

Summary: Intervention & Options

Department /Agency:
BERR

Title:
Impact Assessment of Regulatory Budgets Consultation

Stage: Consultation

Version: 1

Date: 5 August 2008

Related Publications: Enterprise: unlocking the UK's talent. The Government committed to consult on the introduction of a new system of regulatory budgets.

URN 08/1139

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What is the problem under consideration? Why is government intervention necessary?

Government introduces regulation to achieve important goals and to correct market failures, but in doing so, significant costs can be imposed on the economy. Checks within the current system to oversee costs from regulation do not consider the total costs introduced over a period nor whether those costs could be absorbed. This could lead to over-regulation and potentially a higher level of costs imposed on the economy than would be the optimum over a given time period (though there is no consensus what that optimum level is).

What are the policy objectives and the intended effects?

The Government is therefore exploring the introduction of a new system of regulatory budgets as a means to control the total costs of regulation that it imposes in a given period and to improve the prioritisation of regulatory action across Government.

What policy options have been considered? Please justify any preferred option.

The Government has considered the following options to improve the prioritisation of new regulatory proposals and manage overall costs of regulation: a robust process for determining priorities; publish regulatory accounts; set a minimum net benefit for new regulations; set a constraint, or budget, for the total costs of regulation. The options involving greater transparency and prioritisation alone would not necessarily limit the total costs of regulation nor ensure effective prioritisation. Hence, the Government's preferred approach is to introduce regulatory budgets.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Performance of the regulatory budget system will be reviewed in Autumn 2009, under shadow running. A further evaluation will be undertaken towards the end of the first budget period.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



Date: 5 August 2008

Summary: Analysis & Evidence

Policy Option: Regulatory Budget	Description: Introduce a system of regulatory budgets for departments.
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' Staff costs to Better Regulation Executive, £845,000; Staff costs to departments and regulators, £1.95 million; IT system, £50,000; Hypothetical fall in benefits (based on assumed scenario), from benefits forgone £15 million. One-off transitional staff costs of £100,000
	One-off (Transition) Yrs	
	£ 10,000 10	
	Average Annual Cost (excluding one-off)	
£ 2.85 million	Total Cost (PV)	£
Other key non-monetised costs by 'main affected groups' There will be costs in terms of net benefits foregone because regulations are not taken forward or delayed. The level of these will depend on the level at which budgets are set.		

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Hypothetical reduction in costs of new regulation based on assumed scenario (see paragraph 50), £150 million
	One-off Yrs	
	£ 10	
	Average Annual Benefit (excluding one-off)	
£	Total Benefit (PV)	£
Other key non-monetised benefits by 'main affected groups' The benefits are from better prioritisation of regulation; greater control over the introduction of regulatory costs; greater certainty for the regulated community of the regulations and costs they will face; full accounting of government intervention in the economy.		

Key Assumptions/Sensitivities/Risks Assumptions: reduction in costs of regulation by 10% improvement to b-c ratio to 1.1. Risks are: initial estimates prove inaccurate; impacts can not be monetised; new incentives to misrepresent regulatory costs; poor system design could create incentives to pursue inappropriate regulation.

Price Base Year 2007	Time Period Years 10	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
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What is the geographic coverage of the policy/option?	UK and reserved
On what date will the policy be implemented?	April 2009
Which organisation(s) will enforce the policy?	to be determined
What is the total annual cost of enforcement for these organisations?	£
Does enforcement comply with Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	No
What is the value of the proposed offsetting measure per year?	£ none
What is the value of changes in greenhouse gas emissions?	£ none
Will the proposal have a significant impact on competition?	No
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A Small N/A Medium N/A Large N/A
Are any of these organisations exempt?	No No N/A N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ 0	Decrease of £ 0	Net Impact £ 0

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

Overview

1. A fundamental requirement of a market economy is a certain degree of regulation (e.g. property rights). As societies develop and become wealthier, the public tolerance of risk (or at least, of risk imposed by others) tends to reduce and the demand for regulation increases. Generally speaking government departments have 2 levers with which to achieve their objectives. They can choose either to spend/tax or regulate. Both approaches impose a real cost on the economy, alongside the benefits they offer by changing incentives and behaviours. But they are subject to different degrees of scrutiny and control. Public spending and taxation is subject to strict controls by the Treasury. The cost of regulation, while subject to different types of scrutiny, is more loosely constrained.
2. Regulation is introduced to achieve a particular outcome; either to correct a market failure to make markets work better; or to achieve a social outcome. Very often, regulation can seem cost-free to policy makers and many stakeholders – but the cumulative costs can be very real for business, the voluntary sector, front-line public sector workers and citizens, even if for each individual piece of regulation a good case can be made. Indeed, carefully designed regulation that corrects for a significant market failure should improve the allocation of resources and yield benefits in excess of any costs. Ideally, therefore, we would want to have a system to maximise the net benefits of regulations that takes in to account the total costs introduced. But existing decision making systems do not consider the total costs of regulation introduced over a given period. Introducing this discipline to policy making is not straightforward.
3. The process of Impact Assessment assesses individual regulatory proposals on their own merits, whether the benefits of the proposed regulation justify the costs. The impact on the economy of the cumulative costs of proposed new regulations is not normally assessed as part of this decision making process. Given that the economy's capacity to absorb change is finite, there is a prima facie case for a clear robust process for determining the government's regulatory priorities, or the risks regulation is intended to act against, and hence the costs that the economy should be expected to absorb.
4. The consultation document explores introducing a system of regulatory budgets, to better control the total costs introduced through regulation and deliver better prioritisation by government of regulation.

Background

5. Most of the debate about applying a regulatory budget has taken place in the United States, including an attempt, through a piece of Congressional legislation, to introduce a requirement on the president to submit an annual regulatory budget to Congress each year which they would have to approve.¹ The Office of Information and Regulatory Affairs, part of the White House, publishes an annual report to Congress which sets out the total annual costs and benefits of federal regulations introduced.² They have

¹ The Regulatory Accountability Act, proposed by Representative Lamar Smith during the 104th Congress. It never came up for a vote.

