

REGULATORY LESSONS FROM THE LEAKY HOME EXPERIENCE

*Symposium of the 2009 Report on the proposed Regulatory Responsibility Bill:
16 February 2010, Institute of Policy Studies*

February 23, 2010

Brian Easton⁰

I begin this paper with a manufacturer's warning that I use the term 'regulation' slightly differently from the way it was used this morning, coming as I do as an economist from the tradition of mathematical systems analysis. By its standards a market is a regulatory system, so it finds limiting the term 'regulation' to just to statutes and the regulations that are derived from them. It also recognises that some administrative practices are regulatory. The legal framework for regulation may be quite adequate but the administrators may fail to implement it effectively.

So when I talk about the Global Financial Crisis being a result of regulatory failure I am allowing that the law, the market and the administration may all have had a role in that failure. Thus the statement has little informational content; its importance is that when we try to disentangle what happened or remedy it, we do not concentrate on one element of the regulatory system – very often they are intricately interrelated.

Behind this is a view that much public policy is concerned with designing or improving the regulatory system of the economy (and sometimes of non-economic activities). Typically the change is not the imposition or removal of regulation, but a modification of the current regulatory system to one which is hoped to be more effective. In particular the so-called 'deregulation' of the 1984 to 1994 is better thought of as a change in the overall regulatory system with greater emphasis on market regulation. Hence my preference for calling this 'market liberalisation'. I add that even the most extreme proponents of this liberalisation knew that there was a need for law to enable the effective working of markets.

Humpty Dumpty said that he could make words what he chose to mean. While that may be true the danger is that others will misunderstand what their meaning is and that get trapped into sterile and misleading uses. That has happened, I think, with 'regulation'.

The Size of Economic Crises.

I do not propose to spend much time on the Global Financial Crisis, whose regulation is outside the scope of this seminar. But we might note that its costs to the US Government are

⁰1. Economic and Social Trust On New Zealand, www.eastonbh.ac.nz

estimated at US\$90 billion, or about 0.6% of US annual output. The equivalent cost in New Zealand would be NZ\$1.1 billion. The cost of leaky homes is put around \$NZ11.5b or about ten times as much.

Comparing the two figures is not quite right, since the American one does not include the private costs of the crisis, and the leaky-home figure does not include health and trauma costs. However, the comparison does suggest the failure to build watertight homes is an economic disaster in magnitude comparable to the Global Financial Crisis.

Thus the leaky home episode is a major test of regulatory failure in New Zealand. This paper uses the experience to evaluate the proposed Regulatory Responsibility Bill

Leaky Homes

In 1991, when the market extremists were still triumphant, the system of dwelling construction was dramatically changed. Before then domestic construction was largely regulated by Local Authority by-laws that prescribed the manner in which construction was to be carried out. Different Councils prescribed different building methods and the building industry found this heterogeneity unsatisfactory.

The 1991 Building Industry Act, which came into force in July 1992, provided for regulating construction through a building code which set out performance criteria to be achieved rather than prescribing the precise manner in which buildings were to be constructed. For instance, builders were just told that the structure must last 50 years, the cladding 15 years, and the walls and roofs must be impermeable to water.

The belief was that the old regime stifled the use of new materials, design and construction thereby discouraging innovation and raising building costs; under the new regime new methods were introduced.

However it appears that little thought was put into considering issues of what redress would the house owner have if the performance standards were not attained. Suppose the cladding fell off after 14 years?

The answer is that the aggrieved party can take the matter to litigation, but who exactly is to be sued: the local authority or its building inspector, the builder, the architect, the buildings material supplier, the developer, the home owner who onsold it, or even the legislators and their advisers who passed the change of legislation? Many will have passed on, and they cant possibly collectively find the \$11.5b. (Suing the government is not really an option.

Parliament is too clever to allow that, yet many think the government of the day has the greatest culpability, although were it to own up it would be the taxpayer who would pay.)

The leaky home syndrome appears to have risen from at least two innovations which, no doubt, were cost-saving at the time. The first was the use of a 'monolithic cladding' which has proved not to be watertight unless it was used very strictly according to specification. The second was the use of untreated timber, without the realisation that the treating for borer also better sealed the wood from water. Additionally, some house designers used the opportunities for cutting back water protecting features such as eaves.

The problems of house construction may not be confined to leaky homes. The collapse of the apprenticeship system and the operation of some not very qualified builders has meant the quality of the workmanship has not always been high. There are other new materials, often imported – following the ending of import controls – means that poor and unsustainable construction may plague other elements of the housing stock in a manner similar to leaky houses.

