

The Paradox of Regulation

What Regulation
Can Achieve and
What it Cannot

Fiona Haines

**Society bound
up in red tape**

Oil refinery disaster

Economy in freefall

The Nanny State

**Contradictory messages and
its impact on regulation**

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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book is available from the British Library

Library of Congress Control Number: 2011924288



ISBN 978 1 84844 863 6 (cased)

Typeset by Cambrian Typesetters, Camberley, Surrey
Printed and bound by MPG Books Group, UK

Abbreviations

AASB	Australian Accounting Standard Board
ABC	Australian Broadcasting Corporation
ACCC	Australian Competition and Consumer Commission
AFP	Australian Federal Police
AIFRS	Australian International Financial Reporting Standards
ALP	Australian Labor Party
APRA	Australian Prudential Regulatory Authority
AQIS	Australian Quarantine and Inspection Service
ASIC	Australian Securities and Investments Commission
ASIC	Aviation Security Identification Card
ASIO	Australian Security and Intelligence Organisation
AUASB	Australian Auditing Standards Board
AVID	Aviation Identification
BRTF	Better Regulation Task Force
CBA	Cost Benefit Analysis
CLERP 9	Corporate Law and Economic Reform Program 9
CoAG	Council of Australian Governments
CSI	Container Security Initiative
CTFR	Counter Terrorism First Response
Customs	Australian Customs Service
DFAT	Department of Foreign Affairs and Trade
DIPNR	Department of Infrastructure, Planning and Natural Resources (NSW)
DOTARS	Department of Transport and Regional Services (later renamed Office of Transport Security (OTS))
DOFI	Direct Offshore Foreign Insurers
ERA	Esso Resources Australia (also referred to as 'Esso')
ESC	Essential Services Commission (Victoria)
ESV	Energy Safe Victoria
ETD	Explosives Trace Detection
FCR	Financial Condition Report
FITB	Future Income Tax Benefits
FRP	Financial Reporting Panel
HAZOP	Systematic Hazard Analysis (lit. Hazard and Operability Study)

HIH	HIH (Insurance) Pty Ltd
IASB	International Accounting Standards Board
ICA	Insurance Council of Australia
ICAA	Institute of Chartered Accountants of Australia
IFRS	International Financial Reporting Standards
ISPC	International Ship and Port Facilities Code
KPI	Key Performance Indicators
MHF	Major Hazard Facility
MHU	Major Hazards Unit of Victorian WorkSafe
MNC/MNE	Multinational Corporation/Enterprise
MSIC	Marine Security Identity Card
MUA	Maritime Union of Australia
NCTC	National Counter Terrorism Committee
NOHSC	National Occupational Health and Safety Commission
NOPSA	National Offshore Petroleum Safety Authority
NSW	New South Wales
NT	Northern Territory
OCL	Outstanding Claims Liabilities
OCP	Outstanding Claims Provisions
ODRC	Optimised Depreciated Replacement Cost
OECD	Organisation for Economic Co-operation and Development
OHS	Occupational Health and Safety
ONA	Office of National Assessments
OTS	Office of Transport Security
PAIRS	Probability and Impact Rating System
RPT	Regular Public Transport
SOARS	Supervisory Oversight and Response System
TSP	Transport Security Plan
VIC	Visitor Identification Card
VWA	Victorian WorkCover Authority that housed WorkSafe the Occupational Health and Safety regulator

Acknowledgements

This research has constituted a considerable part of my professional and personal life for the past six years. It has benefitted enormously from the support and collaboration from colleagues, research participants and friends. The project began as part of a research partnership with my dear friend and long-time collaborator Adam Sutton. His contribution to this work is considerable and I owe him an enormous debt of gratitude for many of the ideas and concepts elaborated on in this book. Indeed, had it not been for his devastating illness and subsequent retirement from academic life in 2008 this would have in all probability been a joint project with both our names clearly identified with this work. In fairness to Adam, however, I did not want his name linked with any weaknesses in the work (he was a most fastidious taskmaster in our joint projects!), so I have decided to dedicate the book to him rather than continue the joint authorship we had intended for this work when starting out in 2005. We were most fortunate in this work to secure the services of Chris Platania Phung who began work on the project as a research assistant but whose contributions went far beyond the confines of that role and far beyond the point at which the money ran out! Thank you, Chris.