² See www.whitehouse.gov/OMB/infoereg/regpol-reports_congress.html for reports which present the costs and benefits of federal regulations. Annual costs and benefits data is available back to 1981.

not yet set a budget constraining the costs imposed from new regulations. Similarly, the academic literature on regulatory budgets is largely of US origin.³

6. The Better Regulation Task Force, in its “Regulation - Less is More” Report, published in March 2005 recommended:

“...that the Government should start developing a methodology for assessing the total cumulative costs of regulatory proposals. We believe that it should be possible to have the fundamental elements of such a methodology within the next two years. At this point, the Government should reassess whether full regulatory budgets, taking into account the cumulative impact of regulation, should be introduced”

7. In response to this recommendation the Government committed to explore a methodology to accurately measure the cumulative cost of regulation. The study, published by DTI in 2007⁴, found that it is very difficult to measure cumulative costs and that this would not be a practical way forward. It concluded that (accurate) aggregation of all regulatory impacts is only possible if all impacts are monetised and if all interactions between different regulations are taken into account. The Government accepts the conclusions of this research, that it would not be possible to estimate the total cost of the stock of regulation.

8. Since “Less is More” the better regulation agenda has gained momentum. A new Impact Assessment (IA) template was introduced in May 2007, to improve the quality and transparency of the cost-benefit analysis underlying regulatory decision making. The Administrative Burden Measurement Exercise has been completed and a target of a 25% reduction on the 2005 baseline in administrative burdens by 2010 set for departments. Simplification Plans, the means by which the reductions in Admin burdens are presented, have been published twice. Departments are on-track to meet the target.

9. In the Spending Review 2007, the PSA Delivery Agreement 6: Deliver the conditions for business success in the UK included an indicator of the total benefit/cost ratio of new regulations.⁵ The source for the data for the indicator will be IAs, the impacts presented in the new template. There are some technical issues to resolve, but the new data will come on-stream for 2008-09. Any move to a regulatory budget would use this data.

The costs of regulation

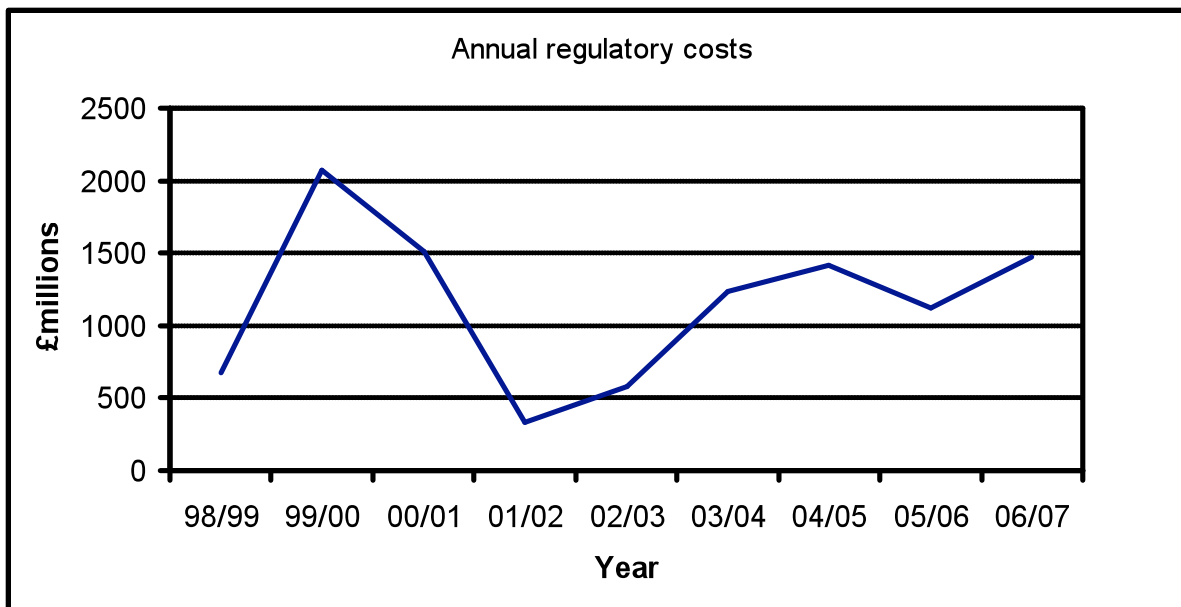
10. The flow of new regulation introduces about £1 -1½ billion of new costs every year⁶ – around 50%-70% of this originates in the EU. The chart below, based on data from the British Chamber of Commerce’s burdens barometer, shows the flow of regulatory costs from 1998 to 2006.

³ See for example a paper for the OECD “Controlling Regulatory Costs: The Use of Regulatory Budgeting” in 1992 by John Morrall of OIRA. The paper set out 10 requirements for a regulatory budget. The UK is close to having 9 of these, with the tenth being a clear constraint on costs of regulation. A number of the requirements relate to having clear source data.

⁴ www.berr.gov.uk/files/file35725.pdf.

⁵ See www.hm-treasury.gov.uk/media/1/D/pbr_csr07_psa6.pdf

⁶ Derived from British Chambers of Commerce data, which in turn is taken from Government Impact Assessments.



11. Over the last three years, 2004/05 to 2006/07, the annually recurring costs of new regulations introduced were £4,014 million. The corresponding monetised benefits amount to £2,062 million. This amounts to a benefit-cost ratio of $\frac{1}{2}$. However this includes regulations for which benefits are not monetised. Including only those IAs with monetised benefits the ratio rises to about 1⁷. This clearly indicates the difficulties faced by Government Departments in monetising benefits, and the strong need to improve this going forward.

The impact of the costs of regulation

12. Controlling the costs of regulation is important for the economy. The global economy is becoming more competitive. Many formerly heavily regulated countries are following the UK's lead and simplifying and eliminating regulation. While this presents opportunities for UK businesses in terms of new markets and access to new consumers, it also presents challenges. To remain competitive it is clear that the UK must keep its regulatory burden as light as possible.⁸

13. As well as international competitiveness better regulation is important to productivity, enterprise and economic growth for other reasons. The 'opportunity cost' of complying with a regulation diverts resources away from productive activities.⁹

14. The cost of regulation has an impact analogous to the effects of fiscal budgets.¹⁰

- macro effects – on output, employment, prices and growth. Public spending is financed by diverting resources from the private sector through taxation and borrowing. Similarly, business finance expenditures required by regulation by borrowing, increasing prices, reducing other expenditures, and reducing dividends. These are the same way firms finance taxes and have the same broad effects on the economy as do many taxes.

