

On regulatory forbearance

*This short paper discusses the use of the term "regulatory forbearance" in the context of policy discussions. It is not a fully referenced document and is intended to inform policy discussions.*¹

Context

The term "regulatory forbearance" has made a resurgent appearance in policy discussions, at least in the telecommunications space. It was used by a number of people in the course of a discussion² of what principles and objects should underline the Convergence Review³. It has been used in New Zealand to describe a period during which new fibre investments would not be subject to Commerce Commission pricing decisions.⁴

The contention of this paper is that "regulatory forbearance" is a term of craft that specifically refers to an act of a regulatory agency and not to a piece of legislation. The paper goes on to argue that the distinction is important because the ability of a regulator to "forbear" provides an effective tool for creating commitment. The paper goes on to consider circumstances in which forbearance can be detrimental.

In brief the position of the paper is that "regulatory forbearance" should not be used as a synonym for no regulation or for an "access holiday".

Regulation and regulators

Regulation is widely understood to refer to centralised decision making that replaces or directs outcomes that would otherwise occur in a market. In a separate paper the breadth of the use of the term will be more broadly considered, but this definition is sufficient for this paper.

In economies with a strong constitutional form of government and "the rule of law" regulation is achieved by the passage of appropriate instruments according to the constitutional requirements. In the Westminster system as operating in Australia this entirely depends upon the passage of legislation by the relevant Parliament (from here on the discussion will assume national regulation). The legislation may empower the Governor-General in Council, or a Minister or a specified agency to make further rules by sub-ordinate instrument. These instruments are, confusingly, sometimes known as "regulations" but they can be "determinations", "declarations" and a variety of other terms.

These rules collectively are the "regulations" from an economic perspective. Enforcement of rules ultimately relies on the ability of someone being able to decide a rule has been broken and that some consequence must occur. This body is a court (within certain contestable limits) to ensure the separation of judiciary from executive and legislative government.

Outside of the rules themselves and the courts there may or may not be additional bodies called "regulators". Regulators have differing degrees of powers. In the USA some regulators have extensive executive powers as the legislature has sought to remove these from the President. In Australia the executive powers are usually more circumspect.

Regulators have specific defined tasks:

1. They can make new rules (sub-ordinate instruments) as permitted by their governing legislation; and
2. They are usually empowered to initiate action in a court to determine if a rule has been broken.

Ultimately a regulator's day is made up of a host of other things, but these are things done in support of the above. Those other things include monitoring and reporting on the state of the things that they regulate, they communicate with others about what the regulation is supposed to achieve and conducting inquiries in relation to the rules generally or a breach in particular; and they provide certain administrative machinery to facilitate the operation of the rules (such as licencing regimes, acceptance of undertakings, publication of registers).

One particular power is to reach agreement not to pursue court action on the basis of the party agreeing to an agreed remedy.⁵

Within this framework the concept of "regulatory forbearance" is understood to be an active decision by a regulator to not do one of the things it can do (make an instrument or prosecute) when it could otherwise do so. It does not mean denying the regulator the ability to make that decision. This accords with the definition "Refraining from doing something that one has a legal right to do"⁶

The ITU's "Regulatory toolkit" says;

The concept of regulatory forbearance has two elements:

- *A regulator may refrain from applying certain regulatory conditions or from intervening in certain markets. For example, the Canadian Radio-television and Telecommunications Commission has explicitly stated that it will forbear from regulating certain services.*
- *A regulator may reduce the scope of regulation or withdraw entirely from regulating specified markets.⁷*

The process of legislation not empowering a regulator to do something is different from the concept of a regulator "forbearing" to use a power they have.

Why the ability to forbear matters

The promoters of regulation in all sectors share a common failing. This is the belief that merely passing a law (creating a rule) automatically results in that rule being obeyed. If they find it doesn't work they either suggest tightening the rule or increasing the penalty.

A simple example is the problem of drink driving. Creating the law alone doesn't stop it. It is not uncommon to see after a case of a fatality due to drink driving to see calls for a reduction in the permitted alcohol level (even though the offender was already over the existing limit) or tougher penalties (though clearly the offender was oblivious to any penalty).

What we are really trying to affect is behaviour, and the rule itself is only one device. Advertising campaigns explaining the personal risk and consequences are therefore another tool used. These campaigns will go as far as targeting the friends of potential offenders as more likely to have an effect than directly advertising to potential offenders.

Regulation of economic activity is no different, the ultimate goal is to achieve a certain kind of behaviour. In achieving these outcomes a regulator is confronted by exactly the same kind of reputation issues as a firm trying to promote its brand.⁸

The effectiveness of reputation can be observed in the "that the monetary policies of more independent central banks tend to be less inflationary and less activist."⁹ The situation in Australia today of a central bank with a very clear statement of expectations about the expected outcome of monetary policy results in a market that adjusts its behaviour.

When inflationary pressures build market interest rates can actually increase prior to an official rate rise, sometimes to the extent of forestalling the need for a rise.

This example of “regulatory commitment” demonstrates the value of a highly powered regulator combined with very clear policy goals. The regulator in this case is able to forbear on a rate rise because the market adjusts to the circumstances itself. The publication of Board minutes adds to these inbuilt “self-regulatory” mechanisms.

The significant difference between an empowered regulator exercising forbearance and the alternative of the potential for additional legislation is the speed with which the relevant act could occur, and hence the affected parties to believe the commitment of the regulator and/or policy maker to the relevant goals.

Empowering a regulator with effective powers, a clear objective and the ability to exercise forbearance enables the creation of credible reputation for the regulator, and the ability to obtain the desired behaviour with minimal action (meaning intervention).

