prescription-only pharmaceutical products, and general insurance). However, other goods and services tend to be more discretionary in nature and are consumed by much smaller numbers of consumers (for example, many of the products which are advertised and thus subject to the advertising code are discretionary in nature).

The magnitude of the welfare costs that market failure imposes on consumers, and other individuals in the community, depends to some extent on the value those individuals attach to a particular product. This will depend on:

- the magnitude of net benefit each individual in the community expects to derive from their consumption or exposure to the product;
- the proportion of their budget they spend on that particular product; and
- the number of individuals that consume, or are affected by the provision of the product.

The greater the importance of a particular good or service to individual consumers and the wider community:

- the greater the potential welfare costs arising from the failure of the market for that good or service to operate in an efficient and equitable manner; and
- the greater the incentive for some form of regulation, including self-regulation.

As a result, market failure in the markets for essential goods and services, such as pharmaceutical products, can impose significant welfare costs on consumers and the wider community. This means that the need for some form of regulation, including self-regulation, tends to be greater for essential goods and services.

It is important to note, however, that this does not mean that if the price of a product is low, the overall cost to the community from a market failure associated with the product will be low. For example, in the case of misleading advertising, even if the product advertised has a low price the costs arising from asymmetric information could be high if:

- there are large number of consumers being mislead;
- each consumer makes a large number of repeat purchases of the good, so that their total expenditure on that product makes up a significant proportion of their total budget (eg as is the case for supermarket produce for low to medium income earners); and
- consumer choices between highly substitutable products are being distorted (this is discussed further in Section 2.2.4).

Although community demand for some form of regulation will be much greater where markets fail to produce goods and services that are essential to the welfare of most individuals in the community, so too will community expectations as to the effectiveness of that regulation. Where market failure results in the inefficient and inequitable provision of goods and services that are essential to the welfare of the community, the community will expect that any regulation introduced to address that market failure will be the most effective available. For example, the community expects that information provided in relation to pharmaceutical products will be accurate in view of the potentially serious consequences of inaccurate information.

This does not necessarily mean that government legislation and regulation has to be used to address market failure in the markets for essential goods and services. However, it does mean that if self-regulation is used, the community needs to be confident that such a regime is the most effective form of regulation for dealing with that market failure. For example, self-regulation of pharmaceutical firms is unlikely to be effective unless the community has confidence in the integrity of that self-regulatory regime.

This suggests that self-regulation will be more effective in dealing with market failure in the markets for essential goods and services in those cases where:

- the government has been involved in the development of the self-regulation;

- the self-regulatory authority comprises representatives of all key stakeholders with an interest in the provision of those goods and services including firms, consumers, consumer associations, and representatives of the wider community including the government; and
- the self-regulatory authority is regarded by the community as being independent.

2.2.2 Expected economic life of the product

The expected economic life of a product also influences the importance of a product to consumers and the magnitude of the potential costs that consumers of that product will incur as a result of a market failure. For example, consider the case of a firm that provides misleading information to its customers about the performance of its product. This imposes external costs on both the consumers of that product, and the firms supplying substitute products, thereby reducing overall economic efficiency.

If the product in question has a relatively short economic life, then the cost to each consumer that has been mislead by that information may be relatively small. That is, for low cost products with short economic lives, the costs of determining product quality via 'experimentation' could be relatively low so long as the consumption or use of that product does not impact on health or safety.

By contrast, where the product in question is expected to have a relatively long economic life, and expenditure on that product comprises a large proportion of the consumer's budget, the costs of such experimentation will be much higher. As a result, consumers will tend to demand more accurate information in relation to the prices and performance of the durable goods and services. This increases the incentive for firms supplying those products to self-regulate the provision of information in relation to those products.

2.2.3 Complexity of the product

The complexity of the product subject to self-regulation also has important implications for the effectiveness of that self-regulation. Greater product complexity increases the potential magnitude of the information asymmetry that exists between firms, consumers, and the wider community about the performance of that product. This increases the risk that some firms will seek to provide consumers with misleading information in relation to those products and hence the incentive to implement some form of regulation, including self-regulation.

For example, pharmaceutical products tend to have highly complex effects that are often not understood by the general public. As a result, pharmaceutical firms have an incentive to self-

regulate their activities to ensure that both medical practitioners and the general public are supplied with more accurate information on the performance of alternative pharmaceutical products.

