# Brexit and the political economy of regulation

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# Outline

- Broad policy options for the UK.
- Three false beliefs:
  - On leaving the EU, the UK will no longer be a participating member of the ‘Single Market’:  reapplication and an entry fee would be required.  (Indicative of an dysfunctional style of interpretation.)
  - UK regulatory policy is <world class>, is superior to EU regulation and there will be a large regulatory policy dividend resulting from Brexit. (Agriculture and fisheries excluded from the considerations here.)
  - Non-EU members of the EEA are necessarily ‘rule-takers’: they have no rule-making influence.
- Concluding reflections on Brexit and the future.

# Broad policy options

- Remain in the EU: an option still existing in an 'undead' state. View as a tangled bundle of an enhanced free trade agreement + a customs union + a programme of progressive political integration.
- The EEA or a close look-alike: continued membership of the Single Market via the EEA Agreement – a highly enhanced free trade agreement (FTA) – or something very similar.
- Neither of the above, encompassing a variety of specified and unspecified sub-options, for example:
  - Trading under WTO rules plus a web of bilateral FTAs.
  - A CETA look-alike with the EU (though not as a 'transitional' option).
  - Unilateral tariff disarmament (*Economists for Free Trade).*

# A shared thread: enhanced FTAs

- Enhanced FTAs can be viewed as embryonic markets or market segments, at various stages of development.
- A market is an economic institution: a set of rules, both formal and informal, that governs or regulates a distinct set of transactions.
- The function or purpose of market is to reduce the costs of exchange transactions (‘transactions costs’) or, put another way, to reduce barriers to trade.
- The rules are a collective good:  they are shared by all participants.
- See *The political economy of markets.*

# Belief 1: Automatic exit from the EEA

- Belief (or negotiating ploy?) comes chiefly from Article 126(1):
- *"This agreement shall apply to the territories to which the Treaty establishing the European Economic Community (20) is applied and under the conditions laid down in that Treaty (21), and to the territories of Iceland (22), the Principality of Liechtenstein and the Kingdom of Norway (23)."*
- Read in context the force of Article 126(1) is to provide for 'special territories' (Gibraltar, Faroe Islands, Åland Islands, etc.).
- Often read as a 'clean slate' or *ab initio* definition the geographic scope of the EEA, but it isn't.

# The slate is not clean

- Territorial provisions in treaties serve to define the scope of the territories of the given set of Contracting Parties to which a treaty will apply. In the beginning is Contracting Party status.
- Neglect of the prior given is a first indicator of a general UK cultural problem in interpreting policy and regulatory documents: the CAT has given us a useful word to describe the cognitive style – 'pixelated' – a tendency to focus on a few pixels of a bigger picture and ignore the rest.
- On Brexit day, Article 126(1) will become silent as to the scope of the territory that the UK, as a Contracting Party, is committing to the Agreement. Is Gibraltar included or not? Many international Treaties have, in fact, been silent on the question of territorial scope.

# What does silence imply?

- If the Agreement remains silent as to the relevant *territory* of the UK (a Contracting Party), the default position in international law is 'the entire territory'. See Vienna Convention on the Law of Treaties, Article 29. "*Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.*"
- No intention to exclude has been established, nor is likely establishable.
- Trivial to end the silence: add 'UK' after 'Norway'. When Austria, Finland Sweden acceded to the EU their names were cut, over nine years later(!), from the end list (see footnote (23) at Article 126(1)). Reversing the process, 'UK' could be pasted in.

# Belief 2: UK regulation is superior to the EU's

- Exclude consideration of agriculture and fisheries. Criteria for *prima facie* judgment: the two (related) principles of good regulation that are most directly linked to economic effects.
- Proportionality: A loose cost-benefit test. Disproportionality occurs when costs of regulatory measures are manifestly and significantly in excess of likely benefits.
- Targeting/necessity: Regulation should be focused on identified aims and problems and minimise negative side effects, particularly distortions of competition. That is, these distortions should be no more than is strictly necessary to achieve the desired aim.

# Smart metering

- EU Third Energy Package (2009): 80% coverage of homes by 2020 "*wherever it is cost-effective to do so*".
- UK (the late DECC, 2009): 100% coverage by 2020.
- The EU target is softer and embeds consideration of proportionality (which the UK target doesn't: there is no cost trade-off).
- The difference is substantial: every network regulator knows that the final, incremental 20% of coverage can be much more costly than the average. The cross-subsidisation required is possibly beyond market capabilities, suggesting further distortions of competition to come.

