**4.1 Guidance on direct versus indirect impacts**

The Equivalent Annual Net Direct Cost to Business (EANDCB) only measures the direct costs and benefits to business or civil society organisations. It focusses on those impacts immediately felt by those businesses directly impacted by the regulatory change. The need to distinguish between direct impacts and other (indirect) impacts can prove challenging. This section provides further information to help guide this.

In early 2015, the Department for Business, Innovation and Skills (BIS) and the RPC commissioned an independent research project, which aimed to:

* set out the different definitions of direct and indirect impacts in the literature;
* present a microeconomic framework for thinking about the treatment of direct impacts within the OIOO/OITO system; and
* develop some criteria that could be used to help officials classify direct and indirect impacts.

The research, which was undertaken by Brian Titley Consulting Ltd, was commissioned in the context of the OIOO/OITO rules that operated within the last Parliament but is also relevant to the methodology for the Business Impact Target (BIT).

This guidance builds on the findings of this research project. A summary of practical steps and criteria to distinguish between direct and indirect impacts of regulation on business is presented below.

**4.1.1 Definition, criteria and practical steps to distinguish between direct /indirect impacts**

Only direct impacts on business should be scored for inclusion in the BIT.

A direct impact on business is defined as:

*“an impact that can be identified as resulting directly from the implementation or removal/simplification of the measure”.[[1]](#footnote-1)*

Subsequent effects that occur as a result of the direct impacts are indirect. These are not scored in the BIT but could be included in the net present value of the policy to society as a whole.

There is no clear economic definition of direct and indirect effects and there is no such distinction in the HM Treasury Green Book. It is often difficult to judge when economic impacts on business are direct or indirect and where the boundary lies between the two. The following section provides guidance to assist departments in distinguishing between direct and indirect effects, along with some examples from the previous parliament. However, this will always be a matter of judgement and, therefore, this guidance should not be treated as definitive.

**Step 1- Identify the broad type and scope of the regulatory measure**

Departments should consider whether the anticipated impacts are consistent with the type of measure being proposed. For instance, an impact is more likely to be direct if it:

* bans, restricts, liberalises, increases or decreases the cost of a particular activity; and/or
* displaces or restricts specific business activities designed to maintain or create sales, e.g. product differentiation and promotional activities.

In addition, if the impacts fall on those businesses subject to the regulation and accountable for compliance, they are more likely to be direct than impacts on businesses further down the supply chain.

**Banning of Inducements to Make Personal Injury Claims (RPC14-FT-MOJ-2125):**

This proposal banned lawyers from offering claimants financial inducements, or similar rewards, in return for making a claim. The objectives were to discourage weaker personal injury compensation claims from being made and to prevent claimants from being misled by offers of inducements which do not materialise in practice. The IA estimated that the policy would result in a reduction in the overall volume of claims. However, the IA asserted that the subsequent reduction in income to lawyers would be a result of behavioural change on behalf of the claimant, and therefore should be considered to be indirect.

The RPC rejected the behavioural change argument and concluded that the reduced volume of claims would be a direct impact of the regulation. This is because the proposal introduces a direct ban on an activity, resulting in a loss of profit to business. The ability of lawyers to attract customers, who would have used their service in return for an inducement, has now been banned. The lost profit to solicitors from a reduction in these cases should, therefore, be considered to be a direct impact of the proposal. (IA)

See also case study ‘Standardised Packaging of Tobacco Products’.

**Step 2 - Distinguish between first round and subsequent impacts**

Immediate and unavoidable (first round) effects of a measure in the affected market are more likely to be direct. This could involve a shift in either the supply curve (e.g. due to a change in production costs) and/or demand curve (e.g. from removing a restriction on purchasing a product) or a regulated change in the market price[[2]](#footnote-2) (e.g. imposing a minimum price which moves price away from the market clearing price).