However, greater product complexity can also reduce the ability of firms to self-regulate. In particular, it makes it more difficult for firms to detect and prove instances where information is incomplete, inaccurate or misleading. For example, in the case of complex pharmaceutical products and accounting services, it may be difficult for the self-regulatory authority to prove that the information provided by a firm has misled consumers and adversely affected other firms in the group.

Self-regulation is likely to be least effective in relation to highly complex products that have potentially adverse effects on the community that are not well understood by either the firms supplying those products or consumers. For example, this may be the case in relation to products that highly complex effects on the health of consumers, or the quality of the physical or social environment.

2.2.4 Availability of substitutes and the magnitude of product switching costs

The availability of substitutable goods and services, and the costs of switching consumption to those substitute products, also influences the potential magnitude of the welfare costs arising from market failure, as well as the incentives and ability of firms to self-regulate their activities.

The availability of close substitutes, and the presence of relatively low switching costs, can limit the scope for market failure in certain circumstances. For example, as discussed in Chapter 3, the ability of a firm to engage in misleading advertising is reduced when highly substitutable products are available from other firms and consumers. In such cases, consumers can compare the product against its substitutes, and firms producing substitute products will tend to refute any misleading claims. Similarly, as discussed in Chapter 5, the ability of a supermarket to overcharge is constrained by the ability of consumers to purchase those products from other supermarkets, and the relatively low costs associated with switching from one supermarket to another.

However, the availability of close substitutes, and the presence of low switching costs, also can increase the welfare costs arising from market failure. In general, the welfare costs arising from market failure will be greater, the greater the extent to which that market failure distorts consumer choice between highly substitutable consumer goods and services. As a result, self-regulation will tend to be more effective in those cases where it succeeds in reducing the

extent to which market failure distorts consumer choices between goods and services that are relatively close substitutes in consumption.

Once again, however, it is important to recognise that the degree of substitutability between products (ie the income-compensated cross price elasticity of demand) is only one of many factors that influence the magnitude of the welfare losses arising from market failure. As noted above, even in those cases where the product in question has few substitutes, or the costs of consumers switching to those substitutable products are high enough to limit any change in patterns of demand, market failure can still result in significant welfare costs if those products are highly valued by most individuals in the community.

2.2.5 Technological innovation

The incentive and ability for firms to engage in self-regulation, and the effectiveness of that self-regulation, is also influenced by the pace of technological change. Changes in technology can result from the emergence of new products, production techniques, and methods of marketing the product. These advances in technology have the potential to both increase and decrease the incentive and ability of firms to engage in effective self-regulation.

For example, the continual emergence of new and increasingly complex consumer goods and services has the potential to increase existing information asymmetries between firms and consumers regarding product performance. This increases the scope for the provision of misleading information, increasing consumer demand for self-regulation.

At the same time, however, the Internet is providing consumers with an unprecedented, relatively inexpensive, means of accessing information on the prices and performance of readily identifiable products, and ordering those products online.

Self-regulation authorities need to acknowledge the influence that the Internet can have on the achievement of self-regulatory objectives. For example, the pharmaceutical manufacturers' Code requires that Australian pharmaceutical companies with publicly accessible Internet sites, do not use the Internet to promote prescription products to the public. Recent amendments to the Code require that the Australian sites do not make reference to other information sources or Internet sites that would be in breach of the Code. However, it must be recognised that it can be difficult to enforce compliance with such requirements. For instance, the effectiveness of these provisions under the pharmaceutical manufacturers' code is likely to be limited because the general public can readily access promotional material on prescription medicines from pharmaceutical sites developed outside of Australia. The development of e-commerce also means that the general public could in

some instances obtain drugs that the Therapeutic Goods Administration has registered as being of high risk without a prescription.

The introduction of new technology also has the potential to reduce the magnitude of external costs imposed on consumers. For example, as discussed in Chapter 4, direct marketing techniques can reduce the magnitude of the external costs arising from advertising by improving the ability of firms to confine their product promotion to those individuals who are most likely to be interested in those products.

However, the introduction of new technologies also has the potential to increase the external costs imposed on consumers and the wider community. For example, Chapter 4 also notes that the introduction of direct marketing technologies such as telemarketing and direct mail ('junk' mail) increased the scope for harassment of consumers.