⁷ Source, British Chambers of Commerce data on Impact Assessments.

⁸ In 1997 the OECD reported that "regulatory costs are the least controlled and least accountable amongst government costs. Many governments have no idea how much of their national wealth they are spending through regulation."

⁹ "How Businesses Use Their Time" Barclays Bank plc 2003.

¹⁰ These are discussed in Morrall 1992, "Controlling Regulatory Costs: The Use of Regulatory Budgeting", OECD.

- micro effects – allocation of economic resources. Regulation, like public spending, diverts resources to public purposes. For some regulation could be an alternative means of achieving the same objective as spending. Basic allocative effects are similar, although the efficiency of the methods may differ.

15. Regulation can have an impact on the development of a business. The perception of regulation and in particular regarding the complexity of regulation relating to creating a business can adversely affect the decision to start up a business.¹¹ Regulation can also act as a barrier to growth by distorting the incentives for existing businesses, for example through the introduction of costs which make expansion uneconomic. 14 per cent of businesses surveyed stated that regulation is the main obstacle to growth.¹²

16. Regulation often imposes more than one type of cost those regulated. Economic efficiency losses from fulfilling the required outcome (for example, the purchase of specific equipment or adapting existing equipment to meet minimum standards) can not always be recouped. In addition there may be transfer costs, losses to one group in society that should be offset by gains to another group. For both of these there may be associated administrative costs (for example record keeping or reporting requirements). The cost of regulation, and the uncertainty from changing regulation, can have a disproportionate impact on smaller businesses.¹³

17. The impact of the costs of regulation on businesses is borne out in surveys. The NAO report that

“Although regulation is largely accepted as a ‘cost of doing business’, research has continually illustrated that businesses believe that complying with regulation is more time-consuming and costly than it should be and, therefore, a strain on company resources. Whereas the purpose regulations often understood, it is the cumulative burden of all regulations that makes complying resource-intensive, in particular for micro and small businesses. Business are concerned with the total cost of complying with regulation and rarely distinguish between administrative burdens and other costs.”¹⁴

18. The same report includes results from NAO’s own survey that “around three-fifths of respondents said that regulation is a key challenge and an obstacle to their business’ success.” Moreover, almost half of business rated a reduction in costs as a very important for the future success of business. Only just over 10% said cost reduction would not be important to their success.

19. In addition, the British Chamber of Commerce (BCC) argue that British business is feeling the pressure of an ever increasing burden of red tape. A Populus poll commissioned by the BCC showed that regulation remained the number one concern for businesses ahead of education and skills and the UK’s tax burden.¹⁵

Rationale for Intervention - Controlling the total costs of regulation

20. The absence of a strong control on the total costs that can be imposed on the economy through regulation is a form of regulatory failure, or governance failure, that generates negative externalities for the economy. The problem is that in the absence of some form of control of total regulatory costs, the Government, in its effort to address and correct market failures (e.g. environmental externalities) or

¹¹ Household Survey, Small Business Service 2005.

¹² Annual Small Business Survey 2006, BERR 2008.

¹³ Centre for Strategy and Evaluation Services LLP, forthcoming in BERR economic papers

¹⁴ National Audit Office, “Reducing the Cost of Complying with Regulations: The Delivery of the Administrative Burdens Reduction Programme, 2007”, July 2007.

¹⁵ See www.britishchambers.org.uk/6798219244850483614/regulation-and-red-tape.html

outcomes which society finds undesirable (e.g. inequalities in wealth, incomes or opportunities), can view the ability of the economy to absorb/respond to regulatory costs as unlimited. This could lead to over-regulation and potentially a higher level of costs than the optimum over a given time period (though there is no consensus what that optimum level is).

21. The gains from tackling the negative effects of regulation are potentially significant:

- The Government's initiative to set a target for reducing administrative burdens by 25 per cent by 2010 could increase UK GDP by 0.9 per cent by 2025.¹⁶
- Research into the macroeconomic impacts of regulation suggests that reform of regulation of product markets is positively correlated with total factor productivity growth, with the strongest impact from reforming administrative burdens.¹⁷
- Other research found a strong negative association between regulation and growth although this relationship is less strongly negative if the quality of institutions improves.¹⁸
- Some research focuses on the negative impacts arising when regulations create barriers to entry (e.g. Crafts, 2006:19). These barriers can constrain the intensity of competition – and also discourage the formation of firms²⁰ – as new firms find it harder to enter existing markets and compete with incumbent firms.²¹ This diminishing of competitive pressures can then reduce firms' incentives to innovate or to imitate²² (impeding technological diffusion).
- Negative impacts can also arise where regulations impede the adjustment of labour markets. Scarpetta and Tressel (2002)²³ find evidence to suggest that where strict employment protection legislation raises the costs of hiring and firing workers, and hence of labour adjustment in response to technical changes, this can reduce incentives to innovate, and hence can reduce productivity growth.

Policy Objective

22. The objective of the policy is to introduce a system to better manage the costs of new regulation, to prioritise those which deliver higher benefits and better controls the total costs imposed on the

¹⁶ The Lisbon Strategy – An estimation of the economic impact of reaching five Lisbon targets, Gelauf, G M. M. and A. M. Lejour, Industrial and Economic reforms Papers No 1. Brussels: European Commission 2006.

¹⁷ Regulation, Productivity and Growth: OECD Evidence, Nicoletti, G & Scarpetta, S., OECD Economics Department Working Paper 347, 2003.

¹⁸ Regulation and Macroeconomic Performance Loayza, N. V., Oviedo, A. M. & Servén, L., World Bank Policy Research Working Paper No 2469 2005.

¹⁹ Crafts, N., (2006): 'Regulation and Productivity Performance', Oxford Review of Economic Policy, vol. 22, no. 2.

