COST-EFFECTIVE

BUSINESS REGULATION

Views from the Australian Business Elite

William Clifford
and
John Braithwaite

Australian Institute of Criminology
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A view shared by many of the executives was that detailed specification of corporate rules was not necessarily the best way of implementing self-regulation. The ever-changing environmental circumstances confronting executives were thought to be so unique that 'almost everything is an exception'. Or as another business leader explained: 'It would be like drawing up a separate set of rules for each position on a football team. The left winger must do such and such, the centre something else'.

Some business leaders felt that putting in place organizational structures which reduce the chances of company standards being compromised was more important than writing rules. For example, one problem is incentive systems which encourage employees to cut corners. At GEC, workers who make certain types of electrical fuses are paid according to how many they produce. This is an incentive for productivity but a disincentive for quality. GEC puts aside the fuses for a day and has them checked for safety by another shift. We left the interviews with the question in our minds being whether it is more important for researchers to focus on the way organizational structures impact self-regulatory effectiveness rather than on what company rules are written.
increased private security costs for industry. Against this Edward Graham contends that the environmental, health and safety regulations of the past ten years have brought an improvement to standards of living which are not reflected in the usual output statistics. Brittan also refers to a possible side effect of regulations, the evasion of which produces a 'black economy' (black market?) of small scale domestic and unregistered activity dodging both the tax and regulation agencies and operating outside the scope of the usual productivity indicators. Again, someone pays for the economic activity within the 'black economy'.

The foregoing should not be taken to imply that regulation is unnecessary. There are certain basic standards of quality production, safety and waste control which just cannot be expected to develop from industrial self-regulation, market forces, or enlightened social responsibility. Here a degree of governmental intervention is both necessary and desirable: and, in providing it, the taxpayers are buying themselves a basic level of protection. While everyone argues that 'some' regulation is necessary, the crucial question is how much and in what circumstances?

Sometimes governmental regulations are necessary to avoid market regulation by the most powerful firms. Into this category fall trade practices legislation and other measures necessary to prevent industrial giants squeezing out existing competition. Here the regulations are actually designed to avoid the creation of order and to avoid that predictability in pricing which collusion in industry could well ensure. Other regulations can work in the opposite way - setting necessary standards of production or performance so high as to prevent marginal companies from entering the market cheaply but at an unjustifiable risk to consumers.
The impetus for Regulatory Reform in Australia

Many countries have seen efforts in recent years to make the cost of business regulation an issue. Last year a British study found that in that country at least 252 different government authorisations confer powers of entry to companies on inspectors, quite apart from the police. A Business Roundtable study of 48 US companies found that in 1977 incremental costs of $2.6 billion were born to meet requirements imposed by six federal regulatory agencies.

The sponsoring of this kind of research by the business community has now begun in Australia. During 1977, Eric White Associates surveyed the top 100 companies in Australia. The survey found that the direct cost of monitoring and complying with the information requirements of regulatory agencies (including staff time and expenses) averaged $110,000 per company. A recently released Confederation of Australian Industry survey for the year 1970-71 put the costs of compliance with Federal and State government regulations at $3.720 million. It was further concluded that business regulation tied up about 54,400 private-sector employees full-time in that year. The number of government regulations made in Australia per year has shown almost a three-fold increase since 1960. The study found the costs of state government regulations to be far more significant than federal regulation.

This evidence has produced a political response. The Minister for Business and Consumer Affairs, Mr. Garland, has announced that he sees the 1980s as a decade in which private enterprise will be forced to become more and more responsible for finding its own solutions to problems, as business becomes increasingly free from regulation. Both the South Australian and Victorian governments have expressed support for the 'sunset' approach to business regulation which will be discussed later. The major forum for the deregulation debate has become the Campbell inquiry into the Australian financial system.

While these developments are healthy and long overdue, the debate has proceeded in a rather one-sided fashion. While the documentation of the costs of regulation from industry-funded studies has been impressive, systematic enumeration of the benefits of regulation has been absent. The problem is that the benefits of a cleaner environment are not so quantifiable as the costs of environmental protection technology. Douglas M. Costle, Chairman of President Carter's new Regulatory Council and Administrator of the Environmental Protection Agency, has made a valiant effort to enumerate the benefits side of the regulatory equation. We can do no better than quote him at length:

Those benefits run from savings in lives at one end of the spectrum, to aesthetic benefits at the other. In between, you find benefits ranging from savings in property maintenance - not having to paint your house or clean your clothes as often - to the protection of farm and timber crops from saline soils and acid rains.