Subsequent effects in the regulated market beyond the immediate implications of the measure are likely to be indirect. These effects occur subsequent to the adjustment to a new equilibrium immediately following the measure. For example, it could be the result of:

* a significant reallocation of resources;
* product and/or process innovation by existing businesses;
* the creation of new firms/institutions; and/or
* productivity gains due to changes in business models or working practices.

**Proposed changes to Part L of the Building Regulations 2013 (RPC11-CLG-1130):** The policy amended the building regulations to increase energy efficiency standards. The measure imposed a cost on builders, but was beneficial to the eventual occupants of buildings because of lower heating costs. As the lower costs would be an automatic result of the more efficient buildings and not require a change in behaviour, they were considered to be direct. The policy was, therefore, considered to be zero net cost under OITO, as the energy savings to non-domestic consumers were expected to exceed the costs to developers. (IA) (Opinion)

**Amendment to the Energy Act 2008 Powers to Implement and Direct the Rollout of Smart Meters (RPC10-DECC-0558):** Smart meters are a new form of gas and electricity meter that provide the customer with more information about their energy use. The smart meter also provides the supplier with more information, allowing for more targeted tariffs. The policy was to mandate the roll out of smart meters. If smart meters result in more efficient use of energy, this could have large benefits for business users. However, these benefits were considered to be indirect because they result only if business customers choose to act on the information and change their behaviour, rather than as a direct result of having a smart meter. This case is purely about giving customers more information on which they can choose whether or not to act. The required behavioural change was, therefore, considered to be an indirect effect. (IA)

**Step 3 – Identify whether the impact is a partial equilibrium or general equilibrium effect**

Next, departments should reflect on whether economists would consider the impact to be a partial equilibrium or general equilibrium effect. Partial equilibrium effects occur in the regulated market. General equilibrium effects are in related markets and/or the wider economy, coming from first round effects in the regulated market that are sufficiently large to result in changes in other markets. Therefore, cost, price and/or quantity effects that occur in related markets or the wider economy as a result of changes in the regulated market are second round, general equilibrium effects and, therefore, indirect and non-qualifying against the business impact target.

**Step 4 – Consider whether the direct impact is counter-intuitive**

A final consideration is whether the net direct impact on business is counter-intuitive. For example, can it be supported by relevant market data and/or a defensible “theory of change” specifying the steps between the regulatory measure and the anticipated impacts?

An example of this would be a regulatory measure that is widely agreed to be detrimental to business being assessed as having direct net benefits. This would provide *prima facie* evidence to look again at the direct/indirect classification. However, departments should not, of course, seek to define policy objectives in a way that is intended to influence the classification of the impacts into direct or indirect.

**Standardised Packaging of Tobacco Products (RPC12-DH-1229):** This proposal aims to reduce tobacco consumption by mandating the standardisation of tobacco pack colour, shape and the removal of all branding except brand name in a standardised type face. In this case, the impact of the loss of profit to manufacturers and retailers is direct as it: restricts economic activity from use of branding, prohibits a form of promotional activity; and has a reduction in cigarette consumption of cigarettes as its primary objective. If loss of profits was considered as an indirect cost, this would score as net beneficial to tobacco companies (due to ongoing savings in the production of packaging), which would be a counter-intuitive outcome. (IA)

**Step 5 – Consider whether the impact is ‘pass through’**

When a regulatory burden is placed on businesses they have to decide how to respond. They may increase prices, cut wages, reduce investment or reduce dividends. The EANDCB metric is an attempt to capture the burden on business of regulation. If a mechanism exists that enables some or all of this burden to be passed on to other businesses and/or consumers, this subsequent effect is generally regarded as being indirect for the purposes of the BIT. The BRFM (paragraph 1.9.45) states that pass through should be excluded from the calculation of the EANDCB. The first round impact of the regulatory change, for example the compliance costs to business, is the direct impact of the regulation. The second round impact, after pass through (such as higher prices to consumers) would be an indirect impact of the regulation. Only the direct impact should be included in the EANDCB. Without this rule, any increase in regulatory requirements on business could potentially score as zero on the basis that the cost is ultimately borne by consumers in the form of higher prices.

