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Primer on Regulation

Susan E. Dudley
Director, Regulatory Studies Program,
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About Susan E. Dudley, series co-editor & author

Susan E. Dudley is the Director of the Mercatus Center at George Mason University's Regulatory Studies Program and adjunct professor at the George Mason University School of Law. She has written on a variety of topics related to regulatory policy and applied finance. Before joining the Mercatus Center, she was Vice-President and Director of Environmental Analysis at Economist Incorporated, a consulting firm in Washington, DC, and has worked at several government agencies, including the Environmental Protection Agency, the Office of Management and Budget, and the Commodity Futures Trading Commission. Susan holds an MS from the Sloan School of Management at MIT and a BS (*summa cum laude*) in resource economics from the University of Massachusetts.

About Frederic Sautet, series co-editor

Frederic Sautet is a Senior Research Fellow at the Mercatus Center at George Mason University. Prior to joining Mercatus, Frederic was a Senior Economist at the New Zealand Commerce Commission and a Senior Analyst at the New Zealand Treasury where he focused on economic transformation, entrepreneurship, utility development, and tax policy. Frederic holds a doctorate in economics from the Université de Paris Dauphine and did the course work for his doctorate at the Institut des Etudes Politiques in Paris. He also studied at New York University as a post-doc. Frederic's current work focuses on entrepreneurship, institutions, and social change.

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PRIMER ON REGULATION

SUSAN E. DUDLEY

EXECUTIVE SUMMARY

This primer provides an overview of regulation, from theoretical issues to analytical ones of how to write a good regulation. It examines the constitutional underpinnings of regulation and discusses who writes and enforces regulation and how they do it. It also provides insights into the different varieties of regulation, and how to analyze whether a regulatory proposal makes citizens better or worse off.

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1. What is Regulation?

Regulations, or rules, are the primary vehicles by which agencies implement laws and general agency objectives. They are specific standards or instructions concerning what can or cannot be done by individuals, businesses, and other organizations.

Also called administrative laws, regulations affect every aspect of our lives. From the moment you wake up until the time you go to sleep, regulations influence what you do. Yet people know very little about the impact of regulations or the process by which they are produced.

This primer provides an overview of regulation, from theoretical issues to analytical ones of how to write a good regulation. It examines the constitutional underpinnings of regulation and discusses who writes and enforces regulation and how they do it. It also provides insights into the different varieties of regulation, and how to analyze whether a regulatory proposal makes citizens better or worse off.

We begin with a look at a day in the life of a regulated American family. This first chapter presents statistics on the size and scope of regulation and classifies regulations into basic categories for subsequent discussion. Chapter 2 explores theories of regulation. Chapter 3 reviews the constitutional underpinnings of executive branch regulation. Chapters 4 and 5 describe the process by which government develops regulations and examine the incentives regulators face. Chapters 6 and 7 delve into the nature of the different types of regulation particularly those addressing health, safety and the environment, and economic matters. In Chapter 8, we roll up our sleeves and analyze regulations to understand what makes for good policy. Chapter 9 concludes with a brief look at the challenges and opportunities the future holds for regulation.

A Day in the Life of a Regulated American Family

What do you think of when you think of regulations?

You probably think of rules like the Federal Trade Commission's "Do Not Call" regulations requiring telemarketers to honor people's preferences as to whether they would like to receive phone calls in the middle of dinner or perhaps environmental regulations restricting emissions from a power plant. You might be surprised to know just how many regulations you encounter in an average day.

Your day starts when your clock radio goes off in the morning. The Federal Communications Commission regulates not only the airwaves used by your favorite radio station, but also the content of the programming. Electricity provided by a utility that is most likely regulated by the Federal Energy Regulatory Commission and by state regulatory agencies powers the radio.

The Consumer Product Safety Commission regulates the label on your mattress. The price of your cotton sheets is higher than it otherwise would be due to the U.S. Department of Agriculture's (USDA) subsidy and price support programs for U.S. cotton producers, as well as quotas and tariffs for imported goods.

The Food and Drug Administration (FDA) regulates the content of your toothpaste, soap, shampoo, and other grooming products. The Environmental Protection Agency (EPA) regulates the quality of the water coming out of your showerhead. Complying with EPA water quality standards can cost households over $300 per year, but you won't see this as a separate item on your water bill. The cost is passed along to you in your local taxes which finance your municipal drinking water system. On your way out of the bathroom, you may have to flush your low-flow toilet twice, a result of mandates imposed by the Department of Energy's appliance efficiency rules.

As you prepare your morning breakfast, you will check your FDA regulated labels for nutritional information. The FDA also regulates information about the health benefits of foods so juice labels may not tell you about the latest research that links certain ingredients to the prevention or mitigation of certain diseases.

The FDA and USDA also have a hand in regulating your coffee and sugar. Also joining you for your cup of java is the Commodity Futures Trading Commission, which regulates the hedging of coffee beans, sugar, and other commodities on futures markets.

The USDA's Agricultural Marketing Service artificially inflates the price of the milk you pour in the coffee, as well as the price of cheese, butter, and other dairy products through price supports and marketing orders. USDA even regulates the size of the holes in the Swiss cheese you grate into your omelet. Your eggs seem more attractive to you since you have seen television ads paid for by the government-sponsored marketing cooperative, the Egg Board, which uses taxpayer-financed subsidies to encourage egg consumption. Even your toast is more expensive because of various subsidy and acreage restriction programs in wheat farming.

The EPA, FDA, and USDA Animal Plant Health Inspection Service (APHIS) regulate the fruit you serve for breakfast. The USDA's Agricultural Marketing Service also has a hand in your fruit, setting grade standards and purchasing fruits and vegetables "to correct supply and demand imbalances" (and keep prices high).

Tariffs and import restrictions on steel issued by the regulators at the International Trade Commission make sure that the Japanese car you drive is more expensive than it would otherwise be so that foreign car prices are as high as U.S. vehicles. The U.S. vehicles are costlier because the domestic manufacturers are complying with costly labor standards created by the Department of Labor and Occupational Safety and Health Administration (OSHA).

If you have children, they must ride in the back seat, because the passenger air bags required by the National Highway Traffic Safety Administration (NHTSA) have killed children and small adults riding in the front. If you always buckle your seat belt, the airbags are not making you much safer, since NHTSA designs its standards to protect adults who do not buckle. The price of your next car will be higher, now that car companies must comply with new standards that require advanced airbags with sensors in passenger seats that detect the size of the person and whether a seat belt is in use, and adjust airbag inflation accordingly. What new risks this new regulation will introduce are unknown.

Your car is also subject to NHTSA's fuel economy (or CAFE) standards and EPA emission standards. If you don't have a carpool, you may have to take a roundabout way to your office, because the most direct route is reserved for "high occupancy vehicles" during the morning rush hour. The EPA's air quality state implementation plans or "SIPs" mandate that states set aside roads for carpools or forfeit federal highway funds.

At work, regulations issued by the Department of Labor may keep your workplace safer, but they may also limit the arrangements you can negotiate with your employer. The one-size-fits-all employee benefits standards prevent you from negotiating benefit packages that best suit employee needs, so you are unwittingly forced to accept lower wages in exchange for benefits you may not want. Regulations guarantee you a minimum wage for your work, but discourage employers from hiring low-productivity workers.

Regulations covering product safety, food, pharmaceuticals, and the environment make products you buy more expensive than they would otherwise be. These rules may keep some unsafe products off the market, but they also prevent valuable and potentially life-saving new products from becoming available to Americans.

As you can see, regulation touches on everyday lives in thousands of ways that we may never imagine. Regulations have benefits as well as costs, but most people are unaware of their reach and influence. Sometimes regulations confer benefits on all of us, and sometimes they just benefit a subset of consumers or producers. This primer aims to make the complicated and arcane world of regulation more understandable to interested people outside the Washington, D.C. Beltway.

Estimating the Scope of Federal Regulation

Taxes, and subsequent spending, are one way the federal government diverts resources from the private sector to accomplish public goals. Regulation of private entities—businesses, workers, and consumers—is another.

Every year, more than 60 federal departments, agencies, and commissions employ a combined staff of more than 240,000 full-time employees to write and enforce federal regulations. Together they issue thousands of new rules each year. Like the programs supported by taxes,

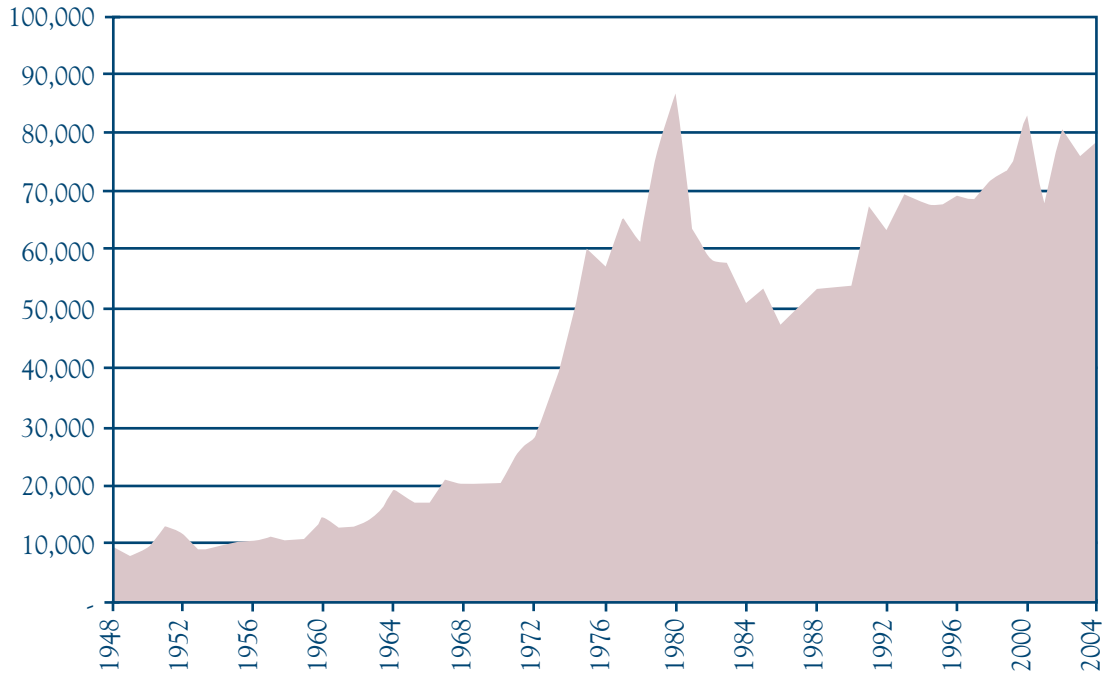
regulations provide benefits to Americans. Indeed, the desired benefits of regulation are the force behind legislative initiatives that create them, and the benefits of regulation are often better understood, qualitatively, at least, than the costs. However, unlike the fiscal budget which tracks direct spending supported by taxes, there is no mechanism for keeping track of the off-budget spending generated through regulation.

Thus, efforts to track the change in regulatory activity over time often depend on proxies, such as the number of pages printed in the *Federal Register*, or the size of the budgets of regulatory agencies.

The size of the *Code of Federal Regulations* (which now occupies over 20 feet of shelf space) provides a sense of the magnitude of the stock of existing regulations with which American businesses, workers, and consumers must comply. The number of pages in the *Federal Register* provides a sense of the flow of new regulations issued during a given period and suggests how the regulatory burden will grow as Americans try to comply with the new mandates. In 2004, the federal government printed 78,851 pages of rules and announcements. At a reading rate of four minutes per page, 2.5 people would have to read eight hours per day for a year, just to keep up with the new rules and pronouncements. The graph in Figure 1.1 shows the growth in the

Figure 1.1

ANNUAL PAGES PUBLISHED IN THE *FEDERAL REGISTER*



Source: Page counts maintained by author

number of pages in the *Federal Register* over time.