Despite the difficulties, some economists are beginning to measure the benefits of regulation. In 1977, for example, after evaluating existing studies, the American Lung Association estimated that air pollution could be costing us $10,000 million annually in health damages. Dr. Lester Lave, chairman of the department of economics at Carnegie-Mellon University, and Dr. Eugene Seskin, a senior research associate at Resources for the Future, have published their study on Air Pollution and Human Health. They estimate that the annual health benefits
of controlling pollution from factories could be as much as $20.2 thousand million in 1976 dollars. In a forthcoming study, Dr. Edwin Mills of Princeton University has estimated the recreational, aesthetic and ecological benefits of water quality improvements to be of approximately the same magnitude.

Thus, now that economists have been asked to look for figures, they are beginning to find that health, safety, and environmental regulations have a sound economic base. To place such benefits on a more human scale, let me quote examples cited by Dr. Stewart Lee, chairman of the department of economics at Geneva College. He finds that in the regulated products groups, safety packaging requirements have produced a 40 percent drop in ingestion of poisons by children over a four-year period. Since the safety standards for cribs became effective in 1974, crib deaths have fallen by half, and injuries by 45 percent. The Burn Institute in Boston reports that in 1971 - prior to the children's sleepwear standards - 34 percent of its flameburn injuries involved sleepwear. In 1977, the figure was zero.

According to the U.S. government's General Accounting Office, 28,000 lives were saved between 1966 and 1974 because of federal motor vehicle safety regulations. The same report showed that in one state, where a detailed analysis was conducted, there was also a substantial reduction in the frequency and severity of injuries. With auto accidents the number one cause of paraplegia in the United States, these figures are significant.\textsuperscript{12}

Putting a Price on Morals?

Traditionally the law is believed to embody principles of morality which are so central to the culture as to justify codification and enforcement by the state. Not all morals, but presumably only the most central ones, become laws. There is an influential body of thought in our culture which says that we should not set a price on morals, that justice should not be for sale.\textsuperscript{13} Certainly, no one could dispute the undesirability of situations where people and organisations with greater wealth can buy superior treatment by the law than is available to the poor.\textsuperscript{14} Nevertheless, it is our contention that considerations of cost should be a factor in determining which laws are enforced systematically, indeed in determining whether morals should become laws in the first place. This is not only desirable, it is inevitable. Police departments, for example, have finite resources to confront problems which are infinite in their dimensions and are forever making decisions to deploy enforcement resources in one area to the neglect of another. A police department which had a policy of systematically enforcing every law violation which came to the attention of its officers would spend all its time on prosecutions for obscene language and public drunkenness charges, while devoting much less attention than they do at the moment to solving murders. In other words, citizens implicitly accept the principle that police departments weigh the cost of enforcement against its benefits.
This kind of reason has not always prevailed in the enforcement of business offences. Many consumer groups have regarded asking the question of the cost of regulation as selling out morality to economics. But the same reasoning does apply as with the police example. If scarce white-collar crime enforcement resources are concentrated in those areas where enforcement is cost-effective, then more companies who have engaged in serious offences will be brought to justice for the taxpayers' dollar. The argument is all the more compelling in the case of business crime because the resources available for regulating business are very much less than the resources at the disposal of the police, probation and parole, prisons and other departments responsible for regulating the conduct of individuals. Moreover, with corporate crime one ill-chosen enforcement action (such as the antitrust action against IBM in the United States) can use up almost the whole of a government agency's budget.

If we are genuinely concerned to provide as much protection as possible to the public, then cost-effectiveness questions must be asked. As was argued in the first section of this paper, it can be that the costs of regulation in a particular area become a greater social burden than the benefit at which the regulations are directed - the remedy can become worse than the disease.

The question which arises when all these broader issues are considered is the extent to which governmental regulation can become so extensive as to be self-defeating: the extent to which the established bureaucracies of the largest and most entrenched firms in an industry can be used to serve public as well as private purposes, namely, to set standards for the industry as well as to encourage self-policing, and the extent to which the interplay of law and discretion will serve the best interests of the citizen. In the last analysis these resolve themselves into questions of costs and benefits.

Beginning with the last point, it is perfectly clear that in every country where regulation of industry or commerce is attempted there will be an area of cooperation between the corporations and government on the application of the regulations. With tax laws now so very complicated, with allowances for depreciation, transfer prices and other national figures so difficult to assign with accuracy and fairness there is often a form of negotiation that the final assessment. On environmental controls, government departments and the firms involved will often agree on the private consultants to be appointed for an impact study - and they will generally agree to abide by their report. Or if there is no actual agreement, it becomes the established practice to abide by it. Frequently individuals who were engineers or other acknowledged experts with private firms succeed in getting supervisory jobs with the government, and not infrequently officials of supervisory governmental agencies retire to take up employment with, or to act as consultants to, the private firms. This interplay, and what amounts to a cross-fertilisation, can lead to greater cooperation or collusion according to the particular issue involved or the point of view of the observer. However regarded, it is a fact of modern business practice - the large bureaucracies, governmental and private, seek ways to interface for smoother day-to-day operations.