The risks

There are two risks with creating a regime in which forbearance is a tool provided to the regulator. The first and most obvious is the potential for an excessively activist regulator who simply fails to forbear. There are two defences against this. The first is clarity of the objective set for the regulator and the second is existing administrative law constraints that can be applied.

The second risk is a regulator that excessively forbears. This has two potential consequences, the first being an obvious enforcement failure but the second is a potential regulatory creep.

The potential enforcement failure is already evident in the case of existing regulators. The ACMA and ACCC have regularly been complained about for their failure to enforce aspects of the rules. ASIC has been criticised for failing to prosecute for unconscionable conduct.¹⁰

There appears to be few effective mechanisms to seek redress from inactive regulators. The Australian Communications Consumers action Network has proposed the adoption of a concept called a “super complaint” lodged by a representative body. An alternative would be to complain to the Commonwealth Ombudsman – though complaints here are usually about excessive rather than insufficient action.

The possibility of regulatory creep can occur if the regulator effectively convinces too many parties to “cop it sweet”. It is not unusual for firms to accept the punishment while still protesting their innocence.¹¹ It is possible that the cumulative effect could be behaviour constrained well beyond that envisioned in policy.

Conclusion

The term “regulatory forbearance” has a very specific meaning that should be preserved. Providing regulators with sufficient powers and clear enough objectives to practice forbearance is likely to be a better way to achieve policy objectives than to avoid regulation.¹²

It has not been discussed here but the provision for regulatory forbearance provides the opportunity to guide market development in cases of significant innovation and technology development.

¹ Paper prepared by David Havyatt. This version of the paper was published on 19 May 2011.

² This discussion occurred at the Network Insight Institute seminar "Internet, Telecoms and Convergence: the legal and policy challenge" held on 9 May 2011 see http://www.networkinsight.org/events/9_may_2011.html/group/7

³ The Convergence Review refers to an independent review "to examine the policy and regulatory frameworks that apply to the converged media and communications landscape in Australia" see http://www.dbcde.gov.au/digital_economy/convergence_review

⁴ Steven Joyce Media Release 'Regulatory forbearance to be replaced' 18 May 2011 at <http://beehive.govt.nz/release/regulatory-forbearance-be-replaced>

⁵ While the ability to "settle out of court" is usually accepted it doesn't always apply. For example in a criminal case the accused can plead guilty but the court still determines the punishment. As will be discussed later the power to not prosecute can be of equal public policy concern.

⁶ West's Encyclopaedia of American Law

⁷ ITU *ict regulation toolkit* section 2.3.5 at <http://www.ictregulationtoolkit.org/en/section.1679.html>

⁸ Eduardo Faingold and Yuliy Sannikov 'Reputation in Continuous-Time Games' *Econometrica* Vol 79 No 3 (may 2011) 773-786.

⁹ Susanne Lohmann 'Optimal Commitment in Monetary Policy: Credibility versus Flexibility' *The American Economic Review*, Vol. 82, No. 1 (Mar., 1992), pp. 273-286

¹⁰ Evan Jones 'Bank's SME story doubtful' *Australian Financial Review - Letters* 18 May 2011.

¹¹ See Lucy Battersby 'Watchdog hits Optus with fine for misleading ads' *Sydney Morning Herald* 19 May 2011.

¹² There are some who would think the "regulatory pyramid" is a version of the regulatory forbearance philosophy discussed here. That is the concept that you give industry a chance to self-regulate before you directly regulate. True forbearance requires that the consequence of inaction is more than just the regulation that could have occurred anyway. As an example, the forebearance approach to mobile premium services would have been to not regulate, but to start prosecuting the mobile carriers for their complicity in harm (if any) to consumers.

About DigEcon Research

Purpose

DigEcon Research is a stand alone research body. Ultimately, its pursuit is policy research, the focus of which is the meaning and significance of the Digital Economy. This policy research encompasses both economic and social research.

Researching the significance of the Digital Economy

The concept generally referred to as the Digital Economy is frequently discussed but there is little shared meaning in the term. A key definitional issue is whether the Digital Economy is something yet to happen or in which we are now embedded.

DigEcon Research focuses on the analysis of social and economic change rather than an analysis of a notionally static "Digital Economy". Analysis of the change as it occurs should highlight those areas where there is genuine policy choice rather than merely a need to adapt policy to changes that have already occurred.

Before Thomas Kuhn popularised the idea of "paradigms" J.K.Galbraith railed against the "conventional wisdom". There is no denying that what Kuhn called "normal science" or the repeated application of existing theory to new problems results in most practical developments. It is equally true that the application of existing theory to problems they were not designed for results in, at best, vacuous solutions and, at worst, wildly dangerous outcomes.

The Digital Economy challenges the fundamental concepts of neo-classical economics. It also challenges most of the precepts of how societies are organised. In this context policy research needs to focus on what is different, not on what is the same. The Digital Economy is not just a matter of means of production but about the fundamental structures of social organisation.

Work program

This research is designed both to inform policy makers and to assist those who would seek to influence policy makers or to make business decisions. DigEcon Research however does not provide strategy recommendations nor undertake policy advocacy on behalf of any party.

A key element of the research will relate to the direct regulation of the converging industries of telecommunications, media, consumer electronics and information technology. However, the agenda encompasses the wider economic and social policy issues.

The scope of the research agenda will ultimately depend upon the researchers who wish to participate in what is more an idea than an entity.

In the crowded Australian research field there are a number of "bodies" that share some of the objectives of DigEcon Research. DigEcon Research aspires to contribute to the work of these and any other researchers in the field.