

# HELPING REGULATION TO PROMOTE INNOVATION

## Introduction

As the Department responsible for promoting innovation across Government, DIUS has been leading a project with the Department for Business, Enterprise and Regulatory Reform (BERR) and the Better Regulation Executive (BRE) to understand better the ways in which regulation may help or hinder innovation, particularly by business. This arose from a commitment made in the *Innovation Nation* White Paper<sup>1</sup> published in March 2008.

As part of this work, we have held initial discussions with the Confederation of British Industry and the EEF as well as most of the independent regulators<sup>2</sup> and our initial findings were presented to a recent major conference on better regulation<sup>3</sup>.

At the same time, we have also carried out a review of the case study evidence in order to identify the circumstances under which regulation may help or hinder innovation. The evidence suggests that the relationship between regulation and innovation is complex and dynamic. Regulation in conjunction with other government policies can alter the rewards, risks and costs of innovation as well as the demand for consumers to adopt new products, services and technologies. The relationship is also dynamic with changes in innovation behaviour and outputs feeding back to affect regulatory outcomes and policy objectives.

We have found that the way in which regulation is designed, implemented and enforced plays a major role in influencing innovation. The evidence suggests that regulation may have a positive impact on innovation if it is performance or outcome-based, imposes minimum burdens on business and gives firms sufficient time to comply with new regulatory requirements.

From our discussions and research<sup>4</sup>, we have developed a voluntary checklist of principles for regulation to help promote innovation which we believe will be helpful for regulators and practitioners to consider in their work and should deliver better long term outcomes.

We would welcome views on this work by the end of February 2009<sup>5</sup>. DIUS, BERR and BRE will revisit the principles in the context of Government's ongoing development of its Better Regulation agenda.

## Why consider innovation?

Innovation – the successful exploitation of new ideas – is a key driver of productivity, competitiveness and economic prosperity. It can also play an important role in tackling major social challenges such as climate change and energy security.

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<sup>1</sup> <http://www.dius.gov.uk/publications/innovation-nation.html>

<sup>2</sup> Ofcom, Ofgem, Ofwat, Postcomm, The Competition Commission, The Pensions Regulator, Office of the Rail Regulator, Office of Fair Trading, Civil Aviation Authority, Health and Safety Executive, Environment Agency and the Food Standards Agency.

<sup>3</sup> *The new regulatory agenda: light touch, heavy expectation?* London, 18 September 2008

<sup>4</sup> The supporting evidence will be published as a joint BERR/DIUS Economics Paper later in December 2008 <http://www.berr.gov.uk/publications/economicstatistics/economics-directorate/page14636.html>

<sup>5</sup> Please send comments on this work to: [david.rawlins@dius.gsi.gov.uk](mailto:david.rawlins@dius.gsi.gov.uk) by 28 February 2009

Innovation can be technological and non-technological and take place at any stage from product design and development through production to sales and marketing.

**Policy-makers and legislators** should take account of the guidance and good practice that exists. For example, the competition test for Regulatory Impact Assessments explicitly asks about the impact of new proposals on innovation (Box 1)<sup>6</sup>.

#### **Box 1: Innovation as part of the Competition Test in Regulatory Impact Assessments<sup>7</sup>**

Question 3, which asks whether proposals will limit the ability of suppliers to compete, advises policy makers and analysts to consider as part of their assessment whether proposals limit the scope of firms to introduce new products or supply existing products in new ways

Many of the independent **regulators** have the promotion of competition as one of their statutory purposes and even where they do not, must consider the state of competition in the markets in which they operate in order properly to inform their work. As above, market innovation is an important factor in properly considering competition.

The Regulators Compliance Code<sup>8</sup> makes no specific provision about considering innovation but it does include a duty to consider effects of regulatory interventions on economic progress (Box 2). Innovation is one of the essential drivers of productivity and a consideration of how a regulation affects innovation may be one of the ways in which regulators can demonstrate compliance with the code.

#### **Box 2: Regulators' Compliance Code**

*Para 3.1* Regulators should consider the impact that their regulatory interventions may have on economic progress, including through consideration of the costs, effectiveness and perceptions of fairness of regulation. They should only adopt a particular approach if the benefits justify the costs and it entails the minimum burden compatible with achieving their objectives.

**Practitioners involved in implementation and enforcement** often come across businesses trying to innovate in the ways that they operate or the products they produce. Sometimes this innovation has the wrong motive – to avoid proper compliance with regulation aimed at protecting the public. But sometimes a potentially beneficial outcome is precluded by the way that regulations are framed or interpreted. We suggest that the views of people working on the front line are crucial in helping get the balance right between risks and benefits of innovation.

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<sup>6</sup> HMT *The Green Book* <http://greenbook.treasury.gov.uk/>

<sup>7</sup> OFT (2007) *Completing competition assessments in impact assessments: guidelines for policy makers*

<sup>8</sup> Regulators' Compliance Code: Statutory Code of Conduct for Regulators. BERR, 2007. URN 07/1707 <http://www.berr.gov.uk/files/file45019.pdf>

## **Checklist to help regulators promote innovation**

### **1. Consider how regulation may impact on beneficial innovation activity**

Regulatory interventions can impact on different parts of the innovation process influencing decisions on innovation inputs (such as R&D investment) and outcomes (such as the characteristics of new products). Innovation can also be a response to avoid regulation. Consider how the incentives established or influenced by the regulation are likely to promote innovation which achieve better outcomes and aim to avoid, as far as possible, responses which may in themselves be innovative but do not achieve better outcomes.

### **2. Consider how interaction with the stock of existing regulations may affect innovation**

New regulatory interventions may complement existing ones in strengthening the incentives to innovate or they may interact in a way which leads to unintended consequences or actions that prevent innovation or create distortions in the innovation process. Consider how this may happen in developing and consulting on regulatory proposals and where possible, favour approaches that do not hinder or distort the ability of the market to innovate.

### **3. Favour regulatory approaches that are outcome-focused and technology neutral**

A prescriptive stance allows regulators to decide on an approach or technology for the market. This provides certainty but locking the market into a particular technology risks “picking winners” and a sub-optimal approach being chosen or preventing the market being able to take advantage of better solutions coming along later. A more outcome-based approach and one that is technologically neutral gives firms and the market greater freedom to innovate.

### **4. Consider how implementation and enforcement can promote innovation**

People responsible for implementing and enforcing regulation on the ground often look for very prescriptive guidance – it avoids the risk of criticism if something goes wrong – and in some cases, for example in food safety, this is justifiable. But strict application of rigid guidelines can preclude innovations which may ultimately lead to better outcomes. Consider how the knowledge of those on the front line can be used to frame guidance to manage risk effectively whilst not precluding innovative approaches.

### **5. Consider the effects of timing of regulation on innovation**

Regulations may be reviewed periodically or in response to changed objectives or innovations in markets or products. The frequency of review may itself have an impact on the incentives to innovate, for example too frequent review of price regulation may undermine the returns to a particular company on investment in technological innovation. In reviewing regulation, consider the effects that doing so at a particular time or frequency may have and aim to avoid disincentives to innovation where possible.