The manuscript benefitted greatly from a six-month research fellowship I undertook at RegNet at the Australian National University in 2009. It was during this time that the analysis of risk presented here was refined and improved, indeed work on this book was a primary task whilst at RegNet. Ideas, feedback and supportive critiques were provided by the many excellent scholars, graduate students and colleagues at RegNet, in particular Neil Gunningham, John Braithwaite, Valerie Braithwaite, Peter Drahos, Hilary Charlesworth, Mary Ivec, Janet Hope, Kyla Tienhaara, Petrina Schiavi and Kylie McKenna. I was also able to complete final chapters during my sabbatical from the University of Melbourne in the first six months of 2010. Many colleagues have provided extensive and most welcome feedback on various chapters in the book. Most particularly, I would like to thank Kit Carson, Christine Parker, Caron Beaton-Wells, Gary Wickham and Nesam McMillan. The work as a whole also benefitted from fruitful discussions with Nancy Reichman, Susan Silbey, Cate Lewis and Jens Zinn. Peter Ferguson provided excellent copyediting support and Karen Gillen also in preparing the index. To all of you my grateful thanks.

I am also indebted to those who agreed to provide information to me in the course of this research. This included regulators, consultants, those from industry and community members who allowed me to attend meetings during 2008. Certainly, the work of public servants, particularly in those bureaucracies represented here, is pressured and often difficult. Without the consent of those within the regulatory agencies to give of their time and expertise, this research would have been far poorer. The same is true for those within industry. I am also most grateful to those managers, supervisors, technical workers and shop floor staff who agreed to participate in this research and to help me understand the demands of compliance. I have endeavoured to be true to the sentiment expressed in all the interviews and to build on the material each provided, which allowed me vivid and fruitful insight into the regulatory worlds you inhabit. Thank you.

Finally, I would like to thank my husband Bruce for his invaluable assistance. As an engineer he kept me honest with my discussions and elaboration around the Longford explosion and his work as a risk consultant provided invaluable insights into the world of compliance. Finally, he painstakingly read draft manuscripts (plural!) to ensure the work is clear and accessible. I could not have asked for better support both professionally and personally.

This research was supported by an Australian Research Council Grant DP0557431. The University of Melbourne also provided assistance. This financial support was essential to the successful completion of the research and this book.

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1. Introduction

This book was written at a time of heightened concern about the global economy, global warming and, within Australia at least, how to deal with devastating bushfires in Victoria and floods in Queensland. Fran Bailey, a local Australian Federal politician was the latest to repeat the well-worn phrase ‘such devastation must never happen again’ in response to the fires that swept through Marysville, a regional town in her electorate where 34 residents lost their lives. These events were just the latest examples of successive crises that motivate governments and communities to want to learn from their current suffering so that future harm can be avoided. In each arena, the frenzy of policymaking begins. At the centre of many such initiatives is the drive to regulate and control the capricious risk and create an environment where lives, communities, environments or finances are safe (Braithwaite and Drahos 2000; Hancher and Moran 1998). Such regulatory responses are diverse: from strengthened building regulations to provide protection from the expected increased intensity of bushfires to a cap on executive salaries to ensure the pain of recession is shared more evenly. What these responses have in common, however, is the goal of avoiding, or at least reducing, the risk of future harm.

I would argue that much can be learnt about regulation from studying the crises of the recent past. It is here that the problems and possibilities of a regulatory solution to the risk problem become clear. It is then possible, when emotions are less intense, to ask why certain paths were chosen and not others, to determine, in light of the challenges of implementation, what the regulatory approaches devised actually accomplished and whether the reform momentum was sustained.