**Examples of the normal application of pass through**

**Reforming the regulatory framework for employment agencies and employment businesses (RPC14-BIS-2150):**  It was expected that employment agencies would pass these costs on to their customers (i.e. organisations wanting to hire workers}. The direct impact is on employment agencies; the indirect impact is on hiring organisations. Note that this had an impact on the size of the EANCB because some of the hiring organisations were in the public sector and, therefore, not in scope of OITO.

**The future of the energy company obligation (ECO) (RPC14-DECC-2105):** This proposal involved, during the first year, a scaling back of regulatory requirements compared to the existing ECO policy and, therefore, reduced costs to energy supply companies. The Government expected that energy companies would pass on these savings to their customers and the energy companies appeared to have agreed to this. However, the department provided further information which explained that there was no legal requirement, or anything that had regulatory force, for energy companies to pass on these cost savings to consumers. The pass through of business costs to consumers was, therefore, confirmed as indirect.

**Plastic carrier bags charge (RPC14-DEFRA-2124(2)):** This proposal required large retailers to charge consumers five pence for each carrier bag. The policy was expected to result in a substantial reduction in the number of carrier bags that would be used. Since the existing cost of the carrier bags was, in effect, being passed on to consumers in the form of higher prices, the department’s initial analysis suggested that, because retailers would pass on the savings from fewer carrier bags to consumers in the form of lower prices, this would not be a direct benefit to retailers. However, it was confirmed that the direct impact was on retailers and this was reflected in the EANCB (although the measure, as regulatory, was zero net cost under OITO). Note that there was also another pass through issue, in that retailers were expected, though not required, to pass on the net revenue from the sale of carrier bags to local good causes. However, as the latter would be civil society organisations, this had no impact on the EANCB. ([IA](http://www.legislation.gov.uk/ukdsi/2015/9780111127735/impacts/2015/74))

**Exceptions to the normal application of pass through**

There are a very few exceptions to the rule on pass through. As noted above, one might be where the pass through is mandatory, (i.e. backed by regulatory force). Another possibility (example below), is where the business experiencing the initial impact of regulation/deregulation acts only as a conduit. For example, following a Regulatory Framework Group discussion it was agreed that when a cost is paid by an agent on behalf of a principal, this should be considered to be a direct cost to the principal, not a cost to the agent that is passed through.

**HM Land Registry local land charges (RPC13-FT-BIS-1925):** Land charges are currently set at the local authority level. The proposal is to standardise them at a level below the current average. Most customers will be better off, but a minority will see their fees rise. These fees are normally paid by conveyancers on behalf of their clients. Initially, this was considered to be a direct cost to conveyancers that was passed on to clients (who were a mix of individuals and businesses). Following RFG discussion, it was agreed that this should be considered to be a cost to clients since they are ultimately responsible. Conveyancers were simply paying on their behalf. Note that this measure was out of scope of OITO as it related to fees and charges but the issue was relevant to its fast track status. ([IA](https://www.gov.uk/government/consultations/land-registry-wider-powers-and-local-land-charges))

**4.1.2 Other direct / indirect issues**

New Entrants

Costs and benefits to future businesses entering a market were previously sometimes seen as indirect impacts on the grounds that these businesses do not yet exist and any estimates would, therefore, also be somewhat speculative. However, this meant, for example, that deregulatory measures (e.g. simplified guidance), which mainly benefit new entrants, could easily be net costly in OITO terms because of the familiarisation costs to existing companies. This approach was reviewed and the methodology clarified. It is now clear that impacts on new entrants should be treated in the same way as impacts on existing businesses if they arise in the context of normal business ‘churn’. However, any estimates relating to the number of new entrants would normally be accepted only in respect of official data relating to historical turnover (churn) of businesses in the particular industrial sector. Any costs or benefits that are highly speculative would normally still be considered indirect, particularly if they assumed an increase in the rate of entry of new businesses as a result of a proposed change.

