

April 2, 2015

The Honorable Ron Johnson, Chairman
Committee on Homeland Security and Governmental Affairs
United States Senate
Washington, DC 20510

Dear Chairman Johnson:

Thank you for the opportunity to testify on February 25 at the hearing “Toward a 21st Century Regulatory System.” I’m delighted to provide answers to the post-hearing questions you posed in your letter of March 12.

1. OMB’s annual report to Congress on the benefits and costs of regulations is often used as evidence to support the conclusion that the benefits of federal regulations exceed the costs. Considering that this report examines only agency estimates of benefits and costs, how credible is this conclusion?

The annual OMB report is not a reliable guide to whether the benefits of federal regulations exceed the costs or vice versa. There are several reasons for this:

- The annual OMB report contains no information about the benefits and costs that actually occurred as a result of federal regulations. Rather, it is a compendium of agency estimates from regulatory impact analyses conducted before regulations were implemented.
- Many of these benefit and cost estimates are unreliable, because many regulatory impact analyses are seriously incomplete.
- The annual report includes only the estimated benefits and costs of regulations implemented in the previous 10 years.
- Even for major regulations, agencies do not always produce monetized estimates of benefits and costs. For example, for fiscal year 2013, the most recent year covered in the most recent OMB report, just seven out of 54 major regulations had monetized estimates of both benefits and costs.¹
- The vast majority of federal regulations are not considered in the report, because it only considers regulations classified as “major” or “economically significant.” As my colleague James Broughel noted in comments on the most recent draft report,

In the last decade, 33,982 rules issued by agencies escaped OMB review altogether, leaving roughly 92 percent of the regulatory system completely outside of the OMB’s purview. Of the 3,040 rules that the OMB reviewed, slightly less than 4 percent (116 rules) have dollar

¹ James Broughel, “OMB Draft Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities” (public interest comment, Mercatus Center at George Mason University, Arlington, VA, 2014), 5, available at <http://mercatus.org/publication/omb-2014-draft-report-congress-benefits-and-costs-federal-regulations-and-unfunded>. Of the 54 major regulations, 30 were budget regulations. All but one of the budget regulations monetized the full amount of the income transfers.

estimates of both benefits and costs appearing in the OMB's report. It is difficult to take the figures about benefits and costs seriously when such a tiny fraction of rules are included in the report. The OMB should explicitly state in its report that it can't say for certain whether benefits exceed costs during the time frame analyzed or in any particular year.²

In the policy debate over regulation, one frequently hears that benefits are harder to estimate than costs. Some people believe that benefits of regulation are usually harder to estimate than costs because costs are merely money spent by regulated entities, whereas benefits often involve difficult-to-value things such as clean air or the protection of endangered species. This belief confuses monetary outlays with social opportunity costs. The benefits of a regulation are the ultimate outcomes that improve citizens' quality of life. The costs of a regulation are the good things society must forego as a result of the regulation. Properly understood, both benefits and costs can be difficult to measure and convert into monetary terms. Whether one is more difficult than the other depends on the regulation.

Monetary outlays for paperwork and compliance are part of the cost of regulation but by no means the entire cost. For example, the enhanced security procedures at airports in the wake of the September 11 terrorist attacks clearly had substantial economic costs. But they also increased waiting time for passengers. The value of this time is a cost of the regulation. As a result of the increased ticket prices and delays, some travelers substituted driving for flying on shorter trips, and driving is riskier than flying.³ More generally, a regulation may be intended to reduce one type of risk, but it also increases some other type of risk, and that increased risk is a cost.⁴ Thus, the correct estimation of the social cost of a regulation can require assessments of cause-and-effect relationships and monetary valuation challenges that are every bit as difficult as those involved in estimating benefits.⁵

2. Should all agencies be held to the same standards for regulatory impact analysis, given that they have diverse missions, authorizing statutes, and decision-making authority?

All agencies should be held to the same standard enunciated in President Clinton's Executive Order 12866: "Each agency shall base its decisions on the best reasonably obtainable scientific, technical, economic, and other information regarding the need for, and consequences of, the intended regulation."⁶ If enforced consistently, this standard requires agencies to use in their analysis the best scientific, technical, economic, and other information available given the state of current research, but it also avoids requiring agencies to perform analysis that is impossible given the current state of knowledge. Any statutory requirement for regulatory impact analysis should include this standard.

The "best reasonably obtainable information" standard is flexible enough to accommodate differences in the state of the art for evaluating different types of regulations. In some cases, the quality of agency analysis varies depending on the subject matter of the regulation. Statistical analysis of scoring data from the Mercatus Center's Regulatory Report Card finds that

² Ibid., 4.