To understand the strengths and limitations of regulation requires more than a close-grained analysis of a recent disaster and identification of what rules, if implemented could prevent a recurrence of tragedy. I argue the urge to regulate must be placed alongside perennial demands that we are over-regulated. In the lull between disasters, prominent debates revolve around how contemporary societies are being swamped by the proliferation of regulations that threaten individual liberties, dampen entrepreneurial zest and blunt our competitive edge. This demand for more and more protection is an indication, we are told, of how risk averse we are becoming and how the ‘nanny state’ has

been revived in the guise of the regulatory state and the regulatory enforcement officer.

It is this paradox of regulation, namely the presence of conflicting imperatives that is important to understand. Significant benefit can be gained from exploring what these seemingly inconsistent demands can tell us about the shape of our society. This is a study that teases apart the underlying pressures and needs that result in governments espousing in one moment 'this must never happen again' and in the next bemoaning the complexity of laws and regulations that seek to control risk. In doing so, the reality of regulation as at once a technical, political and social project comes to the fore. As such a project, the problems and possibilities of avoiding harm and controlling future risk through regulation become clearer.

The analysis in this book suggests that a lack of effective regulatory techniques may rarely form the central weakness of a regulatory risk reduction strategy. Rather, the analysis here suggests the limited effectiveness of regulation is caused by two different factors. First, regulation as the quintessential instrumental form of policymaking is both politically and technically attractive, but can be thwarted when the risk to be reduced is not amenable to narrow, targeted interventions. Nonetheless, regulation may remain popular as it allows claims that progress has been made and that, this time, the lessons from tragedy have been learnt. Secondly, the analysis here suggests that even when regulation can be effective in avoiding catastrophe it needs sufficient political support to ensure its implementation; but not overweening political intervention that prevents the regulator framing the regime in the optimal direction.

Three separate disasters form the bedrock of the analysis. The first, an industrial explosion at the Longford Gas Plant in Gippsland, Victoria, took the lives of two people and cut gas supplies to the State for two weeks in 1998. Such an event was devastating to the families of those who died, costly for the local businesses across the state that suffered a loss of gas supply and an inconvenience to those Victorians forced to shower in cold water or wait in queues for kindly hotel operators to allow them to use their facilities. The second, the terrorist attacks of 11 September 2001, in the United States of America, was as global in its impact as Longford was parochial. The final catastrophe was the collapse of HIH Insurance, to date the largest financial collapse in Australia; a corporate demise resulting in losses totalling some \$3 billion AUD. In each case, the changes to regulation within Australia were of primary concern.

These particular disasters give life to the analysis of the paradox of regulation. Essentially, this is a book about regulation and risk. It traces the impact of political pronouncements of 'Never again!' that resonated in the wake of these three disparate events. In each case, these injunctions were followed by

regulatory reform. In the case of Longford this resulted in a ground up reworking of what it meant to control catastrophic risk of explosion and fire, but only in the state most closely affected. Following September 11 the regulatory demands placed on sea and airports poured forth from government in the wake of the event, creating a new breed of regulators drawn from the military, rather than industry or the professions, and a level of surveillance in some locations (but not other equally vulnerable sites) that would astonish George Orwell himself. The collapse of HIH occurred during a maelstrom of reform already occurring in the financial industry. Financial regulatory agencies were tentatively reshaping at the behest of the Australian Commonwealth Government to bring their activities in line with contemporary ideas of risk-based regulation, a regime argued to both increase the efficiency and effectiveness of financial regulation. The severity of the impact of the collapse of HIH, however, pointed to weaknesses in risk control and sent shockwaves through the two regulators most closely affected, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA).

I argue throughout this book that regulation embodies the promise of modernity. It creates the vision of technical mastery over threats (whether from technology, terrorists or financial mismanagement). It offers hope of learning from the past to control the hazards of the future. This technical project is both optimistic and seductive. It has led to an explosion of didactic literature that bristles with opportunity. Human agency will prevail; we can be fruitful, multiply and subdue (the threats of) the earth.

