Chapter 6

Funding

The amount and source of funding for a regulator will determine its organisation and operations. It should not influence the regulatory decisions and the regulator should be enabled to be impartial and efficient to achieve its objectives. This chapter raises the key issues for the funding structure of regulators to be effective and efficient.
## Principles for funding

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<th>Supports outcomes efficiently</th>
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<td>1. Funding levels should be adequate to enable the regulator, operating efficiently, to effectively fulfill the objectives set by government, including obligations imposed by other legislation.</td>
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<td>2. Funding processes should be transparent, efficient and as simple as possible.</td>
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<th>Regulatory cost recovery</th>
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<td>3. Regulators should not set the level of their cost recovery fees, or the scope of activities that incur fees, without arm's-length oversight. These fees and the scope of activities subject to fees should be in accordance with the policy objectives and fees guidance set by government or, where these are not in place, the OECD's <em>Best Practice Guidelines for User Charging for Government Services</em> (OECD, 1998).</td>
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<td>4. Where cost recovery is required, the regulator should not be at risk of setting unnecessary or inefficient administrative burdens or compliance costs on regulated entities.</td>
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<td>5. Because of the significant and unpredictable costs involved, regulators should follow a defined process to obtain funding for major unanticipated court actions in the public interest that is consistent with the degree of independence of the regulator.</td>
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<th>Funding of external entities by a regulator</th>
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<td>6. A regulator should only fund other entities to deliver activities where they are directly related to the regulator’s objectives, such as information and education about how to comply with regulation, or research to inform the regulator’s priorities. Any funding of representative or policy advocacy organisations should be the responsibility of the relevant ministry, not the regulator.</td>
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Supports outcomes efficiently

Clarity about regulators’ sources and levels of funding is necessary to protect their independence and objectivity. Transparency about the basis of funding can also enhance confidence that the regulator is efficient, as well as effective.

Regulation is one of many tools to achieve the government’s policy objectives. To contribute to these objectives effectively, a regulator’s funding should be reflected in the resources required to perform its functions with appropriate use of the resources. In addition to meeting its objectives, a regulator may have a legislative obligation to comply with certain other Acts. Compliance imposes additional costs on the regulator which should be taken into consideration when decisions regarding funding are made.

Funding sources may include budget funding from consolidated revenue, cost-recovery fees from regulated entities, monies from penalties and fines and interest earned on investments and trust funds. This mix of funding sources should be appropriate for the particular circumstances of the regulator. To promote efficiency and equity, it should be made clear who pays for the regulator’s operations, how much and why (International Monetary Fund, 1999). A regulator should disclose in its annual report what proportion of its revenue comes from each of these sources.

Regulatory cost recovery

Some forms of regulation require the imposition of fees and charges for regulatory activities such as issuing licences or considering approval applications. The issue of whether regulators should be able to retain the proceeds of any fines or forfeiture is a separate and complex issue that is not examined in this paper.

Cost recovery through fees and charges is most often adopted when government services do not directly benefit all citizens. Many programmes benefit only selected groups in the community (e.g. users of particular services of various professions). In these circumstances, fees on the regulated providers give a mechanism whereby the costs of the regulation are incorporated into the costs of delivering the service.
Where cost-recovery fees contribute to the funding of the regulator, the level of their cost recovery fees, and the scope of activities that incur fees, should be set for a multi-year period by the legislature or the minister in accordance with the policy objectives of the government and any cost recovery guidelines. It may be appropriate for the relevant ministry to develop the proposed fee schedule in consultation with the regulator, regulated entities and other stakeholder groups for the approval of the minister. The anticipated revenues from the proposed fee schedule should be sufficient to allow the regulator, operating efficiently, to fulfil its functions.

When a regulator operates under a cost recovery scheme, care should be given to ensure the scheme does not impose any unnecessary or over burdensome costs on regulated entities or apply significant compliance costs that cannot be justified through a cost benefit analysis. The scheme should be as transparent as possible to demonstrate the fairness of its operation and to build and maintain the trust of the regulated entities.

The proposed expenditure in the corporate plan of the regulator should be submitted to the minister for approval. Some regulators are funded by other means, such as interest earned from investments or specific trust funds. Nevertheless, the power to collect such funding has been granted by the legislature, and the minister remains accountable for its use.