³ Garrick Blalock, Vrinda Kadiyali, and Daniel H. Simon, "The Impact of Post-9/11 Airline Security Measures on the Demand for Air Travel," *Journal of Law & Economics* 50, no. 4 (November 2007), 731-56.

⁴ Cass Sunstein, "Health-Health Tradeoffs," *University of Chicago Law Review* 63, no. 4 (Autumn 1996), 1533-71.

⁵ The Mercatus Center has developed a survey instrument called the Regulatory Cost Calculator that agencies and stakeholders can use to gather more accurate information about costs. For more information, see <http://mercatus.org/publication/regulatory-cost-calculator>.

⁶ EO 12866, §1(b)(7).

environmental regulations tend to have slightly better analysis than other regulations and budget regulations tend to have much worse analysis than other regulations.⁷

If anything, administration of this standard under the executive order may be too flexible. Budget regulations can generate significant benefits and costs via price distortions and mandates and prohibitions attached to the spending.⁸ Nevertheless, the OMB review focuses on ensuring that the budget numbers are correct rather than assessing the (potentially substantial) benefits and costs that occur when federal spending of revenue collection alters incentives.⁹ As a result, decisions about budget regulations are made with little information about overall social benefits and costs.

It would be a mistake to conclude that the “best reasonably obtainable information” standard as implemented by executive order and enforced by OIRA review is sufficient to ensure uniformly high-quality analysis. Scholarly research cited in my written testimony, including the Mercatus Center’s Regulatory Report Card, finds that many regulatory impact analyses are seriously incomplete, and their quality varies widely. Much of the variation that has survived OIRA review occurs for highly questionable reasons:

- Administrations of both parties appear to require less thorough analysis from agencies that are more central to the administration’s ideology or policy priorities. The Bush administration, for example, permitted the Department of Homeland Security to proceed with a number of regulations that were accompanied by very incomplete regulatory impact analysis; the Obama administration did likewise with the first major regulations implementing the Patient Protection and Affordable Care Act.¹⁰ This same pattern appears to occur with other agencies.¹¹ As Donald Arbuckle, who served as deputy and acting OIRA administrator, put it, “In a head-on battle between analysis and politics, politics will generally win.”¹²
- “Midnight” regulations, defined as those that are finalized at the end of a presidential term between Election Day and Inauguration Day, tend to have lower-quality analysis and less extensive explanations of how the agency used the analysis in its decisions.¹³

⁷ Patrick A. McLaughlin and Jerry Ellig, “Does OIRA Review Improve the Quality of Regulatory Impact Analysis? Evidence from the Bush II Administration,” *Administrative Law Review* 63 (2011), 179–202; Jerry Ellig, Patrick A. McLaughlin, and John F. Morrall III, “Continuity, Change, and Priorities: The Quality and Use of Regulatory Analysis Across U.S. Administrations,” *Regulation & Governance* 7 (2013), 153–73; Jerry Ellig and Christopher J. Conover, “Presidential Priorities, Congressional Control, and the Quality of Regulatory Impact Analysis: An Application to Health Care and Homeland Security,” *Public Choice* 161 (2014), 305–20.

⁸ Office of Information and Regulatory Affairs, *2009 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities* (2009), 18.

⁹ McLaughlin and Ellig, “Does OIRA Review Improve the Quality of Regulatory Impact Analysis?,” 188.

¹⁰ Jamie Belcore and Jerry Ellig, “Homeland Security and Regulatory Analysis: Are We Safe Yet?,” *Rutgers Law Journal* (Fall 2009), 1–96; Jerry Ellig and Christopher J. Conover, “Presidential Priorities, Congressional Control, and the Quality of Regulatory Impact Analysis: An Application to Health Care and Homeland Security,” *Public Choice* 161 (2014), 305–20; Christopher J. Conover and Jerry Ellig, “Rushed Regulation Reform” (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 2012); Ellig et al., “Continuity, Change, and Priorities”; Jerry Ellig and Rosemarie Fike, “Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, July 2013).

¹¹ Ellig et al., “Continuity, Change, and Priorities.”

¹² Donald R. Arbuckle, “The Role of Analysis on the 17 Most Political Acres on the Face of the Earth,” *Risk Analysis* 31, no. 6 (2011), 886.

¹³ McLaughlin and Ellig, “Does OIRA Review Improve the Quality of Regulatory Impact Analysis?”; Ellig et al., “Continuity, Change, and Priorities”; and Ellig and Fike, “Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis.”