²⁰ European Commission, (2006), "Economic reforms and competitiveness: key messages from the European Competitiveness Report 2006" cites internal work showing how GDP per capita is positively related to the ease of starting a business as measured in the World Bank's "Doing the Business" database.

²¹ Klapper et al (2004) find that the value added per employee (which is a measure of labour productivity) in "high entry" sectors grows more slowly in countries with restrictive regulations on entry. Klapper, L., Laeven, L. and Rajan, R. (2004): 'Business Environment and Firm Entry: Evidence from International Data', NBER Working Paper No.10380.

²² This has been lent support from firm-level studies such as Nickell et al (1997) which find that greater competition has a beneficial impact on productivity growth. Nickell, S., Nicolitsas, D. and Dryden, N. (1997): 'What makes firms perform well?' European Economic Review, Volume 41, Issues 43-45, pp 783-796.

²³ Scarpetta, S. and Tressel, T. (2002): 'Productivity and Convergence in a Panel of OECD Industries: Do Regulations and Institutions Matter?', OECD Economics Department Working Paper 342.

economy from regulation in a given period. The Government has considered a number of ways by which these objectives could be achieved

The current situation (Do nothing option)

23. There exist a number of checks in the system for developing regulation in which the costs from regulation are considered. The Government introduced a new template for Impact Assessments in 2007. The template makes the costs and benefits of new regulations explicit, to aid decision making by Ministers as to whether the costs justify the benefits of introducing the regulation, and aid scrutiny of regulatory proposals. However, the IA template only presents the costs and benefits from specific regulation being considered. It does not require any consideration of how the specific proposal will contribute to the total costs imposed by new regulations in same period.

24. Departments have processes to scrutinise the costs and benefits in IAs. And some scrutiny of ‘big ticket’ items is conducted by the Better Regulation Executive. Both of these checks in the system ensure the estimates of costs and benefits are as accurate as possible, that the regulatory options are properly considered and the appropriate response chosen. Parliament also scrutinises regulatory proposals (Explanatory Memorandum, investigations by Committees). While these scrutiny mechanisms look for the cost-effective approach none, as a matter of course, consider the contribution of the costs from the specific regulation to the total costs of regulation introduced in a period.

25. External scrutiny also exists. Business groups, and other organisations regularly respond to consultations which helps inform and shape regulatory proposals. In addition, the NAO undertakes an annual review of the Government’s Administrative Burden Reduction Programme. This looks at the Better Regulation Executive’s management of the 5-year programme and they make a value-for-money assessment. The detail of the review is on the simplification plans of the four departments (BERR, HMRC, HSE and CLG) responsible for the five most burdensome policy areas.²⁴ These are Planning Law, Company Law, Employment Law, Tax Law and Health and Safety Law. The NAO also publishes an annual review of the Government’s Impact Assessment process. They evaluate the standard of impact assessment and cost-benefit analysis of Government policies, and the extent to which the process is embedded in Government policy development.

26. Similarly, scrutiny exists at the EU level of final implementation of regulations originating from the EU. The UK must notify the Commission when it has transposed and implemented a Directive. The Commission then takes a view as to whether the transposed regulations meet the requirements of the original Directive. Again, these considerations do not consider the contribution of the costs from the specific regulation to the total costs introduced in a period.

27. The Panel for Regulatory Accountability (PRA) is a Cabinet Sub-Committee that was set up to ensure that proposals which imposed a significant regulatory burden were subject to external challenge. PRA’s terms of reference are to “ensure that the burden of regulation on business, the public sector and the third sector is kept to the minimum necessary”. PRA, for example, scrutinises proposals which are likely to impose a cost of over £20 million per annum on business, the public sector and/or the third sector or which would disproportionately impact on a particular sector to ensure the principles of good regulation are adhered to, and regulatory burdens are kept to a minimum.

28. However, none of these mechanisms routinely review and monitor the cumulative impact of each specific proposal on the total costs introduced from regulation or take a view as to whether the total costs introduced in a period are outweighed by the cumulative quantified benefits and are sensible and manageable. In other words, the current system could be reinforced to ensure that policy makers are forced to consider the opportunity cost/trade-offs between different regulations.

Further Improvements to the current system

²⁴ See www.nao.org.uk/pn/06-07/0607615.htm

29. The development of the better regulation agenda has come a long way. The Government has reformed and improved the Impact Assessment process and there has been a big move towards risk-based enforcement and inspection in response to the recommendations of the Hampton review. But these actions have not addressed the problem that the system does not encourage a wider perspective and consideration of the total cumulative impacts of regulation when considering a single proposal. The current system could be further improved.

30. From 2008 the Government will publish a **benefit-cost ratio** indicator showing the ratio of the total benefits to the total costs from regulation over the last year.²⁵ The Government is developing the form that the reporting on the indicator will take. The new IA library, launched in April 2008, will make collecting and collating costs and benefits data straightforward and could be used for moving to regulatory budgets discussed below.²⁶

Publish regulatory accounts

31. Presentation of the benefit-cost ratio may require presentation of the costs and benefits data in level, or £ million, terms, as well to help explain it. Such information would effectively constitute **publishing annual accounts** of total regulatory costs and benefits introduced each year. This would be similar to the accounts for federal regulations published by the Office of Information and Regulatory Affairs, part of the White House, in the US.²⁷ However, accounts would not, in themselves, directly constrain any of the costs of regulation or incentivise behaviour, and therefore tackle the problem identified, although the transparency of the regulatory account system would enable greater external challenge of government proposals.

More robust process to determine regulatory priorities

32. The Government could go further and put in place a more **robust process to determine the government's regulatory priorities** to explicitly consider the total impact of regulatory proposals. The output of such a process could be a plan of regulations (introduced through primary and secondary legislation), including simplification and removal measures, for a number of years ahead. Such a plan is produced annually by the European Commission, looking one year ahead. No such formal process exists at present – the draft legislative programme is for one year ahead and only includes primary legislation.

33. The benefit of this approach should be better prioritised regulation. In practice this would mean departments and regulators would be able to better allocate resources to prioritised areas and focus on the most important regulations. In so far as better prioritisation would also give greater certainty to the regulated community they would also be able to better plan their resource allocation. However, the scale of the benefits will depend on whether better planned and prioritised regulation will be more effective and less costly.