This is not an altogether undesirable reality. Given the complexity of law relating to the control of companies, settlements in the courts impose severe costs on everyone. Hence, to the extent that matters can be settled through a process of negotiation, considerable cost savings occur. Negotiation is a qualitatively different process from litigation: 'They [negotiators] seek not to reach a solution in terms of rules, but to create the rules by which they can organise
their relationship with each other. Negotiation has the advantage over litigation that it is predicated by the maintenance of harmonious relationships between the disputants rather than by a breakdown of cooperation in an adversarial confrontation. Anthropologists have noted that for disputants who must maintain ongoing cooperative relationships with each other (e.g., husband and wife) negotiation is more often the preferred mode of settlement, while for disputants who have only a transitory relationship (e.g., landlord and tenant) a definitive formal adjudication may be the preferred mode.

While it matters little that a landlord and tenant come out of a courtroom bitter enemies, it matters a great deal if an industrial safety inspector emerges from a courtroom a sworn enemy of the safety manager of a certain company. The latter matters because these people should continue to work together to protect the public. The safety inspector wants the safety manager to be open with him and talk over the problems he is confronting; while the manager wants the inspector to warn him before the event of problems which might run the company afoul of the law, rather than let him go now and prosecute later. A government inspector who has a rapport with industry plays an important role in disseminating safety innovations from the industry leaders in safety to those who lag behind, even though the latter might be within legal limits. A government inspector must therefore confront many circumstances where the grounds of justice and equitable treatment under law call for prosecution, but protection of the public calls for a harmonious negotiated settlement.

This is all very well, but consumer groups are correct to point out that many negotiated settlements may be cozy arrangements suitable to both business and government, and not in the public interest at all. A strong consumer movement combined with a meaningful freedom of information Act are essential protections in a democracy against this inevitable kind of accommodation. In spite of all this, prosecution will frequently be necessary. When prosecution must proceed, efforts should be made to insulate the front-line inspectors who must maintain cooperative relationships with people in the company from the most bitter adversarial interchanges.

Two types of choices therefore must be made. First, it must be decided whether the requirements imposed on industry by a given regulation involve costs of compliance greater than the benefits. Second, given that a regulation has been imposed, it must be decided whether for any given violation, the benefits of enforcement action exceed the costs.

Before major new regulations are introduced the government agencies introducing them should be required to prepare a cost of regulation impact statement. There should also be a requirement to call for submissions from business, consumer, trade union and other groups on the costs and benefits of any proposed new regulation. The United States Food and Drug Administration has a further requirement that the agency must offer in the Federal Register a defence against every substantive criticism made.

Moreover, there is a need for a built-in self-destruct mechanism which forces agencies to review their objectives and effectiveness periodically. A regulation which is cost-effective today may, with changing technological and economic realities, rapidly become cost-ineffective. The US Congress has been considering a number of strategies to give regulations a finite life. One is 'sunset' legislation which, at the end of a specified period, forces a regulatory agency to scrap all existing regulations and start again.
Of course, if the existing regulations can all be justified as working well, this set of regulations can be simply re-enacted in its entirety. One of the problems with proposals to review the costs of regulation is that they themselves might impose considerable costs. Senator Kennedy, arguing that a fixed routine of total review of all US government regulations would impose an impossible burden on Congressional oversight committees, has put forward a 'high noon' proposal as an alternative to 'sunset' legislation. Under 'high noon', one agency would be selected at a time for dismantling and rebuilding of its regulations. Presumably every regulatory agency would eventually have its 'high noon'. Australia does not have anything approaching the costly regulatory apparatus of the United States. Yet the proposals discussed above are worth considering for Australia precisely so we can avoid creating an unnecessarily complex regulatory morass.

Finally, a great many of the complications of regulation could be avoided by up-grading the quality of legal draftmanship. Too often the dull task of drafting regulations is left to those who cannot avoid it. This is an area of legislative activity in which expenditure on good drafting could save millions on futile litigation. It is also an area requiring detailed knowledge of the realities of the industry. To some extent the range of cooperation between industry and the government could be extended by increased consultation with industrial specialists on the control measures required or intended. Interests would not always coincide but the framing of regulations which could be effective in operation and relatively cheaply monitored would repay investment at this point.