Regulation as a modernist project, then, involves the development of processes and styles of enforcement that are argued to ensure greater and greater levels of compliance that will minimise a risk, or avoid a specified harm. Indeed, there are regulatory successes that can be identified and promoted. Yet, regulation often appears as not only the solution, but also the problem. Chapter 2 explores the literature on regulation, teasing apart the technical, social and political elements that comprise this literature. It is a literature that encompasses not only the reform impetus and the techniques considered appropriate to deal with risk but also the nature of the compliance challenge on the ground. The first part of the chapter explores the literature around reform and technique (exploring the ideas of responsive regulation and meta-regulation for example) and then goes on to explore literature on compliance and the problems of the 'law/practice' gap. Through the analysis of regulation the instrumental character of regulation and its political core is revealed.

Chapter 3 explores the ways in which the study of risk as a 'knowable harm' has developed. As many regulatory reform manuals attest, the first challenge of reform is to define the problem, the risk or the harm. It is this instrumental orientation that forms an essential element to regulation (Black 2002). But, while regulation provides the means to achieve a given end, it remains

silent on what ends are most important or able to be reached through a regulatory strategy. A natural complement to the regulatory literature is that on risk and in particular literature that endeavours to identify the specific nature of the harm, its impact and likelihood of occurrence, and specific methods that will reduce that risk. Analyses of risk often are accompanied by an assessment of which threats need greatest attention. Technical understandings of risk provide a logical complement to regulatory control. This form of risk is defined in the book as 'actuarial risk'. By actuarial risk, I mean the physical, environmental and financial impact that is highlighted by the event and calculated as likely to occur in the future. This form of risk is often developed and defined by scientists, engineers, economists and actuaries who develop models of the likelihood and impact of a given hazard being realised.

Clearly, many contest the assumptions that underlie both the regulatory and the risk management project centred on an actuarial understanding of risk. The subsequent sections of Chapter 3 work through the critiques of an actuarial understanding of risk. In working through this literature, I argue that it is unhelpful to understand risk as an essentially singular construct. Rather, three distinct ideal-types of risk affect the regulatory challenge: one actuarial, the second socio-cultural and the third political. The concept of socio-cultural risk is developed through the insights of Durkheim (1964) and Mary Douglas (1992) and their ideas of how risk is centred on concerns with social order. The idea of political risk is developed from the work of Habermas (Borradori 2003; Habermas 1979; 1989a; 1989b; 1989c; 1996) and is comprised of the dual threat to political legitimacy that arises either from a government's inability either to manage the economy in a manner that provides the necessary resources for government, or from an incapacity to reassure the population about their own security and doubts about the capacity of government to provide such security. The lesson from this chapter is that regulation may well be asked to reduce three distinct risk challenges.

Chapter 4 describes the three events that set in train regulatory reforms within Australia. The purpose here is to draw on both primary and secondary sources to provide an insight into the significance of each event. The aim of this chapter is to analyse how the physical and financial crises laid bare through each disaster were interpreted. These interpretations encompassed the underlying physical and technical causes of each disaster, as well as the significance placed on each event by the public and media of the time and by the political elite. Each of the disasters had a distinct actuarial, socio-cultural and political profile that framed what regulatory response was desirable and against what particular form of risk it should be primarily directed. The lessons here were clear, actuarial assessments of cause needed to be set alongside economic and political constraints and opportunities that resulted from each disaster.

Chapter 5 assesses the regulatory reforms that emanated from the three events. This chapter reveals how regulatory reform was propelled by the crisis event, but then modified and attenuated by the location of the event, whether it was embedded within what were seen as essential industries and what reforms were considered necessary to reassure the citizenry that their security needs were paramount. In contrast to much of the regulatory literature that assumes considerable agency on behalf of the regulator to choose a response that could address the actuarial risk raised by the disaster, this analysis demonstrates the limits to the regulator's authority. Each of the three ideal types of risk: actuarial, socio-cultural and political moulded and shaped the regulatory response to disaster. Understanding the interplay between them provides insights into what productive role regulation can play in the contemporary era, and what it cannot.