34. To make a cross-government prioritisation process work, departments and regulators would need to estimate the impacts of regulation on a consistent basis, using the same methodology. They would also need to develop their forward planning and associated estimates of costs and benefits.

35. A clear basis on which to prioritise regulatory proposals would be required. This could be by cost-effectiveness of the proposed regulations or the net benefit they deliver. However, without some form of anchor or constraint there is no guarantee such a process would control the total costs of

²⁵ This is for Public Service Agreement 6 “Deliver the conditions for business success in the UK”, see indicator 5 “ deliver better regulation that works for everyone at www.hm-treasury.gov.uk/media/1/D/pbr_csr07_psa6.pdf

²⁶ Available at www.ialibrary.berr.gov.uk

²⁷ See, for example, the Draft 2007 Report to Congress on the Costs and Benefits of Federal Regulations at www.whitehouse.gov/omb/inforeg/regpol-reports_congress.html

regulation introduced and lead to effective prioritisation. Indeed, the requirements for such a prioritisation are not much different to the requirements for a regulatory budget.

Minimum cost-benefit ratio

36. Because regulation should always be introduced for a reason – to address risk or tackle a specific problem or to deliver social objectives – an objective of every regulation should be to maximise the net benefit from introducing the regulation. Although departments already take account of costs and benefits in decisions on whether to regulate, this could be taken further by setting a minimum net benefit requirement for all departments to deliver.

37. The benefit of such an approach is that it should drive more effective prioritisation and deliver higher net benefits. However, while this approach may stop regulations with low net benefits it would not necessarily constrain the total costs introduced over a period. It is also hard to value some benefits, which in turn makes comparing benefit-cost ratios difficult for a number of regulatory interventions. And ratio numbers will be affected where costs are very small yet benefits very large (the ratio tends to infinity), where costs are very large and benefits are small (ratio tending to zero) and where most of the impacts from a regulation relate to a transfer from one group to another (the ratio tends to 1).

Introduce Regulatory Budgets

38. The discussion above demonstrates that steps involving greater transparency and forward prioritisation alone would not necessarily limit the total costs of regulation nor ensure effective prioritisation of regulatory proposals. This greater level of control could be achieved by developing a system which sets a constraint on the costs of regulation introduced in any specified period – a regulatory budget.

39. A system which **set a constraint, or budget**, on the costs of regulation introduced in any specified period is called a ‘regulatory budget’. A budget focuses on the costs from new regulations introduced, not the costs from regulations already in force. However, the proposal on which the Government is consulting is a budget which would allow for offsetting simplification of existing regulations to be off-set against the budget for new regulations.

40. The objective of a regulatory budget regime is to act as a discipline on policy makers and government so that regulatory costs are imposed on the economy only within an agreed limit that takes account of the overall impact of regulation on the economy, thereby improving prioritisation across Government and ensuring that only the most cost-effective regulation is implemented.

41. The operation of a regulatory budget would not directly focus on the benefits of regulation. The scale of the benefits to be delivered through proposed regulatory intervention would be considered when the Government sets the level of the budgets. The form of the constraint itself would not contain any reference to the benefits from regulation. Having set the budget levels, Government will prioritise those regulations it wants to introduce, on the basis of the highest benefits that can be delivered subject to the cost constraint. It will be for departments to ensure they deliver on those benefits. To this end, the reporting on performance against the budgets will include reporting on the delivery of the benefits.

42. There are two general options for a budget:

- Set an acceptable **level** of cost. There are a number of possible permutations, however there are two possible broad approaches:
 - A) A target on the size of costs from the stock of regulation – similar to the admin burden target but for policy costs. This approach is not practical because measuring the policy costs of the

stock of regulation would be enormously difficult and costly.²⁸ Measuring the policy costs would also inevitably lead to a large number – which could undermine the credibility of the approach.

B) A commitment to cap the annualised recurring costs and transitional costs (or the equivalent annual cost of the present value) of new regulation, probably for a three year rolling period (like spending review periods). This would need to be cascaded to departments, and measures which reduce the costs of regulation would offset measures which impose new burdens.

- Set an acceptable **rate of change** (increase or decrease) in costs from regulation - given that in a growing economy there is a case for sharing some of the benefits from growth through regulation to set, or raise minimum, standards, one option might be to constrain the growth in costs of regulation to the rate of GDP growth.²⁹ An alternate approach would be to set a constraint on the rate at which the costs of regulation can grow.³⁰ As with setting a constraint on the level of costs, there is no analysis to support, or agreement, of the optimal rate at which the costs of regulation should increase. An alternate way of viewing this approach would be to set the rate of change in terms of the equivalent level of costs. This therefore implies that if new regulatory costs were constrained to a proportion of GDP, the new costs of regulation would increase by an amount as a proportion of GDP.

43. Estimating the costs of the stock of regulations in effect would be prohibitively expensive. The cost to estimate administrative burdens alone, which can be relatively easily measured, was over £12m.³¹ A particular difficulty in estimating the stock of regulatory costs is defining the appropriate counterfactual – should it be no regulation at all?

44. The form of **the proposed regulatory budget is to set a constraint on the level of new costs that can be introduced in a given period** from new regulations, offset by savings from removing or simplifying existing regulations. This is set out in the consultation document. The baseline, or counterfactual, against which the proposal in the consultation document is to be assessed is the option of doing nothing to amend the current system beyond those developments which are already planned, in particular the publication of a benefit-cost ratio and associated information.

Benefits

45. A regulatory budget would deliver two key benefits:

- By constraining the amount of resources available should result in a more cost effective allocation of resources. Treating regulatory costs as a free good offers little hope they will be allocated in a cost-effective manner.
- Budgets would require explicit consideration of the aggregate costs of regulation. Allocation processes should then balance the public benefits with the social costs of the private resources used.

²⁸ DTI Occasional Paper No 7, “The impact of Regulation: A Pilot Study of the Incremental Costs and Benefits of Consumer and Competition Regulations” by Frontier Economics published November 2006, found estimating the impacts of existing regulations to be very difficult. Problems identified include the choice of appropriate counter-factual and estimation technique.