On the other hand, consumers may be concerned that the introduction of new technology, such as e-commerce and (in earlier years) bar code scanning in supermarkets, would result in a higher incidence of over charging or even fraud. As a result of these types of concerns, consumers often oppose the introduction of new technology. This consumer concern can provide firms who wish to use that technology with significant incentives to self-regulate their activities in order to reduce those external costs. For example, as discussed in Chapter 4, consumer opposition to the introduction of certain direct marketing techniques, including telemarketing and direct mail (junk mail), provided a significant incentive for firms wishing to use direct marketing to introduce a code of self-regulation. Similarly, as discussed in Chapter 5, consumer concern about the potentially adverse effects of bar code scanning provided a significant incentive for supermarkets to develop and implement the present supermarket scanning code.

The introduction of new technology also has the potential to improve the ability of firms to self-regulate, by improving the efficiency with which they are able to gather information on the preferences of their consumers and process complaints.

2.3 NATURE AND EXTENT OF COMPETITION BETWEEN FIRMS

Although the market failure arising from imperfect competition can provide an incentive for firms to self-regulate, the precise nature and extent of competition between firms also influences the ability of firms to develop, implement and operate effective systems of self-regulation.

2.3.1 Number and size of firms in the domestic market

Self-regulation tends to be more effective in those markets where there are relatively large numbers of competitive firms producing relatively homogeneous products.

In such markets, firms can reap significant economies of scale by grouping together to self-regulate their activities to reduce the external costs each firm imposes on consumers, other firms within that group, and the wider community. In addition, because of the homogeneous nature of the product there is a much greater probability that the external costs generated by one firm will adversely affect the sales of other firms producing those goods.

This does not mean that markets have to be perfectly competitive for self-regulation to be effective. As discussed in Section 2.3.2, self-regulation still has the potential to increase competition between firms by reducing the amount of misleading information provided to consumers on the price, performance and availability of products.

However, it does mean that self-regulation is less likely to be effective in those markets that are dominated by a very small number of firms due to the existence of large economies of scale in production. In these markets, the firms are more likely to share a common interest in using self-regulation as a means of reducing, rather than increasing, the amount of competition between firms. That is, there is a risk that such self-regulation might be considered to be anti-competitive.

Even in markets where the number of firms in the market is restricted by the existence of patents, self-regulation can be effective due to competition at the margin. For example, the use of patents is widespread in the prescription-only pharmaceutical products market. These patents can provide companies with differing levels of market power depending on the nature of the medicine. However, the industry still finds value in clubbing together through self-regulation to deal with matters not covered by patents.

The number of firms in a market can also be restricted by government regulation that restricts the ability of firms to compete on the basis of price. In such markets, competition between firms to attract customers must be on a non-price basis. In this situation, self-regulation can still be effective if it is relevant to the non-price competition that occurs in the market. Non-price competition is discussed further below.

2.3.2 Extent of non-price competition

Non-price competition is a common feature of markets characterised by a large number of firms supplying relatively heterogeneous products. In view of consumer uncertainty about product quality, and the tendency for consumers to use price as a guide to product quality,

such firms are reluctant to reduce their prices in order to increase their sales, since this could signal an inferior product. Rather, those firms resort to a variety of different forms of non-price competition including advertising, packaging, prizes, and 'loyalty' points. That is, non-price competition is one response to market failure brought about by the information asymmetry that exists between firms and consumers concerning product quality. On the other hand, these forms of non-price competition can be used as a means of differentiating products in order to reduce competition.

Where products are heterogeneous, and firms primarily compete using non-price competition, the scope for each firm to provide consumers with misleading information regarding their products is much greater.

However, the nature of non-price competition will also affect the ability of firms to develop effective systems of self-regulation. For example, it may be relatively easy to self-regulate non-price competition in the form of free gifts, or prizes, since it is a relatively straightforward process to determine whether that gift or prize was actually provided by the firm. Even in these cases, the existence of complex terms and conditions associated with those gifts and prizes can make this task more difficult.

It can be more difficult to monitor inducements offered to individual customers on a confidential basis. For example, under the Pharmaceutical Benefits Scheme the cost of all prescription drugs is subsidised. Consequently, pharmaceutical companies compete on a non-price basis. There is a strong incentive to encourage medical practitioners to prescribe their product rather than a competitor's by offering generous inducements, making claims about their product, making claims about competitors' products and by engaging in aggressive marketing. Companies must be continually alert to the claims made by their competitors about products. Importantly, pharmaceutical company employees have the research and scientific training necessary to assess whether a competitor's claims regarding a particular drug are false or misleading. Thus self-regulation can still be effective in this market.