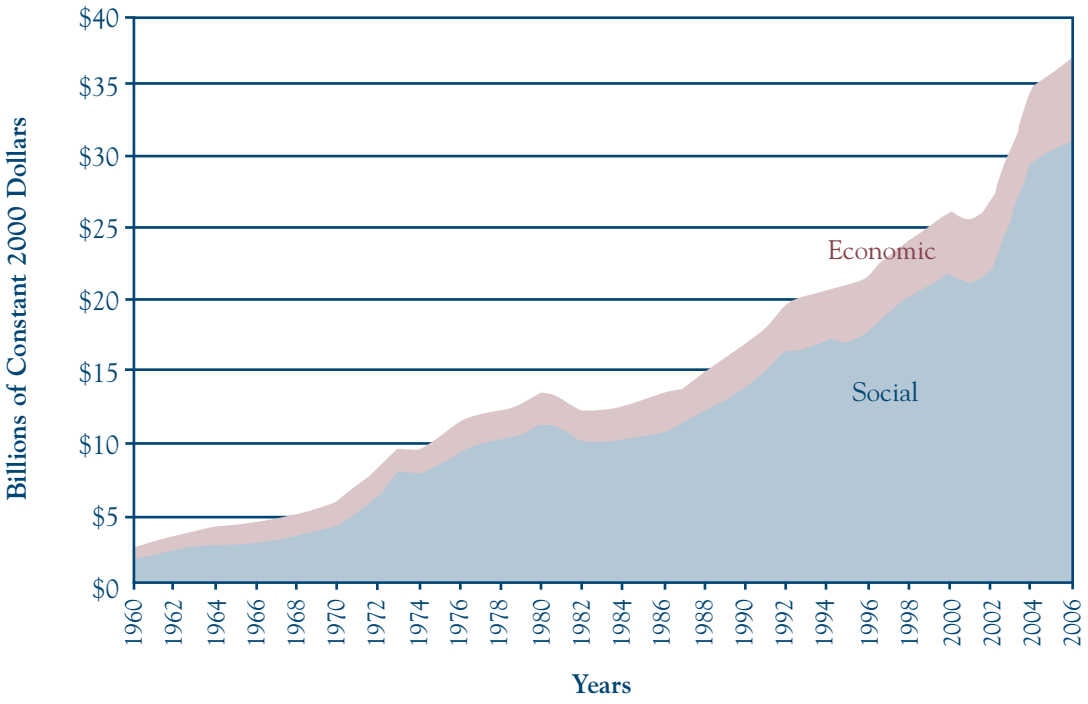
Another proxy measure for the scope of regulatory activity and cost is the direct fiscal budget expenditures devoted to regulatory activity. By analyzing the federal personnel and expenses necessary to develop and enforce regulations, we can track regulatory trends over time, and use those data as a barometer of regulatory activity that provides useful insights into the composition and evolution of regulation.

Figure 1.2 shows the growth in the portion of the Federal budget obligated to writing and enforcing regulations between 1960 and 2006. (Note that figures for 2005 and 2006 are estimates based on the president's budget request to Congress.)

Of course, regulations impose social costs on individuals and businesses beyond the direct tax dollars expended to write and enforce them. *Federal Register* pages, agency staffing, and on-budget costs are merely proxies of this hidden tax. Probably the best recent estimate of the social cost of regulations is a 2005 report, "The Impact of Regulatory Costs on Small Firms," for the Small Business Administration (SBA) by Professor Mark Crain. He estimates that in 2004 Americans spent $1.1 trillion, or more than $10,000 per household, to comply with federal regulations.

Figure 1.2

ADMINISTRATIVE COSTS OF FEDERAL REGULATION



Source: Dudley and Warren 2005

The Office of Information and Regulatory Affairs (OIRA) in the U.S. Office of Management and Budget (OMB) has kept a running total of the costs and benefits of the major regulations issued during the previous 10 years. In its draft 2005 report, OIRA estimates the cost of major regulations issued between 1994 and 2004 at $35 to $39 billion per year, and the benefits at $68 billion to $260 billion per year. OMB's cost figures are so much less than SBA's for a couple reasons. First, they excludes certain costs, deemed transfers (discussed more in Chapter 8), and they cover only "economically significant" regulations issued over the last decade. For example, OMB bases benefits and costs for fiscal year 2004 on agency estimates for only eleven regulations, one-tenth of one percent of the final rules published in the *Federal Register* during that year.

Categories of Regulation

We often divide regulations into two main categories: social regulations and economic regulations. Social regulations address issues related to health, safety, and the environment. The Environmental Protection Agency, the Occupational Safety and Health Administration, and the Food and Drug Administration are examples of agencies that administer social regulations. Their activities are generally limited to a specific issue, but they also have the power to regulate across industry boundaries. For example, the Occupational Safety and Health Administration regulates worker safety across industries. Chapter 7 of this primer discusses social regulations.

Economic regulations are often industry-specific. The Securities and Exchange Commission, the Federal Communications Commission, and the Federal Energy Regulatory Commission are examples of agencies that administer economic regulations. Economic regulation usually entails a broad base of activities in particular industries using economic controls such as price ceilings or floors, quantity restrictions, and service parameters. For example, the Federal Energy Regulatory Commission regulates the rates electric utilities can charge, and the quality of electricity service. Chapter 6 of this primer addresses economic regulations in more detail.

Further Reading:

Susan Dudley and Melinda Warren, *Upward Trend in Regulation Continues: An Analysis of the U.S. Budget for Fiscal Years 2005 and 2006*, Regulators' Budget Report 27. Mercatus Center at George Mason University, and Weidenbaum Center on the Economy, Government, and Public Policy at Washington University in St. Louis, June 2005.

W. Mark Crain. *The Impact of Regulatory Costs on Small Firms*, Office of Advocacy, U. S. Small Business Administration, 2005.

2. Theories of Regulation: Why do we regulate?

In a free-market economy, like that of the United States, why does the government regulate the behavior of firms and individuals? What factors affect the number and extent of regulations, and what motivates individual regulations? The answers to these questions come from theories, or models, of how institutions, businesses, and individuals behave and from empirical analyses and observations.

Before we delve into the different theories, we must distinguish between normative and positive analysis. Normative analysis examines *what should be*. In the case of regulation, it asks when the government *should* intervene in private markets. Positive analysis, on the other hand, examines *what is*. Positive theories try to predict when regulation will occur, and help explain why we see certain types of regulations in some industries and not others. This chapter will focus on these positive theories of regulation We address normative analysis in Chapter 8.

Public Interest or "Market Failure" Theory

Our understanding of why we have regulation has evolved over time. The first theory of regulation recognized that markets are very efficient at allocating scarce resources to their best uses. It is based on a normative notion that government intervention may be appropriate, however, in cases when competitive conditions are not met and markets "fail" to allocate resources efficiently.

The theory holds that politicians seeking to serve the public interest will regulate to correct those "market failures." The concept of market failure comes from the neoclassical economist's paradigm of a "perfectly competitive market"—one in which many buyers and sellers of a homogeneous product all have perfect information. Welfare economists, lead by British economist A.C. Pigou early in the 20th century, focused on the need for government intervention when markets deviate from these "perfect market" conditions.

According to welfare economics, market failures generally fall into one of four categories.

1. **Externalities** occur when one party's actions impose uncompensated costs or benefits on another party. If those actions affect another party's welfare enough that the party would be willing to pay to alter them, resources are not allocated the way they would be if all costs and benefits were "internalized" in the market place.

2. **Public goods** are common resources (such as a body of water) where it is not possible to exclude users. They tend to be overused (Fishermen would over-fish a common fishery) or under-provided (New discoveries might not be made if not for patents granting the discoverer rights to profit).

3. The presence of **monopoly power** in a market gives a firm the ability to control prices. "Natural monopolies" exist when economies of scale are so great that a market can be served at lowest cost only if production is limited to a single producer. In such cases, without some form of intervention, prices would be higher and quantity produced lower than in a competitive market.

4. Finally, when market participants have **inadequate information**, markets may not allocate resources efficiently However, few would argue that perfect information is necessary. More recent empirical analysis shows that perfect information is not even optimal for a well-functioning market.

When one of these market failures exists, a normative approach might argue that public-minded politicians should intervene to correct the market by either internalizing externalities, regulating monopolists, or providing information. Using this normative analysis as a positive theory suggests that we should expect to see regulations enacted to address perceived or real market failures, and thereby serve the public interest.

There are several problems with this public interest theory of regulation, however.

- As a positive theory, it hypothesizes that regulation *will* occur when it *should* because the net social gains are greater than without regulation, but it doesn't explain the mechanism by which that would occur. In other words, it doesn't tell us how or why people, in their role as government officials, businessmen and consumers, etc., will produce the desirable outcome.

- More importantly, the public interest theory does not do a good job of predicting when we will see regulation. We have evidence that many regulations do not correspond to market failures, such as natural monopoly or externalities. Economic regulations, which were the predominate type of regulation through the 1960s, were not well correlated with identifiable market failures, and indeed, they often seemed to serve private, not public, interests.

- As a normative tool (discussed more in Chapter 8), it must also be used with caution. The major complaint about market failure analysis is that it does not recognize the existence of transactions costs or government failures. Transactions costs are the resources necessary to transfer, establish, and maintain property rights. Externalities exist because the transactions costs of resolving them are too high. Identifying a market failure is not in itself justification

for government action, because government action is also not perfect.

Capture Theory

The observation that laws and regulation do not correspond to industries characterized by market failures, and that many regulations seem to serve private interests, led political scientists and economists to hypothesize that politicians and regulators end up being "captured" by special interests, usually the producers they are intended to regulate. As a result, laws and regulations serve, not the public interest, but those special interests.

While the "capture theory" was better at explaining the occurrence of regulation than the public interest theory, it was incomplete. Many regulations do not appear to serve the industry being regulated. The capture theory failed to provide an explanation for *why* regulators would get captured and by *whom*.

Two Nobel Prize-winning economists, George Stigler and James Buchanan, have developed related theories that address these weaknesses in the capture theory, the "economic theory of regulation" and "public choice."

Economic Theory of Regulation

George Stigler's 1971 article, "The Theory of Economic Regulation" offered a clear, testable theory that explained the presence of regulation in different industries. It also helped raise awareness of the incentives and wealth-redistribution consequences of economic regulation. Stigler started with the premise that:

1. The basic resource of the government is the power to coerce.

2. An interest group that can convince the government to use its coercive power to its benefit can improve its well-being at the expense of others.

3. Agents (firms, individuals, government officials, interest groups) are rational and try to maximize their own utility (well-being).

With this foundation, he set forth the hypothesis that regulation is supplied in response to the demands of interest groups acting to maximize their own well-being (income). He observed that legislators' behavior is driven by their desire to stay in office (maximize political support). Regulation is one way to redistribute wealth, and interest groups compete for that wealth redistribution by offering political support in exchange for favorable legislation.

The implication of this theory is that regulation is likely to be biased toward benefiting interest groups that are better organized and have more to gain from the wealth redistribution. Hence, regulation is likely to benefit small interest groups with strongly felt preferences at the expense of large interest groups with weakly felt preferences. Because there often are competing interests in a particular issue, the economic theory of regulation suggests that regulation will reflect a balance of political forces, rather than always serving the reg-

ulated industry, as the capture theory suggested. Indeed, if special interests coincide with the public interest, or citizens are concerned enough about a particular issue for it to affect their voting behavior, regulation may serve the public interest.

Public Choice

Public choice is not a theory of regulation *per se*, but a scientific analysis of government behavior that recognizes that (1) individuals in government (politicians, regulators, voters, etc.) are driven by self interest, just as individuals in other circumstances are, and (2) they are not omniscient. Public choice argues that government officials are not systematically engaged in maximizing the public interest, but are attempting to maximize their own private interests. Thus, public choice economics, developed by James Buchanan and Gordon Tullock, reaches conclusions similar to those drawn from Stigler's economic theory of regulation. Public choice also recognizes that policymakers are not omniscient regarding the consequences of different policy choices, so that market interventions, even when designed to correct market failures, may produce "government failures."