²⁹ Set the constraint as a proportion of the increase in GDP in £millions.

³⁰ The growth rate could be set based on the stock of the costs of regulation, but this would be very difficult and expensive to determine.

³¹ This includes the cost for work undertaken by PWC and does not include the cost of estimating the administrative burdens of HMRC of the Financial Services Authority. Also, it does not include the cost to Government departments of the measurement exercise.

46. The scale of the impact on total regulatory costs will depend on the level at which the budgets are set. This could include lower total costs over a given period than would otherwise be the case. There would also be other benefits:

- Greater prioritisation within a regulatory budget constraint should improve the benefit-cost ratio of regulations taken forward, as those which deliver most benefits receive prioritisation. In other words, greater benefits could be delivered for the same or lower costs. The benefits of this are that business, the third sector and the public sector can use the costs 'saved' to allocate to more value-added productive activities.
- There would be greater certainty to the regulated community from more explicit forward plans for regulation from departments. Greater certainty normally manifests in a lower risk premium. This could be important for business in particular. One would normally look at changes in market instruments to judge the extent of the reduction in risk premiums. But it is not possible to do this until the regulatory budgets proposal is more certain and likely budget levels set.
- A 'regulatory budget' (to sit alongside the fiscal budget) would enable a full accounting of the Government's role in the economy, preventing use of regulation to move spending off-budget when spending constraints are tight.
- An overall constraint on regulation would force a better ranking of risks that departments and agencies are trying to protect against, resulting in a clearer recognition of the opportunity costs of action, a better appreciation of the economic impact of regulation and an improved prioritisation of Government interventions.
- Introducing such a constraint would be a very powerful statement of the Government's regulatory priorities and provide greater certainty to the regulated community of the Government's intentions and likely impact.

47. Without having determined the level of the budget constraint, or the likely regulations that the government will introduce over a regulatory budget period, it is not possible to estimate the full scale of the benefits from introducing regulatory budgets. Therefore we present a hypothetical example of the benefits that could be achieved through setting a budget that would reduce costs. However, depending upon the legislative programme of Government, the benefits forgone by reducing this, possible priorities for regulations and the economic outlook, it may not be appropriate to set the budget as suggested below.

48. An illustrative example of the possible benefits:

- Assume before a regulatory budget there are 5 regulations with an overall benefit-cost ratio of $\pounds 120/\pounds 100 = 1.2$
- Suppose one of the five regulations has benefit-cost ratio of $\pounds 8/\pounds 8 = 1.0$. If this regulation receives no budget cover and is not introduced, overall the ratio would increase to 1.22 ($\pounds 112/\pounds 92$), with no noticeable gain in welfare.
- But, the application of the regulatory budget will also increase the incentive on policy makers to pare back the costs of the remaining 4 regulations, say by $\pounds 22$. The overall benefit-cost ratio would then become $\pounds 112/\pounds 70 = 1.6$. In other words, a measurable net welfare gain of $\pounds 22$
- Further benefits would come from those regulated using the $\pounds 30$ cost saving to undertake more productive activity.

49. We can apply this approach in the above illustrative example to historical numbers for costs and benefits to derive the possible scale of the impact of introducing a regulatory budget under some

assumptions. The historical level of monetised annually recurring costs and benefits is between £1-1.5 billion, with a benefit-cost ratio of about 1. Assuming the introduction of a budget:

- Reduces the costs of regulation by 10% because of improved incentives to bear down on costs from having a regulatory budget; and
- Leads to an improvement in the benefit-cost ratio to 1.1 from better prioritisation of regulations; and
- Costs and benefits from new regulations are £1.5 billion per year.

50. In this hypothetical scenario, the costs of regulation would fall by £150 million (10% of £1.5 billion). This would be a benefit to the regulated community, costs they would otherwise have to bear in the absence of a regulatory budget. Indeed, the total benefits from this fall in costs would be expected to be higher than £150 million as the cost saving could be put to more productive activity by business or the public sector and would materialise as additional output. In this hypothetical scenario, the total benefits from new regulation would also fall, by £15 million, to £1.485 billion (derived from cost of £1.35 billion and a benefit-cost ratio of 1.1). Two effects lead to the fall in total benefits: better prioritisation of regulations leads to some marginal regulations not being taken forward, reducing total benefits delivered. But this, in part, is offset by an increase in benefits from prioritising regulations with the highest net benefits. These two effects reflect an increase in the benefit-cost ratio to 1.1. Overall, the £15 million costs amount to benefits forgone. Despite a reduction in benefits, there would be a hypothetical increase in the net benefit of £135 million.

51. The above estimates are based upon a hypothetical example of how regulatory budgets might impact on behaviour. The real impacts of regulatory budgets will depend upon both the level at which the budget is set, the future legislation that Government is intending to bring forward and the extent to which those regulations differ from what they would have been in the absence of a regulatory budget. Setting budgets at levels that allow the Government to take forward its entire legislative programme would not provide an incentive to reduce regulatory costs. The budget would need to be set in a way that encourages Departments to find new simplification ideas and to improve the quality (higher benefit; lower cost) of its regulatory proposals. It will also be set in a way that acknowledges the benefits forgone from placing a constraint on new regulation.

52. The levels of any regulatory budgets have not yet been decided - the optimal budget could be associated with increasing or decreasing regulatory costs. Any future decision will need to take account of all of these factors to ensure the system delivers reduced costs of regulation whilst limiting any negative impacts through preventing Government introducing worthwhile legislation. The costs and benefits of any final budget set will be presented in a future Impact Assessment

Costs

53. There are costs from introducing a regulatory budget:

- There are direct costs of managing the regulatory budget system. No such system currently exists, although many of the building blocks currently do exist.
- There would be costs in the form of benefits forgone from not taking forward regulation or delaying it. To this end welfare may not be maximised by constraining the benefits that can be introduced if those regulations that are delayed have a benefit-cost ratio greater than 1. Where benefits forgone are from regulations with costs greater than benefits, there would be an unambiguous improvement in welfare. The scale of these costs is dependent on the level at which the budget is set;
- On the other hand, if the overall constraint is set at too high a level, or rate of change, too many costs might be allowed to affect the economy;

54. As with estimating the scale of the benefits, the scale of the costs involved, especially those from stopping or delaying regulations, is dependent on the level at which the budgets are set.