As much socio-legal literature has emphasised, however, the gap between the reforms and what actually happens on the ground, in terms of actual compliance, can be considerable. Three chapters (6, 7 and 8) are devoted to assessing the impact of the regulatory reforms, described in Chapter 5, through research on the way hazardous industrial sites, air and seaports responded to their new regulatory responsibilities. These chapters reveal two critical elements to these responses: firstly, that the kind of actuarial risk to be reduced does make a difference in terms of the capacity of regulation to reduce the risk of future disaster and secondly, that support for the regime was important not only for developing an effective regulatory regime, but also how seriously it was adhered to by regulated sites. Where the actuarial risk severely challenged the capacity of regulation to reduce such risk (because of the agency of the perpetrator of the harm), there was a need to develop a narrative around how the next incident may occur, and what the causal influences could be, to 'tame' the response and the compliance challenge. In these chapters it became clear that the task of reducing the risk of a future industrial disaster was more amenable to a regulatory approach than the tasks of reducing the risk of a terrorist attack or financial collapse. This potential was best realised when there was effective and knowledgeable leadership that took seriously a collaborative approach to risk reduction. In contrast, the security regime that followed 11 September 2001 faced major challenges since security and surveillance could always be seen as insufficient when faced by a determined protagonist. Finally, the response to financial reforms post-HIH pointed to the essential ambiguity in an actuarial assessment of financial risk. Such ambiguity was on the one hand seen as a desirable condition that encouraged the necessary flexibility needed within a financial system and that nurtured the entrepreneurial spirit. Yet, on the other hand ambiguity was the problem, a condition to be dispelled through greater transparency and accountability. In the face of this ambiguity, the financial reforms were vulnerable to creative

compliance and regulatory arbitrage and also viewed by some as clumsy demands that generated poor financial outcomes.

Chapter 9 concludes by bringing together the analysis of the literature together with the insights of the empirical research. This chapter argues that regulation has considerable strengths in reducing the risk of future harm. At best, it can tame actuarial risk and generate confidence in the regulator while also creating a positive dynamic where a 'race to the top' in risk reduction occurs. But the environment where it is most successful is perhaps rarer than we had imagined. To be successful, regulation must embrace actuarial, socio-cultural and political risk reduction through a common regulatory project. Critically, improving risk reduction outcomes involves more than just sweeping to one side the socio-cultural and political risk concerns that were so clearly important in shaping the effectiveness of the regulatory reforms that followed each of these events. Socio-cultural concerns about community and individual vulnerability are, as sociologists would argue, intrinsic to assessments of risk and demands for security. They are substantive and significant. Socio-culturally based fears often lie behind the perennial demand for a strong command and control regulatory response from government. Governments in contemporary society need to take these security concerns seriously.

Hence, scholars promoting governance approaches to risk reduction will need to continue to take government seriously. Regulatory reform is perennially attractive to contemporary governments as they demonstrate their sincerity in providing a sufficient response to tragedy and future threat, but it is a response heavily shaped by an equally pressing demand for them to release the chains around the creativity of the market. Yet, regulation may fail in its promoted aim of increasing safety, security or financial integrity, particularly where the actuarial risk is difficult to encompass within a regulatory framework. The lessons within this book suggest that the regulatory response to disaster is unlikely to carry the full weight of prevention of future tragedy, a load it is often asked to bear. Rather, it must sit alongside commensurate efforts to ensure skilled and knowledgeable actors are available to work in areas of high risk and to ensure that entrepreneurial zest leads to public benefit. Strategies to engender political legitimacy should not be allowed to result in divisive social policies that rest on unrealistic regulatory goals. Neither should we accept that a 'free' market tethered only by specific (but numerous) constraints will, almost magically, generate the future we need.

2. The regulatory paradox

'Like a smouldering fire the Liberals let the deregulation agenda in this country lie dormant for most of their eleven years in office. I intend to re-ignite it.' Lindsay Tanner (Australian Labour Party), Minister for Finance and Deregulation¹

'... Not once have we heard any of them (The Liberal/National opposition) discuss exactly why the world economy has been plunged into crisis over the past two years. Not once have they mentioned the disastrous policies of the Bush administration and the Republican congress in the United States over the past decade. These included the massive and irresponsible tax cuts for the wealthiest section of the population, the reckless deregulation of the financial system ...' Senator David Feeney (Australian Labour Party (Victoria))²