- Regulations proposed during one president’s term but left for the next administration to finalize tend to have lower-quality analysis and less extensive explanations of how the agency used the analysis in its decisions.¹⁴
- Regulations whose OIRA review concluded under an acting OIRA administrator rather than a presidential appointee tend to have less extensive explanations of how the agency used the analysis in its decisions.¹⁵
- Regulations that are more politically salient tend to have lower-quality analysis.¹⁶

In addition, independent agencies, which are not subject to Executive Order 12866, usually produce lower-quality analysis than executive branch agencies.¹⁷ A statutory requirement with judicial review to ensure that the analysis used the best reasonably obtainable information would help eliminate low-quality analysis that occurs for questionable—often political—reasons.

Finally, I doubt that the quality of analysis needs to be diminished to tailor the analysis to the agency’s authorizing statutes and decision-making authority. The statutes that authorize the agency and/or the regulation define the extent of the agency’s decision-making authority. An econometric analysis of Regulatory Report Card data reveals that the quality of analysis does not vary based on the extent of agency decision-making authority. The quality of the analysis is no different when the statute constrains agency authority by requiring the agency to issue a regulation, mandating the form of the regulation, or mandating the stringency or coverage of the regulation.¹⁸ This suggests that any aspect of the analysis that must be tailored to the specifics of the agency’s decision-making authority can be addressed without diminishing the quality of the analysis.

3. Has the quality of regulatory impact analysis improved over time? Is there evidence that OIRA has helped improve the quality of agency regulatory analysis?

A study conducted by the President’s Council on Wage and Price Stability on the eve of its abolition in 1981 pointed out that agencies often produce seriously incomplete analysis of the problem a regulation is supposed to address, the options available for addressing the problem, and/or the benefits and costs of alternatives.¹⁹ The quality of analysis may have improved in some ways since then. But the Regulatory Report Card reveals that many regulations are still accompanied by deficient analysis of these topics, and quality appears to have plateaued during the past 15 years.

¹⁴ Ibid.

¹⁵ Ellig and Fike, “Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis.”

¹⁶ Stuart Shapiro and John F. Morrall III, “The Triumph of Regulatory Politics: Benefit-Cost Analysis and Political Salience,” *Regulation and Governance* 6 (2012), 189–206.

¹⁷ Arthur Fraas and Randall L. Lutter, “On the Economic Analysis of Regulations at Independent Regulatory Commissions,” *Administrative Law Review* 63 (2011): 213–41; Jerry Ellig and Hester Peirce, “SEC Regulatory Analysis: A Long Way to Go and a Short Time to Get There,” *Brooklyn Journal of Corporate, Financial & Commercial Law* 8, no. 2 (Spring 2014), 361–437.

¹⁸ Ellig and Conover, “Presidential Priorities, Congressional Control, and the Quality of Regulatory Impact Analysis,” 315. The econometric analysis is in a downloadable appendix available at <http://mercatus.org/publication/presidential-priorities-congressional-control-and-quality-regulatory-analysis>. In a paper published several years ago, I speculated that narrow delegation of authority to agencies might explain lower-quality analysis (Belcore and Ellig, “Are We Safe Yet?,” 38–41). The more recent econometric analysis shows that I was wrong.

¹⁹ Thomas D. Hopkins, Benjamin Miller, and Laura Stanley, “The Legacy of the Council on Wage and Price Stability” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, August 26, 2014), <http://mercatus.org/sites/default/files/Hopkins-Wage-Price-Stability.pdf>.

Several studies have assessed the quality of regulatory impact analyses during various time periods. Robert Hahn and coauthors used a numerical checklist to assess the quality of the Environmental Protection Agency’s regulatory impact analyses conducted between 1982 and 1999. The analyses earned an average of 40 percent of the possible points, with no significant change over time.²⁰ Checklist evaluations of regulations issued from 2000 to 2009 have generated average scores in the 60–64 percent range.²¹

The Mercatus Regulatory Report Card, a qualitative evaluation with numeric scoring, produced similar results for the 2008–2012 time period. It is not clear if the higher scores since 2000 reflect improvement in the quality of analysis or simply differences in different researchers’ scoring methods. Regardless, there has been no improvement in average Report Card scores from 2008 to 2012, which does not bode well for future analysis.

Empirical research finds that OIRA review is associated with higher-quality regulatory impact analysis and better explanation of how the agency used the analysis to inform its decisions. The quality and use of regulatory analysis is positively correlated with the length of OIRA review time.²² OIRA’s influence in the administration (measured by whether the administrator is a political appointee or acting administrator) is positively correlated with claimed use of regulatory analysis.²³ Prescriptive regulations, whose regulatory impact analyses receive more intensive OIRA review, tend to have higher quality analysis than budget regulations.²⁴

Unfortunately, the quality of regulatory impact analysis still falls far short of the standards enunciated in Executive Order 12866 and OMB *Circular A-4*. Thus, while OIRA review has certainly helped improve agency analysis, further improvement will likely require legislation.