**Budget funding**

Provided the objectives, scope and performance measures of a regulator are clear, budget funding is an appropriate means to fund general regulators, where it is not efficient to impose user-charges.

The government and the legislature should be able to review an independent regulator’s funding levels from time to time. However, secure multi-year funding arrangements can contribute to the independence of a regulator by protecting it from budget cuts motivated by political reaction to unpopular decisions (Kelley and Tenenbaum, 2004).

**Financial transparency**

The process for determining cost recovery fees (imposed by either independent or ministerial regulators) and how they apply should be clear, understandable, accessible to all stakeholders and, above all, transparent.

Financial transparency in budget funding, cost-recovery fees and other revenue sources can reduce the risks to the regulator’s political and administrative independence from government and over-sensitivity to lobbying against the public interest (Kelley and Tenenbaum, 2004). Financial transparency and justification can improve the efficiency of
regulatory operations by providing the information necessary to hold the regulator to account for its activities and expenditures and making any attempt to influence regulatory practice by political or industry interests more apparent (Hüpkes et. al., 2006). This can lead to greater buy-in to the regulatory scheme by regulated entities and may enhance compliance.

**Costs of major and unanticipated court actions**

Governments provide funding to all agencies that ensures that they discharge their responsibilities effectively. In relation to regulators, this should take into account all necessary enforcement, prosecution and appeal activities likely to arise from its functions. It is recognised however that unanticipated court actions may arise that require significant legal costs that may hinder a regulator’s decision to undertake actions.

This presents substantial challenges. On the one hand, given the need for the government to remain accountable for the overall level of expenditure of their regulators, there are issues with a government to providing its regulators with pre-approval of substantial funds for major unanticipated court actions. However, the requirement of an independent regulator to seek ministerial approval for funds to launch a major case would affect its actual and perceived independence.

**Funding of external entities by regulators**

Some regulators may require services provided by third parties to achieve their objectives. Such transactions could include funding a third party to provide information and education about complying with regulation or programmes that may reduce the demand for regulatory intervention. For example, this may include funding an industry association or union to develop relevant guidance or organise workshops on how to comply with new regulation. All contracts involved should be disclosed and the regulator should be able to demonstrate that all activities funded contribute directly to meeting its policy objectives.

Any funding of representative organisations or policy advocacy groups to contribute to government processes should be the responsibility of the relevant ministry, rather than the ministerial regulatory unit or independent regulator.
Applying the principles – Funding

Supports outcomes efficiently

- How much funding does the (independent or ministerial) regulator require to achieve its objectives?
- How much does it cost to meet the legislative obligations of an independent regulator outside its main functions? e.g. funding of related entities required by legislation, annual reporting, etc.
- Does the independent regulator’s annual report (or ministry annual report in the case of a ministerial regulator) disclose the proportion of revenues from budget funding from consolidated revenue, cost-recovery fees from regulated entities, monies from penalties and fines and interest earned on investments and trust funds?

Regulatory cost recovery

- Does the cost recovery scheme impose unnecessary burdens or costs on regulated entities that cannot be justified?
- If fees are charged to the regulated entities to fund the regulator, are they proportional to the costs these entities impose on the regulator?
- Does the annual report of the independent regulator, or the ministry, state the regulator’s total expenditure and revenues from budget funding, cost-recovery fees, penalties and fines?
- Is there a clear rationale for this mix of funding sources for the regulator?
- Are the level of cost recovery fees, and the scope of activities subject to fees approved by the minister or legislature, rather than the regulator?
- Where fees are charged to fund the regulator’s operations, are they in accordance with the policy objectives and fees guidance set by government or, where these are not in place, the OECD’s Best Practice Guidelines for User Charging for Government Services.

Litigation and enforcement costs

- Is there a clear process by which the regulator, with the approval of its minister, can apply for funding for major unanticipated litigation?

Funding of external entities by regulators

- Can it be shown that all funding activities contribute directly to the regulator’s objectives?
- Does the regulator fund any external entities to contribute to government processes?
Notes

1. In the United Kingdom, cost recovery arrangements are governed by guidance from HM Treasury setting out the approach that should be taken when setting cost recovery fees (www.gov.uk/government/publications/managing-public-money).

2. In contrast, providing competitive grants to regulated firms to improve their performance can create perceived or actual conflicts if the regulator subsequently considers enforcement actions against these firms (this is discussed in Chapter 1). See Krpan (2011), pp. 279-281.