Two questions might arise with respect to the conclusions of the economic and public choice models. First, why do politicians and interest groups resort to regulation to transfer wealth from the general public to private interests, when direct cash transfers would be less costly to all concerned? Second, why do politicians often rely on public interest rhetoric when imposing regulations that transfer income? The public choice response is that special interests are disinclined to seek direct wealth transfers because their machinations would be too obvious. Instead, regulatory approaches that purport to provide public benefits confuse the public and reduce voter opposition to transfers of wealth to special interests.

Bootleggers and Baptists

Bruce Yandle colorfully dubbed a special case of this phenomenon "Bootleggers and Baptists." Yandle observed that unvarnished special interest groups cannot expect politicians to push through legislation that simply raises prices on a few products so that the protected group can get rich at the expense of consumers. Like the bootleggers in the early 20th century South, who benefited from laws that banned the sale of liquor on Sundays, special interests need to justify their efforts to obtain special favors with public interest stories. In the case of Sunday liquor sales, the Baptists, who supported the Sunday ban on moral grounds, provided that public interest support. While the Baptists vocally endorsed the ban on Sunday sales, the bootleggers worked behind the scenes and quietly rewarded the politicians with a portion of their Sunday liquor sale profits.

Modern day stories of bootleggers and Baptists abound. A 2000 Department of Energy regulation banned the sale of low-priced washing machines under the guise of increasing energy efficiency. Who were the biggest supporters of the ban? It was not the consumers, who by a

margin of six-to-one preferred to purchase lower-priced machines. It was the washing machine manufacturers—because now they would be able to sell expensive "front-loading" models at an average price of $240 more than the banned machines—who worked behind the scenes to draft the regulations.

Concluding Notes

The school of public choice, and the economic theory of regulation in particular, shed new light on when we are likely to observe regulation and what forms it will take. These theories have proven very useful at explaining regulatory activity. They also tell us that, regardless of ideals and intentions, politicians have the same incentives as other people to maximize their own well-being. Thus, small, organized interest groups can sway the political will to gain specialized benefits while spreading the costs to all citizens.

Further Reading:

James Rolph Edwards. *Regulation, the Constitution, and the Economy: The Regulatory Road to Serfdom*. University Press of America, Lanham MD. 1998 Chapter 5, "The Economic Theory of Regulation."

George Stigler. "The Economic Theory of Regulation," *Bell Journal of Economics*, 1971:3. http://www.ipcreators.org/pdf-files/Stigler%20on%20regulation.pdf.

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Gordon Tullock, Arthur Seldon, and Gordon L. Brady. *Government Failure: A Primer in Public Choice*. Cato Institute 2000.

W. Kip Viscusi, John M. Vernon, Joseph E. Harrington. *Economics of Regulation and Antitrust*. 3rd ed., 2001. MIT Press, Cambridge, MA.

Mercatus Center at George Mason University. Comments on Department of Energy Washing Machine Efficiency Standards. November 2000. http://www.mercatus.org/regulatorystudies/article.php/82.html and http://www.mercatus.org/regulatorystudies/article.php/83.html.

3. Regulation and the Constitution: What would our Founders say?

The American founding fathers did not design our Constitution to be efficient at passing laws. Rather, based on their experience, the framers felt it important to design a government that would not allow the majority to rule with an iron fist. To avoid giving government officials too much power, they based our government on the notion known as the *separation of powers*, wherein power is divided among three branches of government—the legislative branch, the executive branch, and the judicial branch. The Constitution also includes *checks and balances*, through which one branch can challenge the powers or decisions of another branch.

As the Supreme Court has explained, the Constitution "divides power among sovereigns and among branches of government precisely so that we may resist the temptation to concentrate power in one location as an expedient solution to the crisis of the day."[1]

The Constitution grants the *legislative branch* the power to pass laws. It tasks the *executive branch* with the administration and enforcement of those laws and makes the *judicial branch* responsible for the adjudication of conflicts arising from them.

Legislative Branch – Article 1

Article 1 of the Constitution establishes the Senate and House of Representatives and vests all *legislative* powers in these bodies. Section 8 of Article 1 clarifies that these include the power:

> To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;
>
> To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;
>
> To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;
>
> To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

[1] New York v. United States, 505 U.S. 144, 187 (1992).

Executive Branch – Article 2

Article 2 vests all *executive* power in the president of the United States of America. Section 3 of Article 2 specifies that the president "shall take Care that the Laws be faithfully executed."

Judicial Branch – Article 3

Article 3 states that the "judicial Power of the United States shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish."

The Bill of Rights

The first ten amendments to the Constitution further clarify the roles of the different branches and protect freedoms of religion, speech and press, security in people's homes, weapons ownership, and the process of law. Of particular note with respect to federal regulation is the tenth amendment, which states, "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Execution vs. Lawmaking

What is "executive power" as it is used in Article 2 of the Constitution? It means, to carry into effect (execute) the laws of the nation, laws that are written by Congress. Thus, it is the power to administer and enforce laws, but not to make or enact them.

In some statutes, such as the Clean Water Act, Congress will state goals for a specific issue that the agency is mandated to meet, i.e., to reduce well-defined waterborne contaminants. In others, Congress has granted broad powers to an agency to determine within a certain field what is to be regulated and how to accomplish it. For example, the Occupational Safety and Health Act directs OSHA to issue "occupational safety and health standards." A brief review of the history of jurisprudence reveals how such broad delegation of powers, once thought to be legislative in nature, came to pass.

A brief history of the nondelegation doctrine

Until the early part of the 20th century, courts interpreted the separation of powers implicit in Articles 1 through 3 of the Constitution as prohibiting the delegation of legislative powers to the executive. This is known as the "nondelegation doctrine."

> That Congress cannot delegate legislative power to the President is a principle universally recognized as vital to the integrity and maintenance of the system of government ordained by the Constitution. *Field v. Clark, 143 U.S. 649 (1892).*

Over the last century, however, this separation of powers has blurred, and Congress frequently grants executive branch agencies authority for writing as well as administering and enforcing regulations which are sometimes referred to as "administrative laws." As statutes have increasingly delegated legislative power to executive

agencies, courts have struggled with the constitutionality of executive branch rulemaking.

In 1928, the Supreme Court moved away from a strict interpretation of the nondelegation doctrine by introducing the notion of an "intelligible principle." In *J.W. Hampton, Jr. & Company v. United States*, it found that a congressional delegation of power was constitutional because the statute included an intelligible principle to guide executive action. 276 U.S. 394 (1928)

In 1935, the Supreme Court returned to the question of the constitutionality of congressional delegation, but this time, in *Schechter Poultry Corp. v. United States* (39 295 U.S. 495 (1935)), it ruled that the National Industrial Recovery Act (NIRA) was unconstitutional because it provided the president (and private industry associations) "virtually unfettered" decision making power.

While the nondelegation doctrine has been mentioned occasionally in individual justices' opinions over the last 70 years, the *Schechter* decision in 1935 was the last time the Supreme Court found a statute unconstitutional on nondelegation grounds.

In 1946, after the *Schechter* decision, Congress attempted to delineate the procedures with which executive agencies could write administrative law. The Administrative Procedure Act (APA) set in place procedures for executive rulemaking and continues to guide rulemaking today. It is described on page 15.

The nondelegation doctrine today

Constitutional scholars argue that granting unelected executive branch agencies the power to write, administer, and even enforce, regulations is contrary to the U.S. Constitution and distinctly a second best to legislation by the people's elected representatives in Congress. Proponents of executive rulemaking, on the other hand, argue that experts in the executive branch are better able to make decisions on technical issues or to resolve controversial issues in a less political manner.

In 1989, the Supreme Court came down clearly on the side of delegation:

> In our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives. *Mistretta v. U.S.* 1989

The nondelegation doctrine was revived temporarily by a 1999 District of Columbia Circuit Court decision in *American Trucking Associations v. EPA*. The court ruled that because EPA had failed to articulate an intelligible principle constraining its regulation setting ambient air quality standards, its interpretation of the Clean Air Act was equivalent to an unconstitutional delegation of legislative authority. In 2001, however, the Supreme Court overturned the Circuit Court's decision, opining that the constitutional question was whether the *statute* improperly del-

egated legislative power to the agency, and that an *agency's interpretation* of a statute could not affect whether the underlying statute was constitutional or not.

> [A]n agency [cannot] cure an unlawful delegation of legislative power by adopting in its discretion a limiting construction of the statute. *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 472 (2001).

The accepted role of the executive branch in issuing regulation has thus evolved to include a broad measure of discretion and interpretive freedom. Congress must set forth basic policy and it cannot delegate rulemaking authority to the executive without specifying an "intelligible principle" for agencies to follow. In practice, however, this standard has not proven to be constraining. Indeed, the Supreme Court observed in 2001 that courts have:

> . . . almost never felt qualified to second-guess Congress regarding the permissible degree of policy judgment that can be left to those executing or applying the law. *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 474-475 (2001).

Independent agencies

In addition to executive branch agencies, some regulations are carried out by independent agencies. Independent commissions, such as the Federal Communications Commission and the Commodity Futures Trading Commission do not fall clearly into the realm of any of the three branches of government. Members of these commissions are appointed to specific terms by the president, and confirmed by Congress, and must reflect a balance of political parties.

Administrative Procedure Act of 1946

The Administrative Procedure Act (APA) established procedures an agency must follow to promulgate binding rules and regulations within the area delegated to it by statute. As long as an agency acts within the rulemaking authority delegated to it by Congress, and follows the procedures in the APA, courts have ruled that an agency is entitled to write and enforce regulations (subject to judicial checks).

The APA constrains executive rulemaking in three main ways:

1. The agency can only act within the limits set by statutes.

2. The agency actions must
   a. Be reasonable (e.g., have sufficient factual support in the record)
   b. Not be arbitrary or capricious
   c. Not be an abuse of discretion.

3. The agency must follow specified procedures. In particular, it must provide notice to the public of the proposed action and take into consideration public comment before issuing a final rule.

The next chapter provides more detail on the procedures specified by the APA.

Federalism

The Founders drafted the Constitution to limit the powers of national government through the separation of powers, checks and balances, and the amendments. The tenth amendment states that powers not specifically delegated by the Constitution to the national government, "are reserved to the States respectively, or to the people." The appeal of this concept, known as "federalism," is that it encourages diversity among states seeking to serve the different needs of citizens and firms. It also forces states to compete for citizens (taxpayers, entrepreneurs, etc.). Moreover, as James Madison explained in *The Federalist*, federalism provides a "double security" from usurpations of individual liberties by federal and state governments.

While states are better suited to serve citizens' needs and experiment with different approaches to governing (taxes, laws and regulations, etc.), the Constitution does reserve for the legislative branch of the federal government the right to regulate commerce among the states, so as to avoid the significant burdens on interstate commerce that might occur if individual states taxed or prohibited products from other states.

Further Reading:

http://thomas.loc.gov/home/lawsmade.toc.html "How Our Laws Are Made"

http://www.house.gov/house/Tying_it_all.html "The Legislative Process"

The Federalist No. 51 (James Madison).

4. The Regulatory Process: How is the sausage made?

> I have come to the conclusion that the making of laws is like the making of sausages—the less you know about the process the more you respect the result.
> –*Anonymous*[2]

This chapter explores how the regulatory sausage is made. After briefly reviewing the procedures for developing regulations under the Administrative Procedure Act (APA), we examine the role the public, agencies within the executive branch, and Congress play in the development of regulations. Figures 4.1 through 4.3 on the following pages schematically illustrate the regulatory development process.

As discussed in the last chapter, Congress must grant an agency legal authority to issue regulations. To become law, a statute must pass both houses of Congress and be signed by the president. Some statutes, the Hazardous and Solid Waste Amendments, for example, prescribe in detail how regulatory standards should be designed. Others provide executive agencies more general guidance; for example, Section 112 of the Clean Air Act directs EPA to set standards that "protect public health with an adequate margin of safety."

When writing regulations, agencies are constrained by the APA, as well as by enabling legislation.