**Revocation of the Construction (Head Protection) Regulations 1989 (RPC12- HSE-1286):** The policy simplified regulations regarding head protection on construction sites. This was first considered to be a deregulatory IN because transition costs to existing businesses were direct, while benefits to new entrants were indirect. Following the change to the methodology this was reconsidered and validated as an OUT. ([IA](http://consultations.hse.gov.uk/consult.ti/cd239/viewCompoundDoc?docid=62900&partId=63252&sessionid=&voteid)), ([Opinion](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/251177/2013-01-29-RPC12-HSE-12862-Revocation-of-the-Construction-Head-Protection-Regulations-1989.pdf))

Discretionary action

Where businesses are given an option to act, questions often arise as to whether the impact of their actions is direct or indirect. If considered indirect, then just about any deregulatory measure would be treated as having indirect impacts. So the principle is that where the regulation was the main barrier preventing the business from acting, and this is supported by evidence, then the impact can be considered to be direct. When both the removal of the regulation and other factors are required, for example innovation to take advantage of a new freedom, then impacts are considered to be indirect.

**Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 (RPC11-HMT-0869):** This policy allowed credit unions to increase membership and offer more services. It was clear from the evidence provided that the affected businesses wished to grow and were prevented from doing so only by the regulations. The costs and benefits to firms of expanding were, therefore, considered direct and in scope of OIOO. ([IA](http://www.legislation.gov.uk/uksi/2011/2687/impacts))

**Orphan works (RPC11-BIS-1063):** Orphan works are copyrighted works whose author is unknown. This policy allowed the use of orphan works, subject to certain safeguards. One of the main expected benefits of this policy was from new businesses being created to take advantage of newly-available material. As these benefits would arise only as a result of innovation from business, they were considered to be indirect. (Note that there were other direct benefits to existing users of orphan works and, therefore, the policy overall was still an OUT.) ([IA](http://www.ipo.gov.uk/consult-ia-bis1063-20120702.pdf)) ([Opinion](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/373053/RPC11-BIS-1063_5___Orphan_works__IPO__-_IA_f__adj_-_opinion.pdf))

**Extending the primary authority scheme (RPC11-BIS-0899):** The primary authority scheme allows a business operating in multiple local authority areas to nominate a primary authority to co-ordinate all local authority enforcement activity relating to that business. The policy extended the scheme. As the scheme resulted in a reduction in the level of regulatory activity a business was required to undertake, the impacts were ruled to be direct. There have been a number of other policies to extend the primary authority scheme, all of which have been treated in the same manner. (See also deregulation). ([IA](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31985/12-864-impact-assessment-extending-primary-authority-scheme.pdf)) ([Opinion](https://www.gov.uk/government/publications/impact-assessment-opinion-the-extension-of-the-primary-authority-scheme-to-cover-the-age-restricted-sale-of-alcohol-and-fire-safety-regulations))

**Gambling Act 2005: triennial review of stakes and prize limits (RPC13-DCMS-1459):** There is a limit on the maximum value of stakes and prizes used in gaming machines. The policy increased this limit, allowing businesses to make greater profits from higher value machines. As it would be reasonably straightforward for businesses to move to higher-value machines it was accepted that the regulation was the only thing that prevented businesses from gaining these benefits. The benefits were therefore considered to be direct. ([IA](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/249274/Triennial_Review_of_Gaming_Machine_Stake_and_Prize_Limits_Impact_Assessment.pdf)) ([Opinion)](https://www.gov.uk/government/publications/impact-assessment-opinion-gambling-act-2005-triennial-review-of-stake-and-prize-limits))

1. [Cite the BRFM here] [↑](#footnote-ref-1)
2. This effectively shifts part of the supply curve. [↑](#footnote-ref-2)