Nonetheless, it can sometimes be difficult to introduce self-regulation where market participants do not have the necessary information or technical expertise to define poor product quality or recognise that information is misleading. For example, it can be difficult to self-regulate non-price competition in the form of advertising due to the absence of objective definitions of precisely what constitutes deceptive or offensive advertising.

2.3.3 Impact of globalisation and technological change

The globalisation of world markets and the rapid pace of technological change have important implications for the incentive and ability of firms to develop and implement effective systems of self-regulation.

In some respects, the rapid change in technology and the globalisation of world markets is reducing the extent to which self-regulation is required by:

- increasing the ability of consumers to access information on product prices, performance and availability; and
- exposing domestic firms to much greater competition.

For example, the globalisation of the world economy is increasing the amount of competition facing domestic retail firms supplying high value, readily transportable, brand name consumer goods such as electronic equipment and computer software. These domestic retailers now have to compete with a large number of overseas retailers who are marketing their goods directly to Australian consumers via the Internet.

At the same time, however, the combined impact of technological change and the globalisation of world markets also have the potential to increase the need for self-regulation since it:

- reduces the effectiveness of domestic legislation as a means of regulating the activities of firms producing tradeable goods and services, since it is difficult to force non-resident suppliers to comply with that legislation;
- increases the number of new, improved and complex products; and
- increases the number of suppliers, particularly overseas suppliers whose reputations are not well known to consumers.

For example, as discussed in Chapter 4, the rapid growth of direct marketing via the Internet is increasing the scope for disreputable overseas firms to mislead Australian consumers.

In addition, the globalisation of the world economy is also complicating the development of self-regulatory codes since the Australian self-regulatory authority often has to consult with overseas regulatory authorities to develop consistent international standards.

2.4 COMMONALITY OF PRODUCER AND CONSUMER INTERESTS

2.4.1 Similarity of consumer interests

Self regulation tends to be more effective in those markets where consumers, and other individuals in the community who are adversely affected by market failure, share a common interest in eliminating that market failure.

This is more likely to be the case where consumers share similar preferences in relation to products and similar views on social policy issues to other individuals in the community. In such cases, a particular instance of market failure would have a similar effect on most consumers. In addition, consumers could be expected not only to act in their own best interests, but also in the interests of all other consumers and individuals in the community who are adversely affected by that market failure. Firms would also have less difficulty in determining the extent to which individuals were being adversely affected by the actions of firms since the views of one consumer would be representative of all consumers and other adversely affected individuals in the community.

By contrast, self-regulation tends to be less effective in those markets where consumers and other individuals in the community who are adversely affected by market failure do not share a common interest in eliminating that market failure. For example, as discussed in Chapters 3 and 4, individuals often have vastly different views as to what constitutes offensive advertising or intrusive direct marketing. In such cases, a particular instance of market failure may have different effects on different consumers, and consumers acting in their own interests may not act in the interests of other consumers of that product, or the wider community. This divergence of consumer interests tends to reduce the effectiveness of self-regulation. In particular, it makes it much more difficult to:

- develop, monitor, and enforce a code of self-regulation that suits the interests of all consumers; and
- determine the extent to which the consumers and other individuals in the community are adversely affected by instances of market failure.

Although the existence of divergent consumer interests has the potential to reduce the effectiveness of self-regulation, this problem can be reduced to some extent by the existence of:

- an effective consumer association that is able to resolve differences of views between consumers; and

- legislation that provides a clear definition of consumer rights.

2.4.2 Similarity of producer interests

In order to be able to develop an effective system of self-regulation, it is also important for firms to share a common interest in reducing costs of market failure (Sandler and Tschirhart 1980, p1483). This is most likely to be the case where producers use similar inputs and production technologies to produce relatively homogeneous goods and services (ie where the products are substitutes in production) and where those firms share similar views on social policy issues.

In some instances self-regulation will be facilitated by the existence of 'jointness' in the use of particular inputs. Such 'jointness' can create an incentive for firms to associate or club together in the pursuit of similar strategic goals. Like minded firms in a particular market may find it cost effective to club together to jointly undertake and fund functions such as lobbying government, public relations or the collection of industry statistics (see Abolafia 1985). For example, firms in the prescription-only pharmaceutical medicines industry have found it to be in their interests to develop a strong industry association covering the majority of firms in the market. This association has provided a solid foundation for the development of effective self-regulation.