# Carbon abatement 1

- Given EU ETS,  both EU and UK renewables targets are ineffective. Contributions to global emissions are determined by EU ETS quotas. The same is true for carbon budgets beyond EU ETS limits.
- The Climate Change Act 2008:  UK Govt. wanted to go further than the EU's plan.  First intention:  a 60% reduction (from 1990 levels) in GHG emissions by 2050.  Then tightened to 80% in the legislation.
- Underlying philosophy:  whatever the EU does, we want to do it more (to be a regulatory Stakhanovite, to be top of the class).
- Top of the class means being ineffective in the most costly way.

# Carbon abatement 2

- As well as costly ineffectiveness, UK policy has had distorting effects on competitive markets.
- Amber Rudd (on becoming Secretary of State at DECC in 2015): *"We now have an electricity system where no form of power generation, not even gas-fired power stations, can be built without government intervention."*
- One of big gains, arguably the major gain, from market wholesale market liberalisation has been reversed.

# Retail energy price control: EU position

- Gordon Downie on the *Federutility* ruling (Utility Week, 1 May 2015):
- *The price for the supply of natural gas (and by implication electricity) must be determined solely by the operation of supply and demand.*
- *Member States can derogate from that basic principle, but a MS has to justify the derogation on proportionality grounds by demonstrating that:*
  - *the intervention is limited in duration to what is strictly necessary in order to achieve its objective,*
  - *it goes* no further than is required *in order to achieve the objective being pursued,*
  - *it takes proper account of the categories of beneficiary supported by the intervention and the differences between them that might call for difference in treatment.*

# Retail energy price control: UK position

- A politician wakes up one morning and thinks *“controlling energy prices would be a popular and vote-winning thing to do”.*
- No underpinning principles, no well specified objective, no supporting analysis.
- Proportionality? Targeting? Necessity? Legality (the UK is still a member of the EU)? The CMA majority view? A long global history of the adverse side-effects of price controls? The withering critique of the CMA analysis that underpinned the minority view by Stephen Littlechild? All for the birds apparently.

# Retail energy: undue price discrimination

- EU Directive:  general exhortation not to discriminate in prices as between different types of tariff.
- UK:  extended non-discrimination to inter-regional price differentials.
- Led to the consequences anticipated by both internal (to Ofgem) and external advice:  higher retail margins and prices.  Now abandoned, but consumer harms persist.
- A proposal to the GEMA Board to go no further than the EU Directive was rejected.  The Secretary of State wanted Stakhanovism.

# Counter-examples?

- There are some counter-examples, cases where a UK approach would have been better. E.g. gas storage deregulation.
- But they appear fewer in number and, more importantly, EU approaches tend to have a feature that UK approaches often lack.
- EU regulations tend to have relatively clear purposes, but are often flexible as to what they entail. They have to be: they involve compromises among 28 MSs. Although not articulated as such, this amounts to recognition of a 'regulatory equivalence' principle.
- The approach allows for work-arounds, as was done in gas storage. Even when Regulations are poorer than UK comparators, the harms tend to be mitigated.

# Integrated pollution prevention and control

- RPI study of the burden of regulation on small surface engineering firms (2004) for the Cabinet Office. UK transposition of the EU IPPC Directive was found to be a major source of burdens on small businesses and a cause of barriers to expansion.
- Business complaints centred not so much on the Directive itself, but rather on the transposition process. Comparisons with other Member States were raised, carrying the inference that the UK was adopting a non-equivalent approach and going further than other MSs.

# IPPC: Three issues

- Creation of threshold effects: major step-hikes in regulatory costs as the output of small firms expanded, in some cases leading to capex to reduce capacity, to reduce those costs. Regulatory burdens peaked for mid-sized firms. The missing Mittelstand?
- Political/regulatory uncertainty: Investment held back until the Environment Agency made up its mind, which was taking a long while.
- There were greater concerns about changes in regulation than about the overall length of the rule-book. Long, but stable, rule-books could be routinized: changes posed bigger challenges.
- The Directive left discretion to MSs in these problematic areas.

# Immigration policy

- EU:  <freedom of movement>, given specificity by the Treaty and ECJ.
- UK:  Non-EU immigration has always been under UK ‘control’, but there are no guiding principles or policy aims.  What we have is an arbitrary and indefinite target that has been consistently missed by a mile.
- John Reid, giving evidence in Parliament on the immigration directorate of the Home Office: *"Our system is not fit for purpose. It is inadequate in terms of its scope, it is inadequate in terms of its information technology, leadership, management systems and processes.“*
- The recently leaked Home Office document does not suggest that things have radically altered in recent years.

# (EC) 2004/882: Food safety and animal welfare

- Clear and reasonable purposes. Concern that lower-income MSs were devoting insufficient resources to inspection of meat processing plant. Set minimum per-unit charges to fund inspection activities.
- Some MSs (inc. the UK) wanted more flexibility, e.g. to set a more cost-reflective charging structure. Flexibility to do this was therefore built in.
- But Defra had already instituted an enterprise-level charge-capping system and cost-reflective charging was infeasible.
- The FSA, taking a pixelated interpretation of the Regulation, put in a hybrid scheme that led to an arbitrary pattern of price-cost differentials.
- NAO reviewed. Translation of its understated report: “beyond crazy”.