Individual cases involving leaky homes are winding through the courts and other settlement procedures while the 3500 odd homeowners and their families suffer personal disruption and financial stress. Despite the 2004 Building Act's moves towards greater regulation there is a widespread view that more is needed.

The Major Projects

Nevertheless leaky homes may not be the greatest regulatory failure in to New Zealand's economic history – even ignoring macroeconomic crises such as the Great Depression which in any case can be attributed to a severe external shock arising from offshore regulatory failure. The example which comes to mind is the energy based Major Projects (Think Big), although there is no authoritative estimate of their collective cost to the economy. But it certainly would have been a similar order of magnitude as leaky homes.

The Major Projects taught some of us an important lesson. In the early 1980s, considerable effort was put into evaluating the public return on the investments and there was much debate on the criteria to measure this. However with hindsight we know the evaluation exercises missed the point. Suppose the assumptions were not fulfilled. Who would share the cost of the failure?

Those doing the evaluations in the private sector were unaware that the downside risks were not borne equally, while those in the public sector who did know did not seem to have taken these asymmetries into account. In particular it turned out that if there were cost over-runs

(there were some) or the world price of oil was lower than projected (as it proved to be), the cost of the failure was borne almost entirely by taxpayers and consumer-motorists because the corporate investors had their returns guaranteed – one way and another – by the state.

There is a parallel here with the leaky homes. The decisions which were made paid insufficient attention to what would happen if something went wrong.

It is true that in both cases there has been a procedure to settle the failure; in the case of the Major Projects the financial deficits were covered by taxpayers and motorists. In the case of Leaky Homes a slow, cumbersome and expensive process of litigation is settling the costs of redress erratically. Part is borne by the house owner, part by the private suppliers and the local authorities with the central government offering to pay about 10 percent. Many would say that the costs were not borne equitably.

Murphy's Law and Regulatory Assessment.

This is all a nice example of Murphy's law. Not the 'if anything can go wrong, it will' version, but Edward Murphy's original aim to design a system on the assumption that anything which can go wrong will go wrong. I doubt that this thought was uppermost in the mind of the designers of the building code and I don't recall much attention to it in the evaluating the major projects.

Of course accident prevention cannot be all encompassing. Murphy was in the aircraft industry trying to minimise crashes; the easiest way to do this is not to let planes fly. Similarly there are going to have to be some risks in the building code. However, a lot of grief could have been prevented had the designers of the approach to the building code asked 'if things go wrong, what happens next?' That so few aircraft crashes have occurred compared to the total number of crashes, and even fewer have led to death indicates the value of the design principle that Murphy enunciated.

Should we build Murphy's design principle into our policy process? The evidence is that we have often not done so in the past. As far as I can judge, it is not there in current policy evaluation, and it was certainly not in terms of the two major regulatory failures I have just identified. .

The Major Projects was handled outside the legal process as entirely an administrative matter. As it happens, some of the omissions are covered by the 1989 Public Finance Act insofar as the risks the government exposed itself to should now appear as a contingent liability in the government accounts. However, I am not sure whether the guarantees the government gave which ended up as additional costs to motorists are covered by existing procedures. The

precise guarantees could not occur today, because of the greater use of market regulation – such as there being no restrictions on imports of oil. Because of this there later had to be tax increases but they would not have been anticipated at the time of the agreement and so would not be mentioned under the contingent liabilities provisions.

However the leaky homes case, with the benefit of hindsight, is very revealing as to the inadequacy of our approach to regulation.

Regulatory Impact Analysis

Suppose the Building Industries Act and the Building Code were to be reviewed under the current Regulatory Impact Analysis procedures. It would be too much to expect the review to forecast the leaky homes syndrome, but reasonable questions might be like our earlier one – what if the cladding fell off the house after 14 years – would have anticipated the issue of what happens if the construction did not meet the performance standards in the Code.

Note the importance of the time horizon. Of course if the cladding fell off during the construction process there is also a different redress process and it would be mentioned during the detailed analysis. However, the focus probably needs to be on the long term.

The Treasury's *Regulatory Impact Analysis Handbook* sets out a series of issues as follows:

Will any policy options that may be considered, potentially

- Take or impair existing private property rights?,
- Affect the structure or openness of a particular market or industry?
- Impact on the environment, such as regulations that affect the use and management of natural resources?,
- Have any significant distributional or equity effects?
- Alter the human rights or freedoms of choice and action of individuals?
- Have any other significant costs or benefits on businesses, individuals or not-for-profit organisations?
- Is the evidence-base for the effectiveness of different policy options weak or absent?
- Are the expected benefits or costs of the policy options likely to be highly uncertain?
- Is the success of any of the options likely to be dependent on other policy initiatives or legislative changes?
- Are any of the legislative options likely to have flow-on implications for the future form or effectiveness of related legislation?
- Are any of the legislative options likely to be novel, or unprecedented?
- Are any of the legislative options likely to be inconsistent with fundamental common law principles?