Administrative Procedure Act Procedures

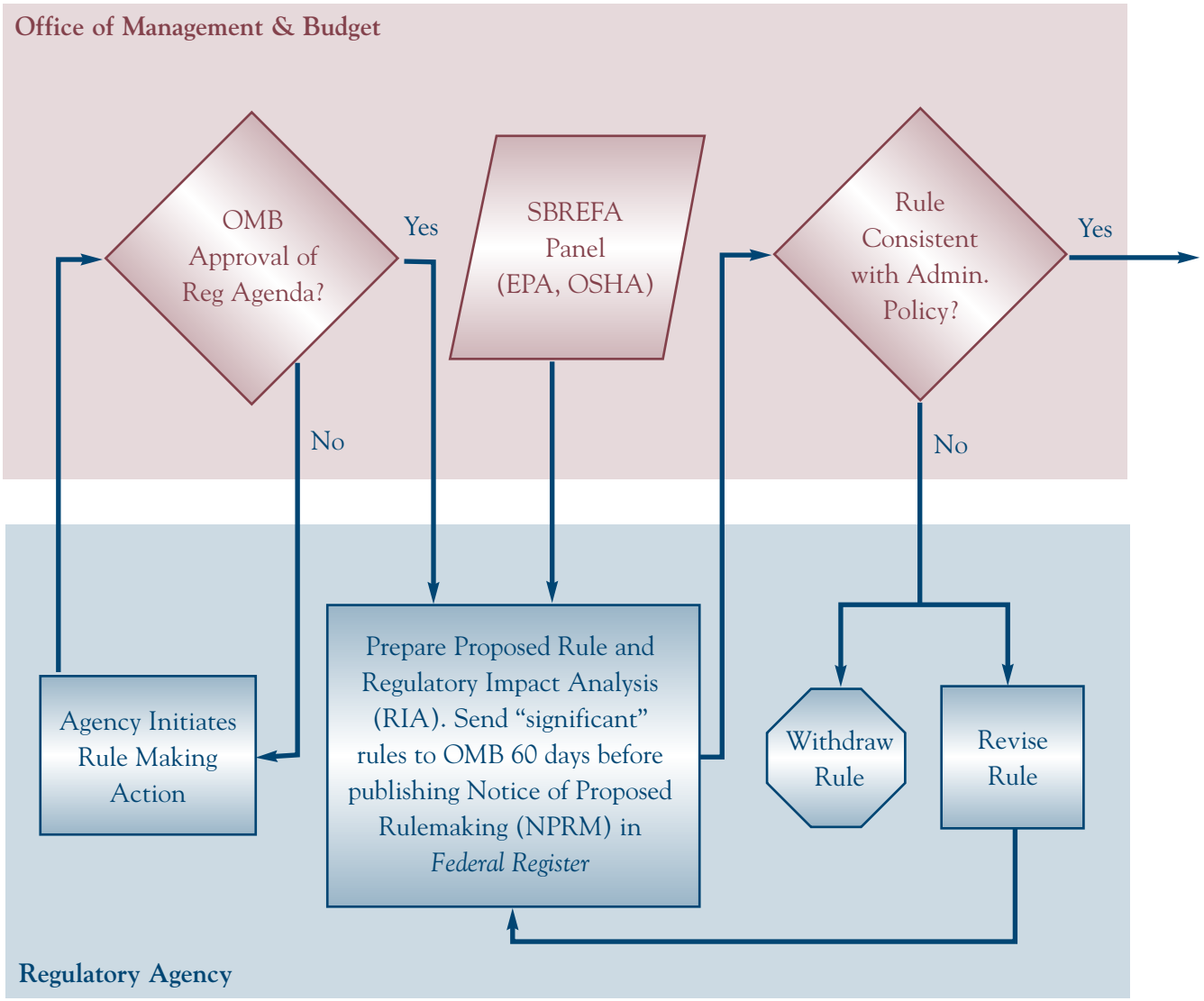
The APA, which was introduced in the previous chapter, describes two types of rulemaking—formal and informal. Formal rulemaking is used by agencies responsible for economic regulation of industries and is only required when a statute other than the APA specifically states that rulemaking is to be done "on the record." Formal rulemaking involves hearings and the presentation of formal documentation to support the rule in front of a commission or judge. Generally speaking, formal regulation is rare except in cases of "ratemaking" by a regulatory commission (such as when the Federal Energy Regulatory Commission determines acceptable rates that electric utilities may charge customers).

Informal rulemaking, or notice and comment rulemaking, is the most common process used by agencies for writing, or "promulgating" regulations. For informal rulemaking, the agency or department first proposes a rule or standard and

[2] This oft-quoted (and sometimes misquoted) remark was made by an unknown member of Congress in the 1870s. Frank W. Tracy, *The Report of the Committee on Uniform Laws, of the American Bankers' Association*, 15 Banking L.J. 542, 542 (1898). Kent Olson UVA Law Library, kolson@virginia.edu.

Figure 4.1

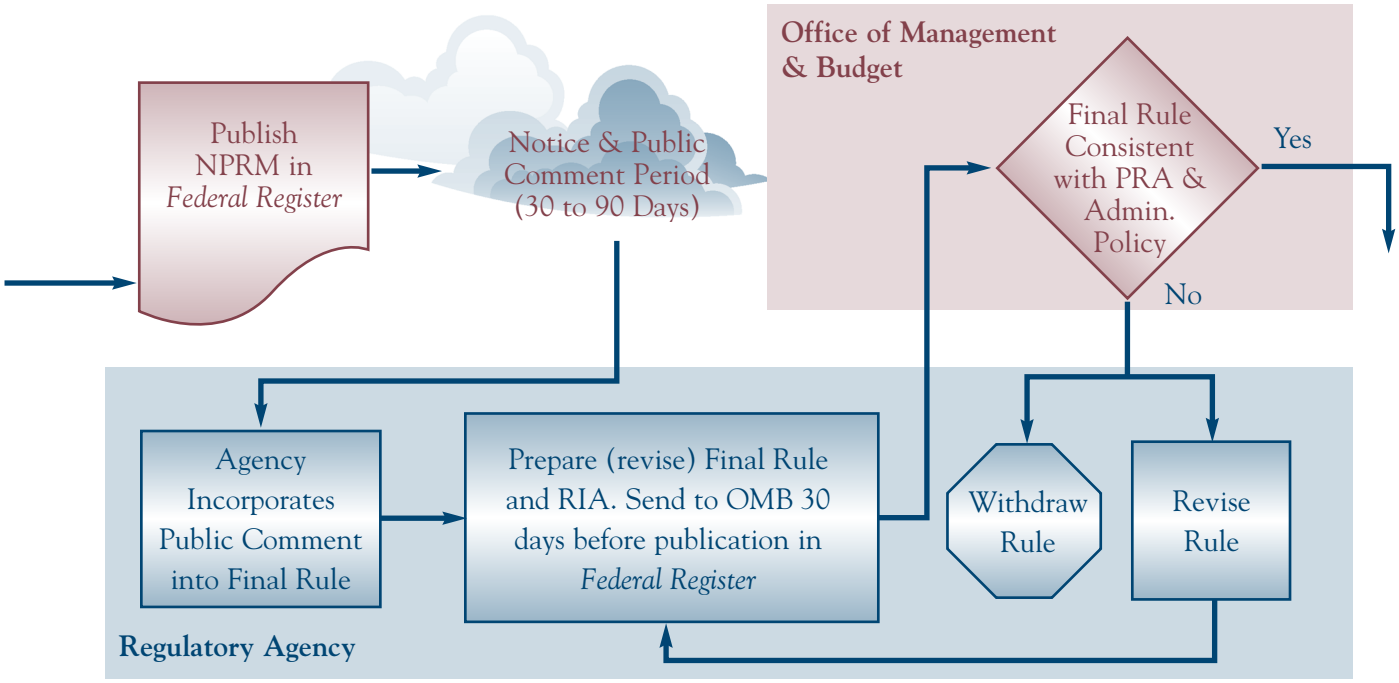
Birth of a Regulation, Initiation Phase



Figures 4-1 through 4-3 illustrate the regulatory development process. Agencies announce the initiation of a rulemaking through the semi-annual Unified Agenda of Federal Regulations (a list of all forthcoming and ongoing regulatory actions). The Office of Information and Regulatory Affairs (OIRA) in the Office of Management and Budget has a role in determining the content of the Unified Agenda. Agencies often spend years developing a regulation before beginning to draft a proposal. Once drafted, regulations that are considered significant must be reviewed by OIRA, and draft regulations of the EPA and OSHA are subject to a SBREFA review if they have the potential to affect small entities.

Figure 4.2

Notice, Comment, & Finalization



Once a draft regulation has passed these reviews, it is published in the *Federal Register,* and the public has an opportunity to comment on it. After reviewing public comment, the agency must submit the draft final rule to OIRA once again before a final rule can be published in the *Federal Register*. Regulations do not take effect for at least 30 days after final publication. Congress has an opportunity to issue a joint resolution of disapproval after a final regulation has been published, and regulations are also subject to judicial review: affected parties can sue to have regulations overturned by the courts.

Figure 4.3

Publication & Possible Review

invites public comment through a Notice of Proposed Rulemaking (NOPR or NPRM). In some cases, the agency will even issue an Advance Notice of Proposed Rulemaking (ANPR or ANPRM) to gather information from the public in advance of issuing a proposed rule.

"Non-rule" rules

In addition to formal and informal rulemaking as defined by the APA, standards and rules that businesses and individuals must follow are sometimes established outside this rulemaking process. The APA exempts from its notice-and-comment procedures "interpretive rules" and "policy statements." While these "non-rule" rules do not carry the force of law and are not legally binding, they are often binding in practical effect. Standards may be set through policies, guidelines, executive orders, and through enforcement cases. Often the kind of enforcement cases an agency brings guides businesses' practices. Enforcement cases help define what the FTC, for example, may view as deceptive advertising. Standards might be applied as fixed criteria in enforcement or approval proceedings. Agencies might guarantee approval for practices or freedom from enforcement action as long as certain guidance is followed.

Public Involvement

While interested parties (e.g., lobbying organizations and those affected by the rule) are often aware of an agency's regulatory plans and communicate with the agency during the development of a proposed rule, the APA requires agencies to provide broad public notice of their intended actions by publishing a proposed rule in the *Federal Register*. The *Federal Register* notice specifies a period for public comment that can range from 30 to 120 days or more, depending on the complexity of and interest in the proposal. The public is invited to submit comments on the rule during this period. These comments are collected on the "rulemaking record."

After the comment period closes, the agency reviews the comments and decides whether to publish a final rule. According to the APA, the final rule must be based on this rulemaking record. Otherwise the agency could be sued and the regulation overturned for being "arbitrary and capricious."

The federal government has recently undertaken an e-rulemaking initiative, designed to improve the public's ability to get involved in the rulemaking process. Visitors to the website, *www.Regulations.gov*, can view and comment electronically on regulations proposed by different agencies. This site continues to evolve and will eventually allow visitors to search all regulations by keyword, access data and models used to support regulatory proposals, and engage in threaded discussions of regulations.

Executive Office Review

Over the last 30 years, Congress and the presidents have added steps to the procedures for issuing and reviewing regulation. This section looks at the role of the executive and legislative branches.

White House Office of Management and Budget

The president of the United States is the chief executive responsible for executive branch agency actions. Every president since President Nixon has established procedures for executive review of agency regulation. (See Table 4.1.) President George W. Bush has chosen to operate under procedures established by President Clinton in Executive Order 12866 (E.O. 12866). The Order requires, among other things, that a regulatory analysis be performed on all rules deemed to be of significant economic impact (*i.e.* impose a cost burden of $100 million or greater per year). The regulatory analysis must include a statement of need for the regulation, an assessment of alternative regulatory approaches, and a cost-benefit analysis.