'We therefore need a frank analysis of the central role of neo-liberalism in the underlying causes of the current economic crisis. We also need a robust analysis of the social-democratic approach to properly regulated markets and the proper role of the state.' Kevin Rudd, Australian Prime Minister (Australian Labour Party)³

Well-designed and properly implemented regulation can bring about good results. Yet a critical assessment of when and how regulation can bring about beneficial ends and when it fails to do so is challenging. This is because the appropriate level of regulation considered necessary, when it is required and how it should be enforced, is vigorously contested. Political debates rage around the need to protect and control, and almost simultaneously a competing demand for a loosening of controls, for a simplification and reduction in the regulatory obligations on business and the community more generally. This suggests that ensuring good regulation is implemented is going to need more than a technical and empirical analysis of regulatory design and its successes and failures (important as these are). To make sense of what regulation can achieve, it is necessary to take seriously the challenges of regulatory reform, as well as how well it performs. There are two interrelated literatures that can assist in developing an understanding of the challenges facing 'good regulation' from inception to implementation; scholarship on regulation and compliance (the subject of this chapter) and risk in the next.

Careful assessment of research and analysis around regulation, regulatory reform and regulatory compliance reveals important elements to the challenge of developing good regulation. In approaching this literature, a useful starting point is to map how the conceptualisation of regulation itself is changing. The

extent of what is considered regulation is expanding, while at the same time the tasks that regulation is set to undertake appears to be narrowing. So, there has been a broadening of the term regulation to encompass activities and actors outside of the state and as expressed through law and subordinate legislation. Regulation is argued to be better conceptualised as governance where control originates from various public and private actors and is given effect not only through law, but also by private agreements, the implementation of non-government standards, accreditation schemes and a multitude of other potential control mechanisms. At the same time as the regulatory actors extend, an instrumental conception of regulation has come to dominate debate. Notwithstanding the multiple sources and methods of control, regulation is defined as an attempt to bring about a clearly defined end. Regulation should be 'problem focussed' and goal-oriented. Paradoxically, the focus on goals and how they may be reached ties regulation back to the capacity for enforcement, and, notwithstanding the shift to governance, takes our understanding of what successful regulation looks like back to the importance of law and law enforcement.

These trends towards governance, instrumentality and an emphasis on 'appropriate' enforcement are prominent within policy reform documents, research and writing designed to improve regulation. Across these literatures better regulation is that which has tightly defined goals (instrumentalism), and uses pressures outside of government to achieve those goals (governance not just government). Policy prescriptions and literature on regulation share a desire to see regulation as tightly defined and 'problem focussed'. Research in the area provides evidence that sharply targeted and suitably enforced regulation under certain circumstances can achieve set goals.

But differences emerge between reform policies and academic research that point to competing philosophies underpinning the project to promote 'good regulation'. Such disagreements point to the inherently political nature of regulation. Disparate values inform what regulation 'should' be asked to do, and what it can achieve. Conflict surrounds what adequate enforcement entails, for example, as well as tensions between policy and research on what a switch to governance actually consists of. For the policy community, a governance approach suggests that adequate standards of risk reduction often will be found within the intentions and actions of the regulated community. 'Good regulation' is thus 'light-handed', since these good intentions may easily be brought to bear in bringing about sufficient levels of improvement and a minimal level of government involvement. The academic literature, however, shares no such view that the result of regulation will necessarily be felt as a 'light touch' by all concerned. Here, governance approaches arguably can result in the antithesis of light-handed regulation requiring significantly greater levels of attention to risk reduction than that required under previous 'command and control' regimes.

Attention to the areas of consensus and points of conflict concerning what innovative, well-targeted and effective regulation looks like in practice can lead us to a broader assessment of the demands on regulation in contemporary society. Clearly, what is argued to constitute a viable 'governance' approach to meeting set goals is not value free. Tensions arise around whether market competition does or does not sit at the centre of a governance strategy. Disputes further develop around whether markets and/or competition are the principal drivers bringing greater health and wellbeing to all. Differences concerning what regulation is needed, the level of competition that should be promoted or prevented and the strength of the regulatory controls required can be understood as key sites of material and ideological conflict. This should alert us to the potential that the successful passage of a regulatory reform initiative itself may be a significant signal of success or failure in of itself, quite divorced from its actual effect on the target regulated audience. Arguably, these contests should not be seen as merely an unwanted side-effect but as an intrinsic component of regulation in contemporary society. The politics of the process may be as important to society (and certainly as important to understand) as the actual impact the ensuing regulations do or do not have.