- Are any of the legislative options likely to be inconsistent with New Zealand's international obligations, or New Zealand's commitment toward a single economic market with Australia?
- Are any of the legislative options likely to include a new power to create delegated legislation, or grant a broad discretionary power to a public body?
- Are any of the legislative options likely to include provisions that depart from existing legislative norms for like issues or situations?
- Are there other issues with the clarity or navigability of, or costs of compliance with, the current legislation that it might be good to address at the same time?
- Will people with expertise in implementation provide input on the policy design before policy decisions are taken?
- Are implementation timeframes likely to be challenging?
 - Are the actual costs or benefits highly dependent on the capability or discretionary action of the regulator? (p.33-34)

While each of the items on the checklist may be reasonable in its own right, at no point is the evaluator asked to consider what might go wrong and what would be the consequences if that happened. It is not interested in what redress process might be triggered if something goes wrong

The *Handbook* is a lineal descendant of the project evaluation approach that was used in the Major Project appraisals. It does not require a cost-benefit analysis (although these are sometimes included for particular cases), but it adds the sort of caveat analysis which should be done with a CBA (but was not, in the early 1980s).

However it shows no evidence of having learned what one might take as the chief lesson of the application of CBA to the Major Projects – what happens if things go wrong? The question of who bears the cost if the policy expectations are not fulfilled, or what would be the process of redress are not pursued at all. The basis of the approach seems to be that the policy will work, but there may be some collateral impacts. Please identify them.

Thus the *Handbook* approach would have done nothing to prevent the leaky homes debacle nor the enormous costs which it has generated.

The Proposed Regulatory Responsibility Bill

The Regulatory Responsibility Taskforce submitted a report in September 2009. It is the version of the Regulatory Responsibility Bill which is evaluated here. Again we ask, would the bill, were it a statute, do anything to prevent or forewarn of the inadequacies of the Building Act and the Building Code?

Again the answer is no. The bill establishes a set of principles, not one of which addresses the issue of what happens if some statute or regulation fails to deliver on its intent. From this perspective the proposed Regulatory Responsibility Bill is ineffective. It would not have made a single difference to the adoption of the Building Act or the Code, nor resulted in a single additional watertight home.

Yet this is surely a major test of its relevance. If the proposed bill would have been useless for dealing with one of our greatest past crises, it is unlikely to be much use for preventing future ones.

One could well argue that is not the intention of the Bill whose purpose is described as

... to improve the quality of Acts of Parliament and other kinds of legislation by—

(a) specifying principles of responsible regulation that are to apply to new legislation and, over time, to all legislation; and

(b) requiring those proposing new legislation to state whether the legislation is compatible with those principles and, if not, the reasons for the incompatibility; and

(c) granting courts the power to declare legislation to be incompatible with those principles.

If so, the bill has the wrong name, not only in terms of the definition of regulation I gave earlier but in terms of the normal meanings of the narrow legalistic term of regulation. Its title is a Humpty Dumpty of choosing a term which means something quite different to the public generally. I leave others to find a more appropriate name, but the proposed bill seems to me to be more one about legislative process than regulatory responsibility.

This failure is all the more surprising, given that three of the members of the working party were deeply involved with the Major Projects. They were on the side of the angels, but are repeating their previous mistake by assuming that the intent of the policy will be carried out, rather than asking what happens if the policy outcome is different from the intent. As the working party report makes clear, this proposal belongs to the same stable as regulatory impact analysis, the lineal descendent of the cost benefit analysis which was so misleading during the major projects debate.

Conclusion: The Murphy Gap

What this paper has identified is a major gap in the formal policy process. Let us call it the 'Murphy gap'. There is not built into the policy process a test of what happens when a policy outcome differs from what was promised. Of course it is rare for promises to be exactly attained, but what we have shown is that in the case of the Building Code (and the Major

Projects) the failure was very large – gigantic. While in principle it could have been anticipated, it was not.

Moreover neither the *Regulatory Impact Analysis Handbook* nor the proposed Regulatory Responsibility Bill address the Murphy gap. One might argue that by ignoring it, and yet giving the impression that they provide a comprehensive review of regulatory impact they exacerbate it by complacency.

Who knows whether a current piece of legislation (and associated regulations) may result in a failure with an economic impact the size of the Major Projects, the Leaky Homes, or the Global Financial Crisis. The short answer is that while there may be some who are aware, there is no systematic way this possibility is being brought to attention to those who are passing or implementing these laws. From this perspective, the proposed bill is irrelevant in terms of in terms of regulatory responsibility.