Table 4.1

HISTORY OF EXECUTIVE OVERSIGHT

Oversight

President	Agency	Cabinet Group	Process
Nixon	OMB	None	Quality of Life Review (Agencies should consider alternatives and costs of "significant" regulations.)
Ford	Council on Wage & Price Stability	Review Group on Regulatory Reform	E.O. 11821 – "Inflation Impact Statements" E.O. 11949 – "Economic Impact Statement"
Carter	OMB & CWPS	Regulatory Analysis Review Group & Regulatory Council	E.O. 12044 – "Regulatory Analysis" made available to public at proposal. Agency should choose "least burdensome" option. Semiannual agenda of forthcoming regulations.
Reagan	OMB (OIRA)	Task Force on Regulatory Relief	E.O. 12291 – Benefit-cost criteria; OMB approval required before publication of proposals.
Bush	OMB (OIRA)	Council on Competitiveness	E.O. 12291
Clinton	OMB (OIRA)	Reinventing Government Initiative	E.O. 12866 – Net benefit criteria.
Bush	OMB (OIRA)	OMB & Council of Economic Advisors	E.O. 12866 – Prompt & return letters

E.O. 12866 also requires review of significant rules by the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA), before they can be published in the *Federal Register* in proposed or final form. (See Figure 4.1.) Each proposed or final rule must meet specific informational requirements before it passes the OIRA review, providing a consistent format for regulations that is designed to reduce the costs to the public of obtaining this information.

OIRA posts on its Internet site a list of rules under review at any given time. Once OIRA has completed its review of a proposed rule, the issuing agency may then publish it in the *Federal Register* for public comment.

Small Business Administration

The Office of Advocacy in the Small Business Administration (SBA) has emerged in recent years as a significant player in the regulatory development and oversight process. In 1976, Congress created the office to provide an independent voice for small business within the federal government. The passage of the Regulatory Flexibility Act of 1980 (Reg Flex Act) (5 U.S.C. 601-612) gave the office more clout. The Reg Flex Act requires agencies to consider the effects of their regulatory actions on small businesses and other small entities and to consider less burdensome alternatives. It puts the Office of Advocacy in charge of monitoring agency compliance with the Act and submitting annual reports to Congress.

The Small Business Regulatory Enforcement Fairness Act (SBREFA), passed by Congress in 1996, reflects concerns that agencies were not always following the Reg Flex Act and that a lack of an enforcement mechanism left small businesses little recourse in the courts. SBREFA amends the Reg Flex Act by specifying the steps an agency must take to minimize the economic impact of a regulation on small businesses, and permitting judicial review of agencies' compliance. In 2003, SBA published a *Guide for Government Agencies on How to Comply with the Regulatory Flexibility Act*.

SBREFA also requires that two agencies—the Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA)—receive input from affected small business through the SBA's Office of Advocacy before publishing a proposed rule.

When a new proposal is expected to have a significant impact on a substantial number of small entities, SBREFA requires EPA and OSHA to convene a panel with representatives from the agency, the Office of Advocacy, and OMB to review the draft proposed rule and related agency analyses under the Reg Flex Act. The panel also solicits advice from small business representatives and prepares a report to the regulating agency, which must consider the report in developing the proposal and include it in the public record of the rulemaking.

Other Agencies

When jurisdictions overlap or a rulemaking affects areas of interest and expertise, other agencies sometimes offer comment on a regulation.

For example, the Federal Trade Commission or the Department of Justice might weigh in on the competitive impacts of other agency rules to ensure regulatory policies do not create market power, or the Department of Energy might raise issues related to the energy impacts of another agency's proposal.

Recently, in response to recommendations in a January 2004 report on manufacturing in America, the International Trade Administration (ITA) in the Department of Commerce has taken an increasingly active role to ensure that regulatory agencies take into account the impacts on U.S. industry's ability to compete in domestic and foreign markets. ITA provides in-depth economic analysis on proposed rules to ensure that industry concerns are heard during the rule-making process.

Role of Congress

Executive agencies exert their regulatory authority under delegation from Congress. Congress monitors the activities of the various agencies through oversight committees responsible for specific agency programs. Through oversight hearings, oversight committee members can hear the testimony of agency representatives concerning the regulatory actions of their agency. If Congress is displeased with the manner in which an agency is implementing its mandates, it can attempt to guide the process through regulatory oversight, or it can pass another law with new directives. Through its appropriations committees, Congress can also reduce the agency's budget, or forbid agencies to use money in certain ways.

These mechanisms can be cumbersome and time consuming, however. To get more control over the regulatory process, Congress has passed a number of legal requirements in recent years governing factors the executive branch must evaluate, information it must provide, and procedures for review of regulations by parties other than the issuing agency.

Some of the most important regulatory review laws are:

- Paperwork Reduction Act (PRA), which established OIRA within OMB to review the paperwork and information collection burdens imposed by the federal government.

- Regulatory Flexibility Act (RFA), discussed above, which requires agencies to assess the impact of a regulation on small businesses and provides for review by the Small Business Administration Office of Advocacy.

- Small Business Regulatory Enforcement Fairness Act (SBREFA), which enforces requirements for small business impact analyses under RFA.

- Congressional Review Act (CRA), contained in SBREFA, which requires rule-issuing agencies to send all mandated documentation that is submitted to OMB to Congress, and allows Congress to

overturn regulations within a specified time with a Congressional Resolution of Disapproval.[3]

- Unfunded Mandates Reform Act (UMRA), which limits the ability of regulatory agencies to place burdens on state, local, and tribal governments.

- Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (section 638(a)), which requires OMB to report to Congress yearly on the costs and benefits of regulations and recommendations for reform.

- Truth in Regulating Act of 2000, which gives Congress the authority to request that GAO conduct an independent evaluation of economically significant rules at the proposed or final stages.

- Section 515 of the Treasury and General Government Appropriations Act for Fiscal Year 2001, commonly known as the "Information Quality Act," which required OMB to develop government-wide standards for ensuring and maximizing the quality of information disseminated by Federal agencies. Under the guidelines, agencies must follow procedures for ensuring the utility, integrity, and objectivity of information used in rulemaking and elsewhere, and offer an administrative mechanism for responding to public requests to correct poor quality information that has been or is being disseminated.

Further Reading:

Jeffrey S. Lubbers. "A Guide to Federal Agency Rulemaking." American Bar Association.

For information on regulations under development visit www.RegRadar.org and www.Regulations.gov.

For information on regulatory oversight at the Office of Information and Regulatory Affairs, visit http://www.whitehouse.gov/omb/inforeg/regpol.html.

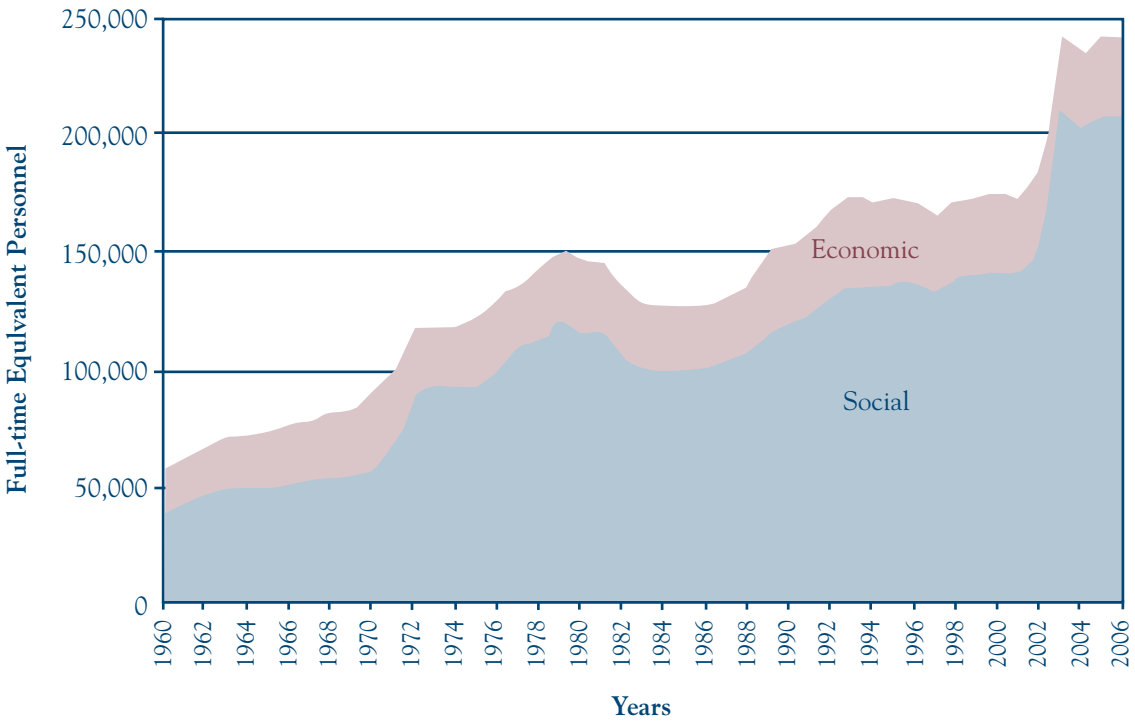
For information on regulatory oversight at the Small Business Administration Office of Advocacy, visit www.sba.gov/advo.

[3] Though passed in 1996, Congress has only issued a Resolution of Disapproval once, overturning an OSHA regulation addressing ergonomics in the workplace. Though resolutions of disapproval require only a simple majority in Congress, they face the threat of presidential veto, which would require a two-thirds majority to override. The conditions surrounding the ergonomics regulation were likely key to its disapproval. It was a "midnight regulation," issued amid much controversy at the end of the Clinton administration. The resolution disapproving the rule came at the beginning of the Bush administration (which did not support the rule), eliminating the veto threat.

5. The Bureaucracy: Who is behind the curtain?

In 2006, the number of full-time federal employees devoted to issuing and enforcing regulations will reach an all time high of 242,376. As Figure 5.1 shows, this is nearly three times the size of the regulatory bureaucracy in 1970.[4] The 1970s witnessed the creation of several new regulatory agencies (notably the Environmental Protection Agency and the Occupational Safety and Health Administration), and a corresponding increase in regulatory personnel of nearly 52,000, or 74.2 percent. During the early 1980s, the bureaucracy was cut back by 16 percent, but increases in the latter part of the decade brought staffing close to 1980 levels by 1990. Staffing increased by about 10 percent during the 1990s. The increased focus on homeland security after the attacks of

Table 5.1
Staffing of Federal Regulatory Agencies



Source: Dudley and Warren 2005

[4] Dudley and Warren 2005.

September 11, 2001 led to another large increase in regulatory activity and staffing. The big (61 percent) jump in staffing between 2002 and 2003 is due to the over 56,000 new employees brought on as airport baggage screeners under the auspices of the Transportation Security Administration.

This chapter briefly examines the federal bureaucracy and why it has increased in size over the last few decades.

A Public Choice View of Bureaucracy

The terms "bureaucracy" or "bureaucrat" generally have negative connotations. Bureaucracy suggests an administrative system marked by rigid or complex procedures. The label "bureaucrat" often is used to disparage an individual who rigidly follows procedures at the expense of acting effectively. Bureaucrats, unelected officials who tend to enjoy secure positions, are alternately characterized as lazy and indifferent to public service, or as zealots seeking their own agenda.

Over the last 50 years or so, economists and political scientists have applied the theories of the firm to government systems. Not surprisingly, they have concluded that bureaucrats are like other people: they are interested in their own well-being and respond to incentives inherent in the structure of the workplace.

Gordon Tullock observes in his primer on public choice:

> We must accept that in government, as in business, people will pursue their own private interest, and they will achieve goals that are reasonably closely related to those of the stockholders or of the citizens only if it is in their private interest to do so. Of course, this penchant does not mean that most people, in addition to pursuing their private interests, have no charitable instincts or tendencies to help others and to engage in various morally correct activities. Yet, the evidence seems strong that these are not motives upon which we can depend for the motivation of long-continued efficient performance.

The increasing size of the bureaucracy, he suggests, occurs because a larger agency increases the chance of promotion and control, which serves the private interests of the bureaucrats. He recognizes that salary and power are not the only motivation, however, and that institutional incentives influence the behavior of individuals in government agencies, just as they do individuals employed elsewhere.