By contrast, where producer interests diverge due to greater product heterogeneity, it becomes much more difficult to set up an effective system of self-regulation, since it is much more difficult for the self-regulatory authority to:

- develop monitor, and enforce an objective set of rules that suit the interests of all producers;
- determine the extent to which each firm's activities adversely affect consumers, other firms, and the wider community; and
- impose effective sanctions.

Once again, although the existence of divergent producer interests has the potential to reduce the effectiveness of self-regulation, this problem can be reduced to some extent by the existence of:

- an effective self-regulatory authority that is able to reconcile the different interests of firms by developing a code of conduct that is acceptable to those firms (Sandler and Tschirhart 1980, p1492);

- a readily identifiable symbol of 'code compliance' that can be displayed by all firms that agree to comply with the code (this not only helps to exclude other firms from enjoying the benefits of self-regulation, but it also creates a common interest among member firms to preserve the integrity of their joint reputation); and
- legislation that clarifies acceptable business practices (eg trade practices and 'fair trading' legislation, and environmental legislation).

2.4.3 Overlap between consumer and producer interests

The effectiveness of self-regulation is also influenced by the extent to which there is an overlap between the interests of firms, consumers and the wider community. In particular, self-regulation will tend to be more effective in those cases where most firms and consumers share a common interest in reducing the extent of market failure (Gunningham and Rees 1997, p406). This is more likely to occur in those cases of market failure where:

- the market failure is due to the activities of only a few firms in the market; and
- the costs arising from that market failure fall predominantly on consumers of the product, and other producers of that product.

For example, consider the case if a supermarket was to set out to mislead its customers as to the price of its products by displaying a lower price on the shelf than is charged at the checkout. As noted in Chapter 5, in the absence of self-regulation, most of the costs arising from inaccuracies in displayed prices in supermarkets would tend to fall on supermarkets and customers, as opposed to other sections of the community. That is, there is a considerable overlap between the interests of most supermarkets and the interests of their consumers and this will tend to make self-regulation more effective.

By contrast, self-regulation will tend to be less effective in those cases where the interests of firms diverge significantly from those of their consumers and the wider community. This is more likely to be the case where:

- the market failure is due to the activities of most firms in the market; and
- most of the costs arising from market failure fall on sections of the community other than suppliers and consumers of the product.

For example, this can occur when:

- the market for a particular product is dominated by a small number of firms due to the existence of significant economies of scale in production, and those firms have a strong common interest in restricting the supply of that product to artificially inflate its price; or

- most firms in the market share a strong common interest in continuing to produce a product that imposes significant external costs on consumers and the wider community (eg a product that has a detrimental effect on the health of consumers, or the quality of the environment).

In such cases, the only recourse for the government is to 'realign' producer interests with those of consumers and the rest of the community through the introduction of legislation and regulation (eg via trade practices and environmental legislation). It is important to note, however, that even in these circumstances, the effectiveness of that legislation may depend on the presence of an effective system of self-regulation by firms.

2.5 CONCLUDING REMARKS

The effectiveness of any form of regulation, including self-regulation, depends on the extent to which it achieves its objective. From the perspective of government, 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's 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.

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 the market failure as well as other characteristics of the market.

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 instances, 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 following list outlines features of markets in which self-regulation is likely to be more and less effective.

2.5.1 Features of the market that make self-regulation more effective

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 with an interest in the provision of those goods and services including firms, consumers, consumer associations, and representatives of the wider community including the government;
  - the administration and operation of the self-regulation is transparent; and
  - the self-regulatory authority is regarded by the community as being independent.

2.5.2 Features of the market that make self-regulation less effective

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

- there is little competition between firms;
- firms take 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; and
- firms, consumers and the wider community do not share a common interest in reducing the market failure.

In addition, self-regulation is also likely to be less effective in cases where:

- the self-regulatory authority:
  - does not have a good understanding of the nature and extent of market failure arising from the activities of its member firms;
  - does not include representatives of the key stakeholders affected by the market failure; and
  - does not maintain a good working relationship with those key stakeholders; and
- any social welfare objectives of the Code are not clearly defined in legislation.