The Possibilities for Self-Regulation

Self-regulation is a dirty word among many consumer groups. This is because certain business interests have attempted to portray self-regulation as a total alternative to externally imposed regulation. It never can be. A situation cannot be tolerated where responsible companies self-regulate while others make quick profits by flouting accepted standards. However, companies which set up effective self-regulatory systems should obviously receive less attention from government inspectors than those that do not. Companies which set up meaningful internal compliance systems therefore assist in ensuring that scarce government enforcement resources are concentrated where they can do most good.

Many of the areas where the benefits of enforcing externally imposed regulations do not justify the costs might be handled by fostering, or even requiring, certain self-regulatory measures. While this smacks of common sense, the practical problem is how to make self-regulation work. Strategies for making the rhetoric of self-regulation a reality constitute one of the most worthwhile challenges for modern business.

The purpose of the research program we are undertaking is to attempt to draw out some general principles of effective self-regulation. This can only be done by relying heavily on the expertise and experience available in the business community. At this stage all we have are many questions and very few answers. We can do no more than conclude by listing a number of questions which could form the agenda for a research program.

1. What is the role of the Board of Directors in monitoring internal compliance programs?

2. Is it desirable to allocate to different Board members responsibility for certain areas of compliance?

3. Can corporate codes of conduct be made effective?
4. Can compliance with codes of conduct be made one of the criteria on which promotion is assessed?

5. Should corporate compliance be a separate function superimposed on normal operating functions or should compliance be integrated into all operating functions?

6. In a transnational corporation should headquarters superimpose compliance audits on subsidiaries or should subsidiaries have autonomous responsibility for compliance?

7. Once compliance reports have been written and deficiencies noted, what procedures should exist for ensuring that the report lands on the right desk and is acted upon?

8. Should government inspectors have routine access to internal compliance reports?

9. How can an organisation be structured so as to foster natural surveillance of the activities of officers to ensure compliance with corporate standards?

10. How should accountability be allocated in an organisation to ensure that a particular person can be held responsible for a particular problem for which he or she is adequately trained and experienced to handle?

These questions are but a beginning. They are all underpinned by the fundamental assumption that internal regulation is likely to be more effective in many circumstances than externally imposed regulation. This is assumed because insiders are in a better position to know where the bodies are buried and are better trained in the technology in which their company specialises than any government employee could ever be. The quest for more cost-effective regulation is therefore seen to have three major thrusts. First, reducing government enforcement efforts which are not cost-effective, second, replacing these with assurances that effective self-regulatory mechanisms are in place; and third, increasing government enforcement efforts which produce benefits which are greater than costs.
FOOTNOTES


6. However, one of the problems with anti-trust enforcement around the world has been that forms of conduct which have been defined as illegal because of their normally adverse economic consequences are prohibited even in particular circumstances where the conduct produces economic benefits. Hence, monopolistic behaviour will be stamped upon even when it generates economies of scale with benefits much greater than anti-competitive costs. See Richard A. Posner, Antitrust Law: An Economic Perspective, Chicago, University of Chicago Press, 1976.


III. THE DISCUSSION

THE ESSO SYSTEM

Paper presented by Mr. A.T. Kline
Director,
Esso Australia Ltd.,
SYDNEY

I happened to be the General Auditor of Exxon Corporation before I was lucky enough to be sent to Australia and so I had some direct contact with the questions under discussion today. I plan on providing some very brief background on Exxon and Esso Australia and our Corporation’s overall system of management control, and also what might be of some interest to you, Exxon’s internal Audit effort, the conflict of interest policy and the business ethics policy.

Exxon Corporation and its affiliates operate in almost 100 countries including Australia. Our major businesses are exploration, production, refining, marketing of crude oil, petroleum products and natural gas, manufacturing and marketing of petro-chemicals, and the exploration for and mining and sale of minerals, including coal and uranium -

Interjection: and shale -

Yes, that is not a major business yet but we hope that it will be.

World wide we have about 170,000 employees. In Australia, as you probably know we produce about 65% of Australia’s crude oil and the natural gas supply for the State of Victoria and we supply about 7% of the petroleum products marketed in Australia as well as petro-chemical and some other operations. With this background let me describe very briefly Exxon Corporation’s overall system of management control. This is basically a decentralised system which delegates considerable responsibility to the Managing Directors of Affiliates and to Division Managers. However, this certainly does not mean that the managers are free to do their own thing in any way that they happen to deem expedient, so long as they make some money. Instead, Exxon