

REPORT

CREATING A **BETTER**
REGULATORY ENVIRONMENT
FOR **INNOVATION**



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EXECUTIVE SUMMARY

THE Forum on Victoria's National Innovation Agenda "*Creating a Better Regulatory Environment for Innovation*" was held on 28 August 2007 in Melbourne at the Investment Centre.

Convened by Global Access Partners (GAP) in partnership with the Department of Innovation, Industry and Regional Development, the Forum brought together a select group of top level government and business executives to explore priorities and actions which may be pursued through the proposed National Innovation Agenda. The need for a better regulatory environment for business innovation is one of five themes identified in the proposal.

A presentation by keynote speaker **Dr Nicholas Gruen**, Chief Executive Officer of Lateral Economics, provided the basis for the discussion.

The Forum advocated urgency in reconsidering the approach to regulation in order to become more responsive to stakeholder needs. Australia needs to become a "regulatory pacesetter" to compete in the global market.

The following points summarise key discussion points and proposals from the Forum:

- ▶ Legislation designed to protect the public in the short term can, by discouraging technological innovation and economic flexibility, prove deleterious in the long term.
- ▶ Just as 'Fordist' production methods have been superseded by Total Quality Management, so the legislative process needs to become more responsive to stakeholder needs in today's fast changing technological and competitive environment.
- ▶ Services and legislation are seen as a 'co-product' by foreign investors and customers and the interaction of public legislation and private services are therefore analysed as a single business proposition.
- ▶ Small nations such as Ireland and Luxembourg have attracted investment funds through the conscious adoption of a more responsive and service oriented legislative mindset and Australia needs to become a 'regulatory pacesetter' to compete in the global market.
- ▶ Some critics have suggested that Australia's federal system has contributed to an overly complex system of legislation. However, in the light of previous criticism, the Office of Best Practice Regulation has recently been streamlined in an effort to improve its effectiveness in reducing any undue regulatory burden.
- ▶ Established firms accept the status quo because it acts as a barrier to entry for new competitors while small firms fail to see their innovations spread industry wide. Major players must be persuaded of the future economic benefits of regulatory reform while small stakeholders must be given opportunities to promulgate the innovations they develop.
- ▶ Carbon trading, financial services, pharmaceuticals, health care, the building industry, data protection and transport are all sectors which would benefit from a new legislative approach.

EXECUTIVE SUMMARY

- ▶ The need to reform the legislative process is a core part of the National Innovation Agenda.
- ▶ Reform requires both high level acceptance that a problem exists and grass roots engagement to produce concrete solutions. The increasing power, and falling cost, of computing allows 'wiki' based solutions to be built through the internet.
- ▶ The legislative mindset must change from the remediation of past harm to the encouragement of future innovation. Allowing regulators to adopt alternative or privatized methods to meet legislative goals is a possible solution, as is the creation of a **'Centre for Smart Legislation'**.

For the full Report of the Forum's proceedings, see pages 7-13.

DISCLAIMER: This Report represents a range of views and interests of the participating individuals and organisations. Statements made during discussions are the personal opinions of the speakers and do not necessarily reflect those of the organisers and sponsors of the Forum.

KEYNOTE SPEAKER

THE Forum featured Dr Nicholas Gruen, Chief Executive Officer of Lateral Economics, as the keynote speaker.

Nicholas Gruen is trained in History, Statistics, Law and Economics and has published internationally on various issues including economic liberalisation and fiscal policy architecture.

He has qualifications in Law (Hons), Melb, History (Hons – First Class) Melb, Education (Dip Ed) Melb, and economics and public policy (PhD), ANU.

Dr Gruen was advisor to Senator John Button on industry policy and to John Dawkins both when he was Minister for Employment Education and Training and as Treasurer.

He was appointed to the Productivity Commission in 1994 and again in 1995 where he was Associate Commissioner on five inquiries and Presiding Commissioner on one inquiry and an industry study.



Dr Nicholas Gruen
CEO Lateral Economics

Dr Gruen joined the BCA in 1997 where he directed the BCA's "New Directions" program.

He founded *lateraleconomics.com.au* and *peaches.com.au*, a discount finance broker, in 2000. He is chairman of *onlineopinion.com.au*, Australia's 18th most popular internet site – and a substantial contributor to Australia's thriving policy blog scene.

Dr Gruen was a weekly columnist for the Courier Mail in 2005 and 2006 and still writes columns frequently for the both *The Age* and the *Australian Financial Review*. He is a Visiting Fellow at ANU and at the University of Melbourne.

Lateral Economics has consulted to a wide variety of firms and governments both large and small in its seven years existence. It has recently completed or is in the process of consultancies for the Victorian, South Australian and New South Wales Governments all focusing on regulating more efficiently.