The centrality of politics and the growing emphasis on regulatory performance brings attention back to the instrumental nature of regulation. Regulation is understood as a means to an end. However, as Weber argued nearly a century ago, the method of enshrining values in rules, a key component of the regulatory project, is a fraught one. Ritualism (following rules with little sense of why they are there) and creative compliance (using rules to escape the purpose the rules are trying to serve – as in elaborate tax avoidance schemes), both problems Weber well understood, remain key challenges. But, arguably a more intransigent problem stems from the Weberian insight that good outcomes from regulation cannot inspire the broader public as to their worth. The Achilles heel of dedicated intellectual engagement in defining the exact nature of the regulatory problem and the most effective method of amelioration cannot, in itself, bring about the necessary social and political commitment to its own project.

PATTERNS IN THE REGULATORY LANDSCAPE

Nearly two decades ago, Ian Ayres and John Braithwaite (1992) pointed to what they called a state of regulatory flux, in their broad sweep of the activities of regulatory agencies in the United States. They highlighted the way that deregulation was often followed by an escalation of punitive measures and an increase in levels of fines against firms. Over a decade and a half later, the impression of the regulatory landscape is one of multiple regulatory cycles in

diverse policy contexts in constant motion, moving from a loosening of regulatory control to a subsequent tightening and back. Arguably, the only firm conclusion possible from these ‘wheels within wheels’ is that future change in terms of regulatory reform is guaranteed.

However, there is some sense of direction that emerges, notwithstanding differences in detail between geographic location and industrial sector (Jordan, Wurzel and Zito 2005). Trends can be seen in three interrelated areas: first, regulatory control as extending beyond government, secondly a dominance of regulation understood as instrumental (‘problem-solving’) projects and finally a shift in what is considered the preferred style of government regulation and enforcement.

For a number of current commentators and writers on regulation, regulation is now argued to be less about government and more about governance (Braithwaite 2000; Freeman 1999; Gunningham, Thornton and Kagan 2005; Hancher and Moran 1998; Rose and Miller 1992; Scott 2004; Shearing 1993). As a governance project, regulation draws on influences beyond government in order to secure higher standards. Multiple players should be brought in to ‘shape’ regulatory space so that the rules of the market can be seen to serve the regulatory goal (Shearing 1993 but see Haines 1997). This orientation of regulation as governance allows for a proliferation of potential initiatives drawing on the support of third parties such as insurers or non-government organisations, allowing for negotiated public and private agreements and employing market-based instruments such as taxes and market incentives in order to achieve enhanced levels of risk reduction.

Under a governance paradigm the prominence of the law and the role of the state in the task of regulation declines, such that all that remains of the regulatory project is its instrumental orientation (Black 2002). This characterisation of regulation as intrinsically concerned with instrumental goals is noteworthy. It signals a shift in emphasis away from regulation as a set of rules that constitute a market (for example in economic regulation a two-airline policy or limiting the number of banking institutions, that is, defining who can trade in a given market) to regulation as intervention in the market in order to redress market ‘failure’ (Baldwin and Martin 1999). Regulation most often is perceived as an instrument designed to solve a problem, a goal-oriented practice for the purpose of reducing a tightly-defined and specific harm (Teubner 1998).⁴

This instrumental orientation to regulation brings to the fore regulation as policing. Regulation is tied to enforcement. The connection between regulation and policing has been noted by a number of scholars (Braithwaite 2008; Carson 1985; Wells 2001), yet it is a connection that makes most sense when regulation is understood as instrumental law. Regulation encompassing law enforcement under a neo-liberal paradigm also can be seen to have a distinct