# Belief 3: rule-taking (fax diplomacy) in the EEA

- In fact, the UK would have multiple channels of influence:
  - Seat at global standards setting bodies, which influence EU standards.
  - 'Decision shaping' rights at the Commission stage.
  - Possibility of rejection or amendment at EEA-incorporation stage.
  - Resort to regulatory 'equivalence' explicitly anticipated in the EEAA, including differing (purposive) interpretations of the same words, which is MRA-like.
  - *De facto* veto on incorporation at EEA level (cf. majority voting in the EU).
  - Ultimate decisions reside with national parliaments (no direct effect).
  - Self administered financial support to low-income EU MSs ('let's talk').
  - Influence will be retained in the development of Regulations for the EU Internal Market, the UK's major export market (via decision shaping).

# Why then the Norwegian complaints?

- Entities with smaller market shares tend to have smaller market influence, see the basic economics of price influence.
- Collectively, the economies of the current non-EU members of the EEA are very small in relation to the EEA as a whole.
- Excluding oil/gas, shipping, fisheries and agriculture (where the Vikings do things their own way) their share of EEA-relevant economic activity is smaller still:  there is nothing much at stake.
- Post Brexit, UK participation would increase non-EU members' weight by an order of magnitude (more if Switzerland joins the EEA).
- The future cannot be expected to be like the *past*.

# General reflections: UK errors of analysis

- There have been failures in basic economics and failures to meet JR standards in decision making (e.g. right questions not asked, all relevant information not assessed, irrelevant factors have had influence).
- Thus:
  - Meters: neglect of major differences in costs-to-serve among households.
  - Carbon abatement: neglect of interactions with EU ETS.
  - Price control: neglect of unintended consequences and the historical record.
  - Price discrimination: neglect of pro-competitive effects of price variations.
  - IPPC: little or no appreciation of effects of incentive structures on investment.
  - Immigration: failure to distinguish between marginal and average costs/benefits and to explore alternative, market-based approaches.
  - Food safety: failure to appreciate the factual context (e.g. Defra policy).

# Reflections on UK regulatory performance

- Tendencies toward unthinking Stakhanovism, pixelation, economic illiteracy, disregard of general principles and ungifted amateurism.
- It is hard to see how regulation that is adaptive to changing circumstances can be effectively developed and implemented with this type of regulatory culture. Such regulation requires more holistic, more purposive types of approach, coupled with an acute awareness that we are usually dealing with *systems* of economic relationships.
- The rule-making ('legislative') tasks of regulators differ from those of public administrators. The detail matters, but as for designers, architects and software engineers, thoughts of how the detail (a small subset of pixels) relates to things as a whole (the picture) should be ever present.

# A systemic problem

- The examples covered give grounds for suspecting that there are systemic problems and that they may go wider than regulation.
- In his Speaker's Lecture earlier this month Francis Maude said this about the his re-introduction to the civil service: *"Based on my experience as a Minister in the eighties and early nineties my expectations were high. And the disillusionment was steep and distressing."*
- Not a critique of individual civil servants, and bright young civil servants were among those identified as victims. It was a critique of a *system,* carrying with it the implication that *systemic* reform was required.
- Reid, Rudd and Maude: senior politicians, each saying that things were badly awry in their bailiwicks.

# Facing realities

- The UK not nearly as good at regulation as its practitioners and politicians like to think it is. There is institutional complacency.
- There are still bright spots, but they are very few in number now. Even in competition law (a brighter spot) we have the Enterprise Act's requirement for remedies to be as "comprehensive as is reasonable and practicable". Note: differs from 'proportionate'.
- Lawyers can emphasise the "reasonable and practicable" qualification, but a psychologist might immediately be struck by the cognitive bias likely to be induced by that first word, comprehensive.

# And what of Brexit?

- None of the above provides the basis of a case for or against remaining in the EU. The episodes described happened whilst the UK has been a Member State and Brexit *per se* will not address the problems.
- My own view is that the underlying Brexit issue is simply that an abiding majority in Britain simply does not sign up to the political purposes of the EU. Economic cooperation yes, political integration no. <Taking back control> was the ideograph that pulled sufficient of that majority together to win the vote. Now that there is an opportunity to unbundle the EU's offering – enhanced FTA + customs union + political integration – I very much doubt that there will be much appetite for full rebundling.
- In contrast, the EEAA has an aim/objective to which the UK <u>can</u> wholeheartedly subscribe. That, I think, is the best way forward now.