SPONSORS & PARTNERS

THE Forum was coordinated by Global Access Partners (www.globalaccesspartners.org) – an influential network that initiates high level discussions on global issues, encouraging the sharing of knowledge, progress and policy change. GAP structures each initiative around the desired business outcomes of its partners and sponsors.

The Forum was sponsored by the Department of Innovation, Industry and Regional Development (www.iird.vic.gov.au) – the Victorian Government's lead agency for economic and regional development.



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PRESENTATION

Beyond Taylorism: Regulating for Innovation

Dr Nicholas Gruen's talk "*Beyond Taylorism: Regulating for Innovation*" began by asking why did not Australia produce the world's first keyless car.

Australia had become a world leader and major exporter of car security technology in the early 1990s, but regulation mandated the use of mechanical locks.

Dr Gruen said that we could never know if the keyless car had ever been proposed, but speculated that had a junior designer proposed it, he would have been 'set straight' by some middle manager pointing to the regulation.

He argued that one feature of heavily regulated industries – such as banking is a kind of 'learned helplessness' in which the regulatory objectives – occupational safety or consumer protection for instance – came to be regarded as the responsibility of outsiders.

These problems have been tackled in the private sector by the transition from mechanistic production line systems of 'Taylorism' or 'Fordism' to the more flexible

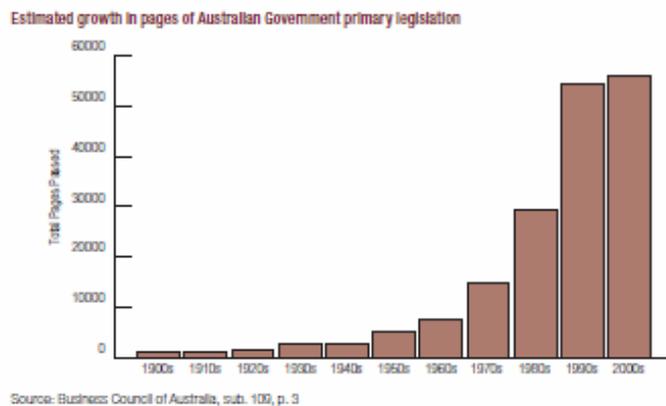
and responsive Japanese "total quality management" (TQM). These systems go to great lengths to harness people's natural desire to do their jobs as well as possible to constantly and incrementally improve products and process.

Dr Gruen argued that the mechanisms we had established in regulation review to tackle overregulation were themselves creatures of the 'top down' mindset. Thus,

rather than seeking ways to empower the review of regulation from those at the 'coalface' regulation review was focused on further constraints on regulation making from the top down – such as the provision of regulatory impact statements (RISs).

Further while we can all agree with introducing quality hurdles to prevent the passage of bad regulation, this is a very incomplete recipe for regulating well. Michelangelo used to say that his masterpieces arose from simply removing the unnecessary marble from the original block, but this seems like an unlikely way to produce masterpieces of good regulation. To regulate well, we need to do far more than simply prevent bad regulation.

Dr Gruen posited a legislative version of 'Moore's law' – what he called The Law of Moore showing evidence that the volume of new legislation doubles every decade.



Australian Government primary legislation
Estimated growth in pages (1990s-2000s)

PRESENTATION

He proposed some ways of reforming our processes to build regulation review along 'post Taylorist' lines and argued that Australia should also become a 'regulatory pacesetter' in specific areas. The examples he provided were in the area of greenhouse gas abatement and the export of financial services, though he indicated a wide range of other potential areas including pharmaceuticals, the regulation of professional services and consumer protection.

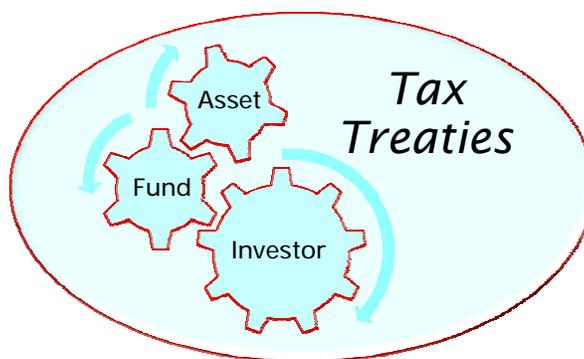
Dr Gruen said Australia could become a global financial centre, into which foreigners invest money, if a more flexible legislative framework evolved in partnership with government and stakeholders. He argued that the competitiveness of a financial centre was best understood by seeing financial firms and regulators as producers of a 'co-product' which

foreigners then invested in. He argued that, along with favourable tax regimes, this was the secret to the success of financial entrepôts like Ireland and Luxembourg both of which had developed regulatory regimes that were both highly responsive to the needs of their financial exporters as well as uncompromising about consumer protection and market integrity.