55. It is possible to estimate the costs associated with introducing and managing the new system:

- The Better Regulation Executive would oversee and manage the new system, working with departments and regulators, requiring up to 13 new staff to do so at a cost of £845,000 per year.³²
- There would be new work involved for departments and regulators from operating the new system, including bidding, forward planning and reporting. Much of the structure to run a regulatory budget already exists – plans for regulation which the Government would like to introduce exist, and costs and benefit information is provided in IAs. Additional work will be required to undertake the better planning and collating for reporting purposes. This could amount to 1-2 new staff per department/regulator depending on the size and amount of regulation each department handles. This would amount to £1.95 million per year.³³
- In addition it is possible that there may be some IT infrastructure required to support the new regulatory budgets system. The Government intends to build on existing systems and use standardised systems as far as possible – for example, the new IA library provides a means of collating the costs and benefits of published IAs. An early estimate is that IT costs might amount to £50,000 per year.

56. In total, these costs could amount to a total of £2.85 million per year in the steady state.³⁴

57. There will be some transitional costs from putting the new processes in place. In the first instance, developing a comprehensive plan of the regulations Government wishes to introduce and the associated costs and benefits may take some resources. Initial work by the Department for Business Enterprise and Regulatory Reform suggest this would amount to 2-3 weeks of one official’s time at cost of £2,500 to £3,750.³⁵ If this is replicated across all 20 departments and, say up to 5 regulators, total costs could be up to £100,000. However, costs for many other departments with fewer regulations should be smaller as BERR is a large department with over 50 regulations in the pipeline. Further costs of engaging in the budget setting process would be similar to the on-going costs estimated above.

58. As a regulatory budget has not been introduced anywhere in the world, the Government has therefore decided it would be sensible and cautious to test the system, to identify potential problems, via a shadow roll-out. The Enterprise Strategy said the Government would consider a pilot for regulatory budgets by SME or by sector. This can not be done for practical measurement reasons. The Government has considered a pilot by department as an alternative but such an approach would not test the cross-Government prioritisation mechanism of a budget nor deliver the associated benefits. The Government has therefore decided to implement regulatory budgets via a shadow roll out. This would involve:

- Departments are set a regulatory budget using the budget system and for the period agreed following consultation, but for the first year budgets are run in shadow form;
- For that first, shadow, year, Departments commit to live within their budgets and to abide by the mechanisms which are put in place for managing regulatory pressures, so, for example, contingency budget arrangements apply; Ministers are asked to look hard at reprioritisation and other options.

³² This is based on staff costs, including on-costs (for example, employer NICs), of £57,000 per year for an average mid-grade civil servant plus £8,000 in overheads, total £65,000 per member of staff. 13 new staff would be required, 10 to work directly with departments and regulators and 3 in a central team.

³³ This is based on staff costs, including on-costs, of £57,000 per year for an average mid-grade civil servant plus £8,000 in overheads, total £65,000 per member of staff and 30 new staff across all departments and regulators, 1-2 staff per department (20) and in the largest regulators.

³⁴ This is based on 10 new staff for the Better Regulation Executive to manage the central coordination mechanism and one additional staff member in 20 departments and regulators. Staff are assumed to be mid-grade with staff costs of £65,000 (staff costs of £57,000 including on-costs per year plus £8,000 in overheads).

³⁵ Derived as 2-3 weeks out of 52 of one official at mid-range salary of £57,000, including on-costs plus £8,000 overheads.

- There are no sanctions if Departments do exceed their budgets during the shadow running year, the Government would give budgets a serious test with the chance to learn from experience and adjust the system if necessary;
- This is accompanied by an active learning process, to identify problems as they happen, and start to design solutions / adjustments which can then be put into the system for full running (including allowing government to learn from attempts to forecast the initial budget and gives Departments time to put robust plans, assessments, etc, in place).

59. This approach would deliver many of the benefits identified above but further allows the new system to be tested and any problems identified and resolved before the full system is implemented. The shadow period will be used a valuable learning period and avoid undermining the wider objectives of the better regulation agenda should problems arise. A drawback of this approach is that the formal consequences of not meeting a budget would not be implemented and therefore would not be tested.

60. The direct costs involved would be the same as for a full roll out as the same amount of initial work to set out the regulatory plans for departments and the associated costs and benefits would be required. The system would operate the same monitoring processes during the shadow running year and so would require the extra staff for both the Better Regulation Executive and in departments. The costs not met from not operating the sanctions mechanism in the first, shadow, year, would likely be small.

Risks

61. There are risks associated with implementing a regulatory budget, in either shadow or full form :

- Consideration of department's forward plans and proposals for regulation to introduce, and the associated costs, will inform the decision on the level at which budgets are set. There is a risk that in estimating the costs for proposed regulations, departments will be unable to accurately estimate the likely impacts. In part this will be due to not knowing which options may be adopted, or indeed, what policy approaches may be considered to tackle identified problems. This risk will increase towards the later years of the budget period. But there is also a risk that estimates of impacts (both costs and benefits) turn out to be inaccurate as better information becomes available. To minimise these risks, it will be important that early estimates of impacts are as accurate as possible, and that the process and supporting methodology has a clear mechanism to manage changes to estimates of impacts.
- IAs provide the source of the information for any budget. To make the system work good estimation of impacts is required in IAs. A particular problem is that not all impacts can be monetised. For example, a non-monetised benefit from the UK adopting an international agreement could be that it enhances the UK's international standing or future negotiating position. Where impacts can not be monetised, the budget system will be incomplete. To mitigate this risk, it will be essential that all benefits and costs are identified, and recognised in setting the budgets and in monitoring performance against them. Ex post reviews of the implementation of regulations could also provide useful evidence of the actual scale of impacts.
- A new regulatory budgets system risks creating new incentives for departments to game the system by misrepresenting the true impacts of regulatory proposals by over or under estimating costs and benefits. Any such gaming could undermine the credibility of the system. To mitigate this risk, a strong scrutiny process would be required. The consultation document discusses what scrutiny of an IA would be required to ensure it was effectively fit for purpose.
- There is a risk to the credibility of the government's better regulation agenda if the design of the system creates incentives on departments and Ministers to regulate in inefficient and inappropriate ways. A particular source for such perverse incentives could be inappropriate boundaries for which costs and regulations are included within a budget. The mitigation of this risk involves full engagement across government and other stakeholders to design the system, including the appropriate boundaries, including through the consultation exercise.