In his book, *Bureaucracy: What Government Agencies Do and Why They Do It*, James Q. Wilson identifies three types of regulatory employees. The "careerist" expects to spend his career at the agency, so his incentives are to see the agency expand and grow. The "politician" sees the agency as a stepping stone for her future career, so her incentives are to gain the support of (or at least not alienate) interest groups. The "profes-

sional" identifies with a set of skills, rather than with a particular agency, and may have incentives to expand or exhibit technical expertise.

Gatekeepers and Exorcists in Risk Regulation

How institutional framework and incentives affect the behavior of regulatory officials is perhaps best illustrated with the case of risk regulation. Peter Huber identified two basic approaches to regulating risks: one calls for "gatekeepers" (whose job it is to keep new risks from being introduced) and the other for "exorcists" (whose job it is to remove existing risks). The Toxic Substances Control Act (TSCA) takes a gatekeeper approach to any production of a "new" chemical, requiring EPA to screen and preapprove new uses. TSCA gives EPA the role of exorcist, however, when it comes to existing chemicals, which the agency may ban or otherwise regulate if it determines they present an unacceptable risk. Huber notes these two approaches provide different incentives and yield different outcomes.

Risk regulators face two possible types of errors: (1) permitting the production of something with unanticipated risks, or (2) not permitting a safe product. Huber showed that under a gatekeeper regime, regulators are likely to err in the direction of disapproving or delaying approval of new products. This bias against approval is a clear outcome of the incentives the gatekeeper faces. If a gatekeeper approves a product that later turns out to have adverse effects, she faces the risk of being dragged before Congress and pilloried by the press. On the other hand, since the potential benefits of a new product or technology are not widely known, the risks of disapproval (or delays in approval) are largely invisible, so the consequences of delay are less severe.

Regulators who must examine and exorcise risks from existing products face different incentives. Unlike new products, existing products already have a constituency, not only the producers, but also consumers, who find value in the product. The risks are known, and possibly less frightening, and the benefits of the product are also clearly visible. As a result, exorcist regulation tends to weigh the risk of the product against its benefits in making decisions about restrictions or bans.

Further Reading:

Peter Huber. "Exorcists vs. Gatekeepers in Risk Regulation." *Regulation*, Nov/Dec 1983, 23-32. *See also*, Huber, *The Old-New Division in Risk Regulation*, 69 U. VA. L. REV. 1025 (1983).

Gordon Tullock, Arthur Seldon, and Gordon Brady. *Government Failure: A Primer in Public Choice*. Cato Institute, Washington, DC: 2002.

James Q. Wilson. *Bureaucracy: What Government Agencies Do and Why They Do It*. Basic Books, 1989.

6. Economic Regulation: Price, entry, and exit

with Jerry Ellig, Mercatus Center at George Mason University

What is Economic Regulation?

In a market economy, individual firms make decisions about what products to produce, how much to produce, how much to charge, and what inputs to use. Consumers and workers decide how much to spend, how much to save, how much to work, and what to buy. Through the interaction of supply and demand in thousands of markets, goods and services are allocated to their highest and best uses.

Economic regulation is the use of government power to restrict the decisions of economic agents. Economic regulations are often industry-specific. The Securities and Exchange Commission, the Federal Communications Commission, and the Federal Energy Regulatory Commission are examples of agencies that issue economic regulations. They regulate a broad base of activities in particular industries using economic controls such as price ceilings or floors, quantity restrictions, and service parameters.

Economic regulation is often justified by concerns of "natural monopoly"—where a market can be served at lowest cost with a single supplier. Economic regulation generally controls:

1. **Price**, by setting a maximum (if the concern is that a monopolist would set prices too high) or minimum (if the concern is "predatory pricing" to discourage competition);

2. **Quantity**, by limiting the amount of a good or service that can be produced (e.g., state limits on crude oil production through the early-1970s), or requiring that all demand be met at a particular regulated price (e.g., electric utilities);

3. **Service quality** (particularly when price is regulated); or

4. The **number of firms**, by limiting new entrants and prohibiting existing firms from exiting a market.

If the firm with monopoly power charges a price that exceeds the price it would charge if it faced competition, ideal regulation can mimic the results of competition and force the firm to charge the "competitive" price. When this occurs, regulation has two beneficial effects for consumers. First, consumers who were already buying the service receive it at a lower price; the gains to these consumers can be measured by the amount of the price reduction multiplied by the amount they were already buying at the monopoly price. Second, the lower price induces consumers to purchase more, and this increased

consumption further increases consumer welfare. Conceptually, this gain to consumers is equal to the difference between the regulated price the consumer pays and the price the consumer would have been willing to pay, summed over all of the additional units that are consumed.

Problems with Economic Regulation

Regulation is intended to make consumers better off by producing a price equal to the competitive market price. However, there is no guarantee that this will occur in practice. There are least five reasons:

1. Prices below competitive market levels can create shortages.
2. Regulation can hold prices above costs.
3. Regulation and monopoly inflate costs.
4. Regulation stifles innovation and entrepreneurship.
5. Expenditures to acquire and maintain wealth transfers increase costs.

Below-competitive prices

If regulators set prices below the competitive level, they create shortages. History suggests that regulators frequently succumb to this temptation. The temptation is especially strong in capital-intensive industries that require high up-front investments that have few good alternative uses. After the investment is made, public policy can reduce prices below the competitive level without immediately creating a shortage, as long as the prices are high enough to cover the firm's ongoing costs of operation. Such prices harm consumers in the long run, because firms will refrain from investing if they expect the unremunerative prices to continue. Eventually, this reduction in investment creates shortages, deteriorations in the quality of service, or other problems that diminish consumer welfare.

Above-competitive prices

Price and entry regulation imposed on a competitive industry can actually increase prices and reduce consumption. This can occur either because policymakers imposed regulation on a competitive industry mistakenly or because they did so consciously in response to political incentives.

As discussed in Chapter 2, political incentives to regulate a competitive industry could come from the industry itself, which may seek regulation in order to forestall competition and increase profits. But political pressures may also come from certain segments of customers, who use regulation to obtain service at subsidized rates, with the subsidies funded through excessive charges imposed on other consumers.

When regulation elevates prices above costs, it reduces consumer welfare both by increasing price and by reducing output. Cross-subsidies can reduce producer welfare as well. If a monopolist is

allowed to overcharge and use the money to fund cross-subsidies, the firm sacrifices some or all of the inflated profits. If regulators force competing firms to overcharge consumers and then hand the money to some other firm to subsidize its service, the firms forced to collect the excess charges will see their sales and profits fall in response to the price increase. (This latter example may appear fanciful in the abstract, but it happens quite frequently in telecommunications regulation.)

Inflated costs

Cost-of-service regulation often distorts the regulated firm's choice of inputs, so the regulated firm fails to produce at minimum cost. The resulting rates might be considered "just and reasonable," because they reflect costs, but the costs themselves are inflated. Competition creates pressure for firms to squeeze out unnecessary costs and provide a combination of price and quality that consumers prefer. Where monopoly is expected to persist, both federal and state regulators have increasingly opted for "price cap" regulation, which caps the prices firms can charge but allows them to earn additional profits by cutting costs.

Stifled innovation and entrepreneurship

Regulation diminishes entrepreneurial incentives to lower costs, improve quality, and develop new products and services. Empirical studies of deregulated industries demonstrate the impact of innovation, for such studies consistently find that deregulation generates larger price reductions than economists predicted based on pre-deregulation costs and market conditions.

Regulatory constraints on profits reduce the rewards for risky but potentially valuable innovation. In theory, regulators could prevent this problem by permitting the firm to earn a sufficient risk premium. In practice, regulators face a continual temptation to disallow the risk premium once an innovation is introduced and proven successful, because the successful innovation will likely remain in place even if regulation reduces its profitability. After the fact, it is often difficult to distinguish between high profits resulting from innovation and high profits resulting from market power. Expropriating these profits, however, reduces incentives for future innovation. And if profit regulation removes the carrot, protected markets remove the stick—the competitive threat that could otherwise spur entrepreneurship.

In addition to altering incentives for discovery, economic regulation short-circuits the market's normal trial-and-error process. Real-world competition is a dynamic process of trial and error. The purpose of competition is to reveal what services, costs, and prices are possible. As Justice Breyer noted in his dissent in *Iowa Utilities Board*, a key case interpreting the Telecommunications Act of 1996, "The competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition

would have set does not thereby become any the less a regulatory process, nor any the more a competitive one."[5] If there is no competitive market, actual competitive prices cannot be observed, but public policy regularly assumes that regulators can estimate prices tolerably close to those that a competitive market would have generated if it existed. In the absence of competition, we do not know for sure what services, costs, and prices are possible; to estimate what competitive prices would be, these things must be assumed, and the assumptions may be wrong. In a very static industry, historical costs may be a useful guide for calculating "competitive" prices. In a dynamic industry, though, attempts to estimate competitive prices that do not actually exist will be fraught with error.

Regulation can also stifle innovation more directly, when firms must obtain regulators' permission before entering new markets or offering new services. In some cases, firms must wait for regulators to establish the legal or institutional framework before they can deploy a new technology. The ten-year delay in allowing local Bell telephone companies to offer voice mail, for example, cost consumers approximately $1.27 billion annually, and regulation-induced delay in the introduction of cell phone service cost consumers $50 billion annually in forgone benefits.[6]

Expenditures to acquire/maintain wealth transfers

Whether it curbs or creates market power, regulation transfers wealth. The fact that regulation is a means of transferring wealth also implies another effect on the welfare of both consumers and the regulated industry. When wealth transfers are available, organized interests will expend resources to obtain them. Regulated firms will spend money to retain monopoly profits, or to protect themselves from below-competitive prices that expropriate their assets. From a society-wide perspective, money spent purely to capture wealth transfers is often considered pure waste. In some circumstances, the total amount of money wasted may even exceed the size of the wealth transfer.

Trends in Economic Regulation

The Interstate Commerce Commission (ICC), the first federal regulatory agency in U.S. history, was established by the Interstate Commerce Act of 1887 to regulate rail rates. Economic regulation grew rapidly from the early 1900s through the early 1970s. By the 1970s and 1980s, the tide had turned, however, and the legislative, executive, and judicial branches moved to deregulate industries once thought of as natural monopolies, including airlines, oil and gas production, trucking, railroads, and

[5] *Iowa Utilities Board*, 119 S. Ct. at 749-50 (Breyer, J. concurring in part and dissenting in part).
[6] Jerry A. Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications," *Brookings Papers on Economic Activity, Microeconomic* (1997).

telephones. The ICC was among the agencies abolished by these deregulatory initiatives in 1995.

The move toward deregulation was driven, in part, by a large body of literature that showed that regulation did not serve the public interest, as discussed above and in Chapter 2. Many markets once thought of as "natural monopolies" have proved quite competitive.

The deregulation in the 1970s and 1980s is generally regarded as a success, having lowered consumer prices and increased choices. Deregulation and consumer choice have aligned service quality with customer preferences. Competitive markets have generated real gains and not just reallocated benefits for consumers and society as a whole, and markets have evolved in beneficial ways that were not anticipated prior to deregulation.

Further Reading:

Robert Crandall and Jerry Ellig. (1997) "Economic Deregulation and Customer Choice: Lessons for the Electric Industry." Fairfax, VA: Center for Market Processes, Inc.

Israel Kirzner, "The Perils of Regulation: A Market Process Approach," in *Discovery and the Capitalist Process* (University of Chicago Press, 1985): 11949.

Clifford Winston, "Economic Deregulation: Day of Reckoning for Microeconomists," *Journal of Economic Literature* 31 (Sept. 1993), 1263-89.

7. Social Regulation: Health, Safety, and Environment

Social regulations are designed to address issues related to health, safety, and the environment. The Environmental Protection Agency, the Occupational Safety and Health Administration, and the Food and Drug Administration are examples of agencies that administer social regulations. Their activities are generally limited to a specific issue, but they also have the power to regulate across industry boundaries. As Figure 1.2 in Chapter 1 illustrates, while economic regulations may have dominated administrative law in the first half of the 20th century, social regulations have driven the increase in regulatory activity since the 1960s.