Ireland and Luxembourg together have a population smaller than NSW. Yet they domicile over three times the volume of funds management as the whole of Australia – which itself has a very large

industry. But whereas 97 percent of the money managed in Australia is Australian money, the entrepôts mostly handle foreigners' money. They export boom is built on regulatory and tax flexibility.

Dr Gruen said that the idea of 'regulation as a service' sounded like a contradiction in terms, until one realized that a great deal of regulation was of this kind – private regulation of standards – for instance in telecommunications and the internet. Delaware was a time honoured model copied by the financial entrepôts.



The tax jigsaw for global funds

Source: Lateral Economics

For decades Delaware has provided corporate regulation as a service with specialist courts, a deep stock of precedents and highly responsive regulators and legislators meeting the corporate need for certainty and flexibility.

Australia could become an export hub with a similar level of responsiveness on tax and regulation.

Unfortunately there is a reflex action within the bureaucracy to look upon this as 'picking winners'. This is understandable where special tax favours are done, but is an excuse for inactivity and mediocrity in regulation.

Australia could advantage domestic greenhouse abatement industries particularly suited to Australia's abatement effort by becoming a regulatory pacesetter in that area.

PRESENTATION

Dr Gruen advocated a 'Kyoto compliant' market and a further 'penumbral' carbon market which, though it might be non-compliant with Kyoto, was nevertheless consistent with its spirit – in the sense that it delivered audited and measured abatement. The purpose of such regulation would be purely to regulate as well as possible. It would not be designed with the primary intent of favouring Australian producers. But this would nevertheless be one of its beneficial side effects – placing Australian innovators in areas particularly suited to Australia's abatement capability in land management and agriculture in the best position to dominate the technological forefront in their niches.

DISCUSSION

A speaker pointed out the problems posed by Australia's federal system in any streamlining of its regulatory system. Individual Australian jurisdictions set their own duties in the financial services industry and, while they do not impose taxes on investors, they increase costs by imposing duties on service providers. A unitary system, such as Luxembourg's, allows a simpler and therefore more responsive system to operate. The speaker noted his own experience in one of the major Australian banks, saying they developed products in Australia, but, because of arcane local laws which prohibited their use, had to take them to the world market.

Over regulation tends to discourage new entrants to the market and therefore laws made in co-operation with existing companies would not necessarily lead to a streamlining of regulation. Large, long established firms would tend to favour laws which discriminate against smaller players and potential new entrants then use their market dominance to demand exception from such regulations themselves.

The speaker noted that Australian **financial services** are sophisticated because of the need to navigate through its complex regulatory environment, but are not attractive to overseas investors precisely because of that highly regulated environment. These issues underscore the need for a new approach.

The creation of a *task force* to explore these issues and propose possible solutions through a three meeting process and a guaranteed outcome was raised by one of the speakers.

The reluctance of established players to simplify a system which currently acts as a barrier to entry for potential competitors was again stressed. Such vested interests can be deleterious to the interest of the economy as a whole. It

was pointed out that two thirds of the experts in carbon trading are Australian, but are working offshore rather than in firms based in their home country due to restrictive Australian laws in this area.

« **Second and third tier companies are keen to embrace web based alternative methods to meet regulatory demands, which still tend to be paper based and therefore cumbersome and expensive to comply with.** »

A Canadian scheme which allowed regulators to adopt alternative methods to meet the goals decreed in legislation was held as a possible model for future development.

Regulatory regimes are still largely paper based, making compliance with them expensive and cumbersome. Second and third tier companies are keen to embrace alternative methods such as web based tools.

Delegated regulations often have a sunset clause, which in the view of some industrialists creates uncertainty because such regulations have to be constantly reviewed complicating attempts to plan in the long term. Others see such sunset clauses as an advantage as they force review of regulations which may have become outdated or unnecessary.

DISCUSSION

It was acknowledged that Australia has well intentioned people trying to deal with the problem of restrictive legislation but the top down method of alleviating the problems meant that practical solutions were missed.

Health care is a highly regulated market and reform and incentives could greatly increase innovation in this area. One area which shows the potential of new thinking sees GPs paid to put patients on care plans produced by private firms. Here a mix of regulation and incentives allow innovative problem solving companies to enter the market to the benefit of all.

The possibility of making Victoria in particular, or Australia in general, 'another Ireland' in terms of responsive legislation was raised. The Melbourne Centre for Financial Services was mentioned as a possible partner in taking steps to make Victoria a more attractive home for financial services.