- There are risks to the credibility of system from the level at which budgets are set. Budgets set at too high a level would not sufficiently constrain the level of new costs introduced; while budgets set at too low a level would not be able to deliver the regulations needed to deliver the government's objectives and may prevent regulations which are generally agreed as necessary. The Government will need to consider and weigh these risks when setting the level of budgets.

Enforcement and Implementation

62. Enforcement of compliance with regulatory budgets will be conducted by the Better Regulation Executive and possibly by a new independent body which would scrutinise the quality and content of Impact Assessments. The costs for these activities are outlined above.

Monitoring and Evaluation

63. An evaluation of the regulatory budgets system will be undertaken in Autumn 2009 and will explore the performance of the system under shadow running and whether the system needs to be adjusted before proceeding to full roll-out. Such an assessment would determine whether there are any problems or weaknesses in the system design, rather than the level of budgets, and would include proposals for how to respond to them.

64. There would also be an evaluation towards the end of the budget period, to inform the setting of budget for the second budget period. The change in budget periods provides a natural point at which a review should take place. Performance by departments against their budgets would be part of the review as the reviews would form part of the process for setting subsequent budget periods, in a similar way to the process of review underlying the Spending Review

SPECIFIC IMPACT TESTS

Competition Assessment

65. The introduction of a regulatory budget will have no direct effect on competition. Indeed, by proposing to exclude the competition authorities and economic functions of the economic regulators from the budgets, budgets will not in any way constrain the activities of these regulators to promote a competitive environment. However, the application of a budget level may have effect on competition in the future depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Small Firms Impact Test

The Enterprise Strategy identified that the cost of regulation can have a disproportionate impact on smaller businesses.³⁶ The impact on small firms will depend on the level at which the budget is set and hence the amount of costs that can be introduced through regulation. The benefits from any constraint would also, therefore, be disproportionately felt by small firms. The actual costs and benefits will depend on the regulations that are prioritised within a budget and those regulations that are foregone.

Legal Aid

66. The introduction of a regulatory budget will have no direct effect on legal aid. However, the application of a budget level may have effect on the future demand on legal aid depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Sustainable Development

³⁶ See page 67 "Enterprise: unlocking the UK's talent", March 2008 available at www.hm-treasury.gov.uk/media/E/3/bud08_enterprise_524.pdf

67. The introduction of a regulatory budget will have no direct effect on sustainable development. However, the application of a budget level may have effect on sustainable development in the future depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Carbon Assessment

68. The introduction of a regulatory budget will have no direct effect on carbon outputs because regulatory budgets are a process for decision making. Any impacts on carbon emissions will depend on the levels at which regulatory budgets are set and decisions by the Government as to which regulations will be prioritised and therefore allocated regulatory budget. However, as regulations which address climate change will be managed outside a system of regulatory budgets these impacts are not likely to be large. The impacts will therefore depend on the extent to which regulations which are not intended to address climate change will have a secondary impact on carbon emissions, and specifically how those impacts differ from what they would have been in the absence of a regulatory budget system.

Other Environment

69. The introduction of a regulatory budget will have no direct effect on other aspects of the environment. However, the application of a budget level may have effect on the future impact on the environment depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover. It may also be affected to the extent that a ring fence for regulations to tackle climate change will affect other aspects of the environment.

Health Impact Assessment

70. The introduction of a regulatory budget will have no direct effect on health. However, the application of a budget level may have effect on health in the future depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Race, Disability and Gender Equality

71. The introduction of regulatory budgets will, in itself, have no direct effect on outcomes on specific groups in terms of race, gender or disability because regulatory budgets are a process for decision making. Any impacts on specific groups, by race, gender, disability or sexual orientation, will depend on the levels at which regulatory budgets are set for each Department and decisions by the Government as to which regulations will be prioritised and therefore allocated regulatory budget. The impacts on those groups will include the impact of regulations which are taken forward because they are given budget cover and specifically how those impacts differ from what they would have been in the absence of a regulatory budget system, and the impacts foregone from regulations which are not taken forward because they are not given budget cover. The overall impact will depend on the mix of regulations and the individual impacts of each of those regulations. The total impact from prioritisation of regulations could be both positive and negative.

72. Given the difficulty in assessing the eventual overall impacts on specific groups at this stage, an assessment of the impact on those groups needs to be made as part of the budget setting process for each Department, as budget levels are set and priorities for regulations to be taken forward are proposed and agreed. The information for such an overall assessment of the impact on specific groups of a regulatory budget system will wherever possible come from the assessments of the equality impacts on specific groups for those regulatory proposals, including those which are included in Departmental planning because they are allocated a budget and those which are not included because they receive no budget. However, for years 2 and 3 of the budget full equality impact assessments may not be available for all proposals, so estimates of the equality impact of such proposals will be needed.

Human Rights

73. The introduction of a regulatory budget will have no direct effect on human rights. However, the application of a budget level may have effect on human rights in the future depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Rural Proofing

74. The introduction of a regulatory budget will have no direct effect rural proofing. However, the application of a budget level may have effect on rural proofing in the future depending on what regulatory proposals are brought forward in the future, the level at which budgets are set and whether the specific proposals will be prioritised by Government and allocated sufficient regulatory budget cover.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Small Firms Impact Test	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Legal Aid	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Sustainable Development	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Carbon Assessment	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Other Environment	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Health Impact Assessment	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Race Equality	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Disability Equality	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Gender Equality	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Human Rights	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Rural Proofing	<input type="checkbox"/> Yes	<input type="checkbox"/> No

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