4. Would it be wasteful to eliminate or modify a regulation that businesses, states, or other regulated entities have already spent money to comply with? How could changing such a regulation be beneficial if the money to comply has already been spent?

The costs that regulated entities have already borne to comply with regulations are irrelevant to determining whether changing or repealing the regulation would be wasteful. Changing or repealing the regulation will not change the fact that these costs have already been incurred. This is why economists call them “sunk” costs. The relevant costs are the costs that changing the regulation would cause in the future. The relevant benefits are the benefits that changing the regulation would cause in the future. If the expected future benefits exceed the expected future costs, then it is efficient to change the regulation. If the expected future costs exceed the expected future benefits, then it is wasteful to change the regulation.

If a better alternative was available at the time the regulation was originally adopted, then the original decision to adopt the regulation was wasteful. High-quality regulatory impact analysis can help avoid this kind of waste.

²⁰ Robert W. Hahn and Paul C. Tetlock, “Has Economic Analysis Improved Regulatory Decisions?,” *Journal of Economic Perspectives* 22, no. 1 (Winter 2008), 67–84; Robert W. Hahn and Patrick Dudley, “How Well Does the Government Do Cost-Benefit Analysis?,” *Review of Environmental Economics and Policy* 1, no. 2 (2007), 192–211.

²¹ Art Fraas and Randall Lutter, “The Challenges of Improving the Economic Analysis of Pending Regulations: The Experience of OMB Circular A-4,” *Annual Review of Resource Economics* 3, no. 1 (2011), 71–85; Shapiro and Morrall, “The Triumph of Regulatory Politics.”

²² Ellig and Fike, “Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis”; Stuart Shapiro and John F. Morrall III, “Does Haste Make Waste? How Long Does It Take to Do a Good Regulatory Impact Analysis,” *Administration and Society* 20, no. 1 (2013).

²³ Ellig and Fike, “Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis.”

²⁴ McLaughlin and Ellig, “Does OIRA Review Improve the Quality of Regulatory Impact Analysis?”

5. Do you know of any empirical research that would help predict how proposed reforms would change the quality of regulatory impact analysis or the quality of new regulations?

Proposed regulatory reforms include (1) requiring advance consultation with stakeholders, (2) requiring advance notices of proposed rulemaking for major regulations, and (3) requiring formal hearings for high-impact rules.

In a recent study using Regulatory Report Card data, Rosemarie Fike and I report several findings that shed light on the likely effects of these proposed reforms. Several types of actions that expand pre-proposal information gathering are associated with higher-quality analysis and greater claimed use of analysis in an agency's decision-making. These include a prior notice of proposed rulemaking in the same regulatory proceeding, a public request for information by the agency, and consultation with state, tribal, or local governments. In addition, when an agency commits to holding a hearing on a proposed regulation in the future, it does a better job of explaining how the analysis affected its decisions.²⁵

The research cited above on the effects of OIRA review implies that requiring independent agencies to conduct regulatory impact analysis, coupled with external review, would lead to better analysis by independent agencies. It also implies that providing OIRA with more staff and resources would help improve the quality of regulatory impact analysis.

To be effective, statutory reforms must have an effective enforcement mechanism. A Mercatus Center working paper by Stuart Shapiro and Deanna Moran found that four major legislative reforms enacted after the Administrative Procedure Act largely failed to achieve their substantive goals, such as reducing regulatory burdens.²⁶ The reason is that political compromises made to secure passage gave regulatory agencies substantial discretion in interpreting and complying with the statutes, and courts gave agencies' interpretations substantial deference. The reforms allowed elected leaders to claim they were fixing an economic problem without having to implement controversial changes, but they did not lead to significant substantive changes in regulation. For these reasons, it is doubtful that legislative reforms will lead to better or less costly regulation without a strong enforcement mechanism, such as judicial review.

I hope this additional information is helpful in the committee's deliberations over regulatory reform. Please feel free to contact me if I can provide any additional information.

Sincerely,

Jerry Ellig
Senior Research Fellow
Mercatus Center at George Mason University

²⁵ Ellig and Fike, "Regulatory Process, Regulatory Reform, and the Quality of Regulatory Impact Analysis."

²⁶ The four reforms are the Regulatory Flexibility Act, the Paperwork Reduction Act, the Unfunded Mandates Reform Act, and the Small Business Regulatory Enforcement Fairness Act. See Stuart Shapiro and Deanna Moran, "The Questionable History of Regulatory Reform Since the APA" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, March 2015), <http://mercatus.org/sites/default/files/Shapiro-Reg-Reform-APA.pdf>.