As discussed in the previous chapter, the normative public interest justification for many economic regulations is to control the prices set by "natural monopolies." The normative justification for environmental, health, and safety regulation is often "externalities" or "information asymmetries." This chapter examines these market failure justifications, explores the concept of risk, which is the focus of many health safety and environmental regulations, and presents an array of regulatory approaches for addressing problems.

Externalities, Property Rights, and Common Law

Environmental pollution is the classic example of an "externality." Consider the textbook case of an upstream factory that pollutes a stream used for recreation downstream. The costs of disposing the effluent in the stream are not accounted for by the factory owner and not factored into the price consumers pay for the product it produces. Instead, they are borne by recreational users downstream.

Early in the 20th century, British economist A. C. Pigou studied this problem and proposed government solutions to internalize such externalities, through what has become known as a Pigouvian tax—an effluent tax imposed per unit of pollution. (The end of this chapter explores taxes and other regulatory approaches further.)

In 1960, Nobel Prize-winning economist Ronald Coase offered a different perspective on externalities. He showed that externalities emerge as a result of poorly defined property rights, and that, as long as property rights are established, parties involved in disagreements can negotiate a solution that internalizes any externality. In the case of the polluting factory and the downstream recreational users, if the recreationists owned the property right to the stream, the factory owner would have to negotiate with them to discharge waste into the stream. The solution they might reach would depend on the two parties' costs to abate or mitigate damages, but could range from the factory paying the recreationists to swim or

fish somewhere else, compensating them for the diminished water quality, limiting its effluent, or completely shutting down.

Several very interesting insights emerge from Coase's work. First, he showed that an externality is a cost jointly produced by the actions of both parties. In our example, there would be no problem if the factory owner didn't discharge waste into the stream, but there would also be no problem if nobody wanted to use the stream for recreation. Thus, the recreationists' use of the stream contributes to the conflict along with the factory's use of the stream.

A second key insight is that in the absence of transactions costs, it doesn't really matter who has the property rights. The same solution (in terms of effluent discharge) will emerge whether the factory owner must compensate the recreationist to continue to discharge effluent or if the recreationist must pay the factory owner to reduce its discharge. Either way, with established property rights and the ability to freely negotiate, the externality is internalized.

A third point worth noting is that Coasian solutions negotiated between affected parties are based on the "particular circumstances of time and place," unlike regulated solutions, which tend to be one-size-fits-all.

Before statutory law attempted to address externalities through regulation, solutions like those envisioned by Coase were negotiated between individuals and enforced through common law—the legal rules and traditions that developed over time through court decisions. Ordinary citizens were able to protect their land and water through legal actions against trespass and nuisance. Some scholars argue that such common law approaches were superior to statutory law because individuals could hold someone who allowed something undesirable like pollution to invade their property accountable for damages. Under a regulatory environment, as long as a polluter obeys standards, damaged third parties cannot demand compensation.

Regardless of the merits of common law solutions to environmental and other social issues compared to legislative and regulatory solutions, it does not appear that social regulations are likely to wane in the near future. Spending on administering and enforcing social regulations grew at an average rate of 2.6 percent per year during the 1990s, and 15 percent per year more recently. Efforts at regulatory reform tend to focus on "smarter regulation" rather than "deregulation," such as occurred in the economic deregulation area in the 1980s.

Regulating Risks

Environmental, health, and safety regulation tends to be aimed at reducing health risks. It is important to recognize, however, that regulations cannot eliminate all risk. Everything we do involves risk; whether we choose to get out of bed in the morning and take a jog or drive a car, or to lie in bed all day,

there are risks associated with our choices. We are willing to accept these risks because the actions that involve the risks also provide benefits. For example, when you drive a car to work, you run the risk of being hurt in a car accident, but avoid the risk of falling off of a bicycle or being injured in a train accident. Moreover you gain the benefit of getting to work in a timely manner, freeing up time for other pursuits.

Since it is impossible to eliminate all risk, regulators attempt to focus regulatory activity on the most significant risks. However, they are not always successful. In 1987, EPA ranked its regulated activities according to the risks they posed to human health and the environment. It found that the activities that commanded the largest share of federal resources and public dollars were not the ones that posed the greatest risk. For example, management of hazardous wastes and the clean up of chemical waste sites ranked relatively low on the risk scale, but high on the effort scale. On the other hand, it turned out that the allocation of resources tracked public perception of risks very well.

A 1996 study conducted at the Harvard Center for Risk Analysis found that a reallocation of current spending from lower risk to higher risk problems could more than double the life-saving results of regulations designed to reduce health and safety risks, even if each agency continued to impose the same total regulatory cost but merely targeted its efforts more efficiently.

Misdirecting regulatory efforts not only misses opportunities for greater risk-reduction benefits, but by imposing unnecessary costs, can actually increase health risks. The positive correlation between income and health has long been recognized; not only are life expectancies longer and health better in wealthier nations, but wealthier individuals within these nations tend to be healthier and live longer. Recent empirical studies have attempted to calculate this relationship quantitatively. They reveal that every $15 million in regulatory costs, by reducing disposable income, results in one additional statistical death.[7]

Thus, key questions for risk regulation are to what extent does the regulation reduce risks and at what costs. Understanding this requires "risk assessment" and "risk management," two related, but distinct types of analysis.

Risk assessment is pure science. It attempts to answer the question, "how much risk is posed by X?" But science alone cannot tell us what policy decision to make. Thus, **risk management** uses

[7] Randall Lutter, John F. Morrall, III, and W. Kip Viscusi, "The Cost-Per-Life-Saved Cutoff for Safety-Enhancing Regulations", Economic Inquiry, Vol. 37, No. 4. 599-608, (October 1999).

the science of risk assessment as well as other information, to answer the policy question, "how much risk is too much?" The answer to this second question requires a balancing of the risk, and the costs and benefits of reducing it. Regulators apply different methods for this balancing act, including

- risk-risk analysis to compare the risks of regulating with the risks of not regulating,
- cost-effectiveness analysis, which compares the cost of different approaches against a metric such as life-years saved or tons of a pollutant removed, and
- cost-benefit analysis, which attempts to quantify and assign dollar values to the benefits of different approaches as well as the costs.

Because resources are scarce, and because individuals have different preferences for, and aversions to, risk, it is important to limit regulatory activities to identified market failures. In the absence of a significant market failure, individuals are better able to make decisions regarding tradeoffs in their lives than government regulators.

Regulatory Approaches

Health, safety, and environmental regulations come in different forms:

Technology-based regulations, like the requirement that all smokestacks be equipped with scrubbers, dictate the mechanism by which a regulated entity must comply. While having advantages for enforcement (it is easy to determine whether the appropriate control has been applied), command-and-control regulations discourage innovation and don't adapt to different circumstances.

Performance-based standards, like limiting emissions to a certain level are superior to technology-based standards in that they allow regulated entities to experiment with different methods of achieving the goals.

Economic incentives have emerged over the last couple decades as a preferred regulatory method. The acid rain program of the 1990 Clean Air Act Amendments, for example, allocated tradable permits to emit a ton of sulfur dioxide over a year to electric utilities and allowed the utilities to trade those permits. Utilities for which the cost of reducing SO_2 emissions was less than average undertook control measures, thus freeing up permits to sell to utilities for which the cost of reductions was greater than average. These marketable permits, along with effluent fees or taxes, are patterned after the Pigouvian model of internalizing externalities.[8]

Clearly defining property rights (along the Coasian model) is employed less frequently,

[8] Pigou did not actually contemplate marketable permits, but rather taxes to internalize externalities.

though patents for new medical products address the "public good" aspect of innovation by allowing inventors to defend property rights to the innovation. The opportunity to profit motivates innovation.

Regulators sometimes address the problem of asymmetric information through **disclosure regulations**, which have the virtue of allowing consumers to make their own choices. For example, energy efficiency labels inform consumers of the expected operating costs of different appliances. The challenges in crafting disclosure regulations are determining how consumers will interpret information and ensuring the mandated information is not misleading.

Further Reading:

Environmental Protection Agency. *Unfinished Business: A Comparative Assessment of Environmental Problems*. February 1987.

Tammy O. Tengs and John D. Graham, "The Opportunity Cost of Haphazard Social Investments in Life-Saving," in R. Hahn (editor), *Risks, Costs, and Lives Saved: Getting Better Results from Regulation*. New York: Oxford University Press, 1996.

8. Regulatory Analysis

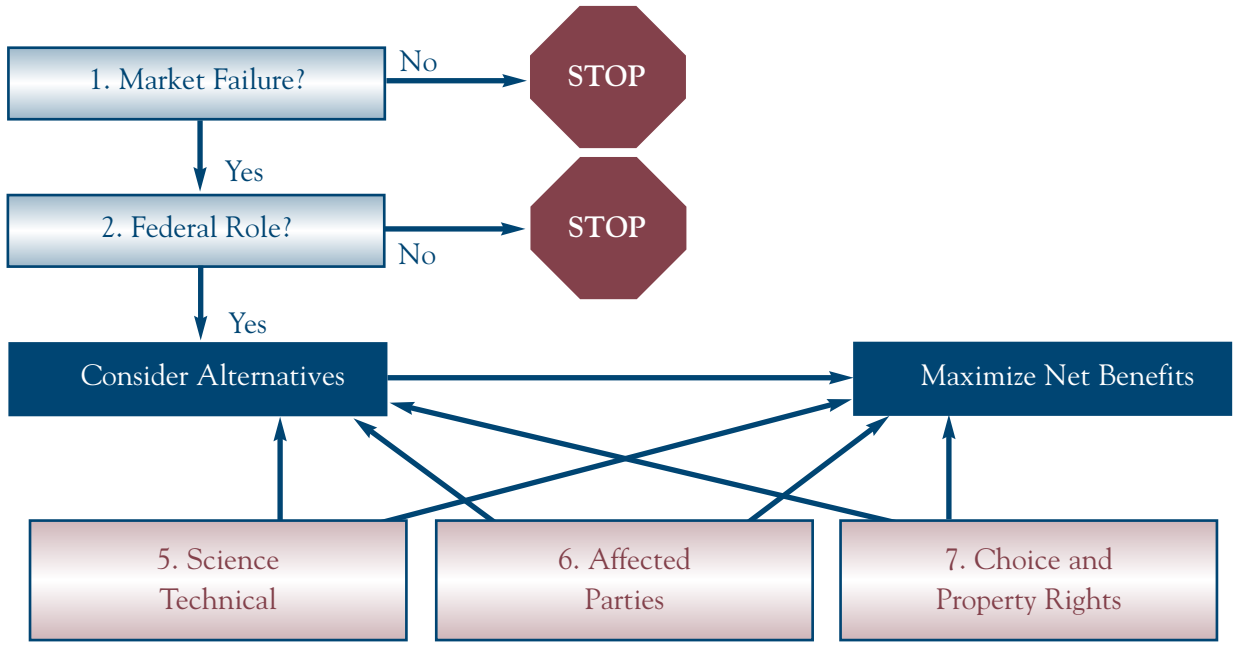
As the volume of regulatory activity has grown, so has the analysis and oversight that accompanies new regulations. This chapter outlines generally accepted principles for addressing the normative question of when and how *should* we regulate. For a more comprehensive discussion of regulatory analysis principles, interested readers should read Circular A-4, "Regulatory Analysis," issued by the Office of Management and Budget and the Council of Economic Advisors in September 2003.

In the simplest terms, the goal of a regulatory analysis is to ensure that a proposed regulation does more good than harm. Figure 8.1 schematically shows the steps in a regulatory analysis. The first two conditions, presence of a market failure and need for a federal role, are necessary but not sufficient for demonstrating that the regulation will have benefits to Americans in excess of its costs. If these two questions are answered in the affirmative, the analyst should then continue to examine alternative approaches to addressing the systemic problem identified, taking into consideration the remaining questions.