It was agreed that Health, the Environment, Agriculture, Telecommunications and Financial Services were sectors where better legislation would drive business opportunities.

Regulators are not inherently averse to risk, but respond to community concerns resulting from highly publicised market failures. This retrospective and risk-averse culture acts as an inhibitor on future innovation.

Regulated companies tend to assume regulators will not listen to their concerns and therefore fail to participate in discussions regarding future legislation.

Victoria was seen as ahead of the curve in adopting ten year sunset clauses and regulatory impact statements in 1984, ideas which became the basis of the current OECD model, but it was moved that this system has become increasingly bureaucratic over time and itself needs reform.

« Health, the Environment, Agriculture, Telecommunications and Financial Services are sectors where better legislation would drive business opportunities. »

The National Innovation Agenda was seen as offering opportunities for improving the regulatory environment in a range of areas.

The experience of the early nineties showed the need for a national political consensus at the state and federal level that a problem existed which needed to be addressed. Monopoly suppliers tend to be content with the existing system which acts to benefit them but the issue of regulation has to be seen by all stakeholders as a barrier to future economic reform before concrete measures can be taken to address specific problems.

Clear paths to successful outcomes have to be seen from the start to encourage engagement. Problems have to be represented as tractable and scalable.

DISCUSSION

Reservations were expressed about the suitability of the **carbon market** to meaningful development, whereas the potential of improving the legislative framework managing the **building market** were raised. Once again vested interests were seen as seeking to use restrictions in legislation to keep new entrants out of a market ripe with new opportunities.

The increasing sophistication of computer technology, combined with falling prices, is set to revolutionise business practice and enable wider participation in the creation and changing of laws. 'Wiki' based online forums allow topics to be debated in a fluid, open platform environment, leading to the creation of consensus based policy proposals by a broad spectrum of interested parties.

Regulatory reform demands both high level support in recognising the problem of poor legislation and grassroots participation in creating better laws.

It was noted that building legislation is currently risk averse and therefore acts as a disincentive for creative people to enter engineering.

The National Innovation Agenda is part of a continuing process of economic reform and the regulatory environment is one of its

five core areas. It was felt that the discussion of reform needed to be more ambitious in its scope and more specific in its proposals. Queensland, for example, is seeking to open up government intellectual property to encourage innovation in the private sector while Procter and Gamble have a three year 'use it or lose it' policy

regarding its own intellectual property, offering their research for use by others if they do not use it themselves.

In the view of some in the industry, unduly restrictive regulation has on occasion stymied potentially fruitful **pharmaceutical research**. However, the notion that fast developing countries such as China present a more attractive venue for developing new drugs was debunked as Chinese regulations are theoretically becoming as stringent as those in the West.

One speaker asserted that **the transport industry** comprises 14% of Australia's economy and could greatly benefit from the harmonising of state and federal legislation.

« **Regulatory reform demands both high level support in recognising the problem of poor legislation and grassroots participation in creating better laws.** »

« **The discussion of reform needs to be more ambitious in its scope and more specific in its proposals.** »

DISCUSSION

It was argued that the small scale and flexible nature of SMEs facilitate innovative responses to market changes but, by the same token, their relative lack of commercial influence reduces the chance of such solutions entering the mainstream of best industry practice. The speaker believed that industry 'innovation champions' could foster better collaboration between firms to share best practice solutions for their mutual benefit in facing, for example, foreign competition.

Another participant believed that **privacy legislation** was ripe for reform and favoured changing the current emphasis on 'up front' notices. She said firms wanted to 'add value' by data mining the information given to them by customers while citizens wanted reassurance that their private details would not be abused. New regulations were needed to create a better legislative environment to benefit all stakeholders.

A further speaker advocated the creation of a '**Centre for Smart Legislation**' in the financial services industry, which she saw as currently hamstrung by over legislation and a fruitful area for more responsive legislation, disclosure and taxation regimes. Such a centre could at least attempt to 'balance the biases' of various stakeholders.

It was pointed out that existing structures designed to foster 'responsive legislation' are ineffective and that the academic debate of such issues does not solve practical problems. The Office of Best Practice Regulation, for example, is subject to bureaucratic pressures which mitigate against action.

Chairman Peter Fritz discussed reframing the roles of companies and legislators in the creation of new legislation in light of seeing "regulation as a service".

The Forum closed with a concise summing up of the day's proceedings from the Chairman, emphasising the potential of Australia's future as a hub of global finance. It was agreed by the relevant stakeholders to build on the progress made during the Forum by holding a progressive series of seminars in the lead up to the GAP Congress on Regulatory Affairs – "*Opportunities for Business*" planned for May 2008.