1. Identify a Significant Market Failure or Systemic Problem

Government should only impose regulations in

Figure 8.1
Regulatory Analysis



the case of a clear market failure that cannot be adequately addressed by other means. As discussed in earlier chapters, market failures generally fall into one of four categories. **Externalities** occur when one party's actions impose uncompensated costs or benefits on another party. As a result, resources are not allocated the way they would be if all costs and benefits were "internalized" in the market place. **Public goods** are common resources where it is not possible to exclude users. As a result, they tend to be overused (people would over-fish a common fishery) or under-provided (new discoveries might not be made if not for patents granting the discoverer rights to profit).

Natural monopolies exist when economies of scale are so great that a market can be served at lowest cost only if production is limited to a single producer. When market participants have **inadequate information**, markets may not allocate resources efficiently; however, it is essential to note that perfect information is neither necessary nor optimal.

Often, what are considered "market failures" are actually systemic problems with the allocation of property rights. For example, many industries thought to be natural monopolies in fact gained their monopoly privileges through government protections, rather than inherent economies of scale. Similarly, some problems associated with externalities and public goods reflect the systemic problem that property rights are not defined to encompass important attributes of a property or action. Regulatory actions that do not explicitly recognize the market failure or systemic problem underlying the need for action are bound to be less effective than those that identify and correct the fundamental problem.

2. Is a federal role appropriate?

The federalism principle embodied in the tenth amendment to the Constitution implies that state and local governments possess the constitutional authority, and the ability to discern the sentiments of the people and to govern accordingly. As a result, public policies that improve social welfare are most likely to evolve when individual states and communities are free to experiment with a variety of approaches to public issues. In general, federal regulations should not preempt state laws or regulations, except when necessary to guarantee rights of national citizenship or to avoid significant burdens on interstate commerce.

Even if a market failure can be identified, there may be no need for federal regulatory intervention if other approaches would resolve the problem adequately or better than federal regulation would. Alternatives to federal regulation include the judicial system, antitrust enforcement, and workers' compensation systems, as well as state and local level actions.

Federal regulation may be appropriate if state or local regulations would burden interstate commerce, or if necessary to protect the rights of national citizenship. However, in general,

regulations developed at the state and local level offer advantages of diversity in meeting citizens' local circumstances and preferences and encourage competition among governmental units to meet the needs of taxpayers and citizens. Thus, the appropriate level of government must weigh interstate burdens against the advantages of diversity and local choice.

3. Examine alternative approaches

Once a market imperfection or systemic problem has been identified, the analyst should examine a wide range of viable alternatives for addressing it. These alternatives should include approaches targeted at the fundamental market cause of the problem. For example, if asymmetric information is identified as the market imperfection of concern, solutions that provide information are most appropriate.

In general, market-based and performance-oriented approaches are preferable to command-and-control standards. By harnessing market forces, market-based approaches are likely to achieve desired goals at lower social costs than command-and-control approaches. Where regulations create private rights or obligations, they should also encourage unrestricted exchange of these rights or obligations.

Health, safety, and environmental regulations should address ends, rather than means. Performance standards or economic incentives are more effective than technology-based standards, which by dictating the means of achieving goals, discourage innovation to improve health, safety, and environmental quality.

Viable alternative approaches should be evaluated objectively and presented to decision-makers. An analysis conducted after a particular regulatory approach has been selected does not provide policy makers the information necessary to make an informed and balanced decision.

4. Choose the regulatory action that maximizes net benefits

The selected regulatory alternative should be the one that maximizes net benefits to society. The rationale for choosing a particular approach over alternatives should include a discussion of how that approach corrects the market failure or systemic problem that has been identified.

A good benefit-cost analysis will have the following characteristics.

4.1 Estimates of benefits and costs should be incremental to a realistic baseline.

Analysis of the benefits and costs of alternative approaches to achieving regulatory goals must be conducted from a realistic and consistent baseline. In most cases, the baseline should reflect the state of the world in the absence of the proposed regulation, and estimated costs and benefits should be incremental to this baseline. How will costs or benefits change if regulations

are enacted? It may be useful to conduct incremental analysis from more than one possible baseline.

4.2 Risks and uncertainty should be treated transparently and objectively.

The analysis should present unbiased estimates of the most likely outcome of different alternatives. In addition, it is useful to present the results of sensitivity analysis to communicate information on the robustness of the best estimate, and the range of possible outcomes. Sensitivity analysis examines different "what if" scenarios to see how changes in key assumptions influence estimated outcomes.

4.3 All values should be discounted to the present.

All monetary values for benefits and costs that occur in different years should be stated in comparable, discounted present value, terms. OMB Circular A-4 summarizes the main rationales for the discounting of future impacts as:

a. Resources that are invested will normally earn a positive return, so current consumption is more expensive than future consumption, since you are giving up that expected return on investment when you consume today.

b. Postponed benefits also have a cost because people generally prefer present to future consumption. They are said to have positive time preference.

c. Also, if consumption continues to increase over time, as it has for most of U.S. history, an increment of consumption will be less valuable in the future than it would be today, because the principle of diminishing marginal utility implies that as total consumption increases, the value of a marginal unit of consumption tends to decline.

It recommends that analyses rely on real, before-tax rates of 7 percent and 3 percent.

4.4 Benefits should be quantified and valued.

The benefits expected from alternative regulatory approaches should be quantified and valued in dollars to the maximum extent possible. The concept of opportunity cost is the appropriate measure of both benefits and costs. "Willingness to pay" reflects an aggregate value of what individuals are willing to forgo for a particular benefit or outcome. Market transactions are the most reliable measure of society's willingness to pay for goods and services. For goods that are not exchanged, statistical techniques, such as travel-cost studies and hedonic pricing models, can often be used to estimate willingness to pay for indirectly-traded goods.

Many health and safety rules are designed to reduce premature mortality associated with accidents or exposure to environmental or workplace risks. Analyses typically rely on statistical measures of risk consequences, such as

statistical lives saved or years of life saved. These don't refer to individual statistics, but rather measure the sum of risk reductions expected in a population. (For example, if the annual risk of death is reduced by one in a million for each of two million people, that is said to represent two "statistical lives" extended per year. A reduction in the annual risk of death by one in 10 million for each of 20 million people also represents two statistical lives extended.)

The use of a years-of-life-saved metric is often more informative than a life-years-saved metric. Lives are never "saved" but rather extended, and different actions may have different effects on life expectancy. A lives-saved metric cannot distinguish between an action that extends a statistical life by 40 years from one that extends it 6 months.

As noted above, objective disclosure of underlying assumptions and values is essential to a transparent, meaningful estimate of benefits.

4.5 Costs should be quantified and valued.

The opportunity cost of alternative approaches is the appropriate measure of costs. This should reflect the benefits foregone when a particular action is selected and should include the change in consumer and producer surplus. To the extent possible, offsetting effects should be reflected in the analysis either as offsets to the benefit estimate or increases in the costs of a selected alternative.

A Presidential Risk Commission recognized the importance of such tradeoffs, noting that risk management decisions should consider "diversion of investments, or opportunity costs—such as having to spend money on environmental controls instead of using those resources to build a school or reduce taxes."[9]

Cost estimates should include a most likely ("best") estimate of the costs as well as a range, and a discussion of the sensitivity of those estimates to key assumptions.

5. Base the proposal on strong scientific or technical grounds

The analysis of benefits and costs should reflect the best scientific, technical, and economic information available, and that information should be presented to decision-makers in a balanced manner. When there is disagreement or uncertainty regarding particular effects or outcomes, the sensitivity of the benefits and costs of alternative actions to different assumptions should be presented clearly.[10]

For actions designed to reduce health risks, analysts must often make projections based on limit-

[9] The Presidential/Congressional Commission on Risk Assessment and Risk Management, *Framework for Environmental Health Risk Management, Final Report,* Volume 1, January 1997, p. 33

[10] OMB has recently drafted peer review guidelines and data quality guidelines, which, when final, will provide guidance on the use of scientific and technical data.

ed information. In these cases it is not only important to base analyses on a balanced review of the most robust data available, but to ensure that the assessment of risk is objective, and not confused with policy choices. *Risk assessment* should be separate from *risk management*.

6. Understand distributional effects

The benefits and costs of any particular action are not always uniform across regulated parties and the beneficiaries of regulation. Those who bear the costs of a regulation and those who enjoy its benefits often are not the same people.

While some government programs are designed to redistribute wealth (e.g., food stamps), others do so inadvertently. It is important to understand whether a regulation will have different impacts on different subpopulations, including those living in different regions of the country, businesses of different sizes, individuals of different ages and different ethnic and socio-economic characteristics.

A good regulatory analysis should also consider tailored requirements for different segments of the regulated population, different regions of the country, etc.

7. Respect individual choice and property rights

Government actions that undermine individual liberty and responsibility, and do not respect private property are not likely to improve the welfare of American citizens. The fifth amendment of the U.S. Constitution provides that private property shall not be taken for public use without just compensation.

As Thomas Sowell has observed:
The whole political system would not operate as well if the government could silence its critics. Similarly, the whole economic system would not operate as well if political control of resources replaced individual control. Both free speech rights and property rights belong legally to individuals, but their real function is social, to benefit vast numbers of people who do not themselves exercise these rights.[11]

Regulations, like the washing machines standards discussed in Chapter 2, that supplant individual preferences with regulators' preferences are unlikely to make citizens better off. Thus, it is important to understand the implications of regulatory action on individuals' ability to make their own choices and act responsibly.

Further Reading:

Office of Management and Budget. Circular A-4. September 2003. Available at: http://www.whitehouse.gov/omb/circulars/a004/a-4.pdf.

[11] *Forbes*39

9. The Future of Regulation

By all measures, federal government regulation of private activities is growing. In 1960, federal outlays directed at writing, administering, and enforcing regulations was $533 million; today that figure is $39 billion. Between 2000 and 2005 alone, budgeted outlays directed at regulations increased 41.6 percent in real terms. The Small Business Office of Advocacy estimates that compliance with federal regulations cost businesses and consumers $1.1 trillion in 2004.

The focus of regulation has changed over the last several decades, and despite this overall growth in regulatory activity, regulation of some areas has declined. Prior to the 1960s, federal regulatory activity was primarily aimed at controlling prices. Beginning in the 1970s, deregulation of many of these traditional industries has allowed market forces to take over the regulation of price and quality with marked success.

In the 1970s, the focus of regulation shifted to actions aimed at protecting health, safety, and the environment. In that decade, Congress established a host of new regulatory agencies, including the Environmental Protection Agency (EPA), the Occupational Safety and Health Administration (OSHA), the Consumer Product Safety Commission (CPSC), and the National Highway Traffic Safety Administration (NHTSA). The budgets of these regulatory agencies have grown significantly since then.

Since 2001 a new regulatory focus has emerged: homeland security. Formed in 2002, the Department of Homeland Security incorporated several existing agencies with regulatory functions. The regulatory portion of its budget grew from $8 billion in 2001 (the regulatory portion of the budget of its predecessor agencies) to a projected $18 billion in 2006.

While the focus of regulations is evolving, so is the process by which they are developed. The emergence of the Internet and electronic rule-making dockets are changing the dynamics of the regulatory process. Regulation is no longer solely the purview of Washington-based lobbyists. Members of the public now have more opportunities to engage in the regulatory debate. The once arcane world of regulation is now accessible to a much wider public, with the potential for making regulators and regulations more accountable.

Understanding the impetus for regulation, the incentives faced by regulators and regulated parties, and the underlying market conditions that lead to regulation are essential for evaluating the consequences of regulatory actions and the legislation that enables them. This is important, not only for understanding the effects of proposed new regulations, but for examining whether existing regulations are having their intended impacts. The concepts introduced in this primer are essential to that understanding and will remain so as federal regulation continues to evolve.

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Mercatus Center
George Mason University

3301 North Fairfax Drive
Arlington, Virginia 22201
Tel: 703-993-4930
Fax: 703-993-4935