August 8, 2016

The Honorable Tom Price
United States Representative
Chair, House of Representatives Committee on the Budget
Washington, DC 20515

Dear Chairman Price:

Thank you for the opportunity to testify on July 7 at the hearing "An Introduction to Regulatory Budgeting." I'm happy to provide answers to the post-hearing questions you posed in your correspondence of July 13, 2016.

**1. You stated that there is not yet a consensus among economists on a method for estimating the costs of regulations. In establishing a regulatory cost baseline, what methods appear to offer the level of transparency, replicability and rigor that this committee should consider as options?**

The goal of establishing a baseline for budgeting purposes is to understand changes relative to the baseline—typically, in percentage terms. Several legitimate options exist that could achieve that goal, and it is not necessarily the case that the baseline must be monetized. A nonmonetized baseline can often be converted to a cost baseline, but this step—while useful—is not required for a baseline to be informative. For example, in a regulatory impact assessment, a baseline accident rate could be established in order to see whether a regulation changes the accident rate. A regulatory *cost* baseline would be a monetized metric, but other data related to the regulatory process, like accident rates, could also be used to produce a regulatory baseline that would give context to subsequent changes.

To that end, I would highlight two methods. The first is simply to measure "regulatory restrictions," which consists of counting the number of individual prohibitions or obligations contained in regulatory text. The Canadian province of British Columbia pioneered a version of this method, calling its baseline a count of "regulatory requirements."[1] This method produces a specific number that can then be tracked to measure progress. In 2001, for example, British Columbia established its baseline count of regulatory requirements at 330,812—a figure that included all regulatory requirements found in formal regulatory text as well as in guidance documents, interpretations, legislation, and other associated policies and forms. By 2004, the province had reduced the number of regulatory requirements by 36 percent, leaving 228,941 requirements.[2]

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[1] Laura Jones, "Cutting Red Tape in Canada: A Regulatory Reform Model for the United States?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, November 2015).
[2] "Measuring Progress," British Columbia government, accessed August 8, 2016, http://www2.gov.bc.ca/gov /content/governments/about-the-bc-government/regulatory-reform/measuring-progress.

Although counting regulatory restrictions or regulatory requirements does not monetize the total regulatory burden or permit differentiation of the cost from one restriction to another, it does produce a transparent and replicable baseline that can be used to track or target percentage changes from year to year. The Canadian government at the federal level has also implemented a version of a regulatory budget, but this budget is not focused simply on regulatory restrictions or requirements. Instead, it uses the Standard Cost Model to convert regulatory requirements into administrative burden figures. But the principle implemented in the budget remains the same in both versions: establish a baseline budget as a function of regulatory text.

The second method I would highlight could be called "dynamic social cost estimation." Rather than measuring paperwork costs, business costs, or compliance costs, social cost estimation takes into account more subtle costs, such as the negative effects on innovation and entrepreneurship that accompany government intervention and that affect other segments of society besides the business community. But these costs are typically observable only in hindsight and through a careful combination of modeling and empirical work. The 2016 study that I authored with Bentley Coffey and Pietro Peretto and highlighted in my written testimony offers an example.[3] That study used data on the number of regulatory restrictions, as does the British Columbia metric discussed above. But it measured the regulatory restrictions applicable to specific industries over time, and estimated how changes in the levels of regulation over time affected innovation and economic growth across industries within the context of a well-established model of economic growth. It offers a very high level of rigor for several reasons:

1. It is based on established economic theory.
2. It is comprehensive, measuring all regulations applicable to an industry rather than only those deemed to be economically significant and considering the effects of rules in their totality rather than one at a time.
3. It is retrospective, using data about what actually transpired rather than best guesses about what might happen.
4. It is dynamic, adding the realistic element of allowing individuals and firms to react to the regulations over time by altering their behavior, in a way that is analogous to dynamic scoring of legislation.

The model and data are formally established and documented, making the study not only rigorous but also transparent and replicable.

**2. When Rep. Hartzler asked about the best methods for performing retrospective review, you did not get a chance to answer. What is your opinion on the best method of retrospective review of regulations?**

Regulations need to be effective. That is, they should accomplish the goals intended by Congress, as codified in their authorizing statutes. In the context of regulatory budgeting, the best method of retrospective review of regulations would focus primarily on whether a rule or regulatory program delivers changes in the desired direction for the outcomes specified by authorizing statutes. Of course, this method would require that Congress more specifically define

[3] Bentley Coffey, Patrick A. McLaughlin, and Pietro Peretto, "The Cumulative Cost of Regulations" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, April 2016).

the desired outcomes for the statutes it approves. Given that legislation's desired outcome or outcomes can be identified, retrospective review should be data-driven, producing information on at least the following six subjects:

1. Obsolescence: Is the issue that the rule addresses still current and significant?
2. Efficacy: Has the rule delivered the desired outcomes?
3. Unintended consequences: Has the rule created unintended effects in other areas of the economy? For example, has the mitigation of one risk led to increases in other risks? Has the rule had any unintended effect on competition?
4. Cost: At what cost, including the costs of any unintended consequences, has the rule been implemented? What costs are already sunk, and what costs would require continued expenditures?
5. Interaction: Does the rule interact with other rules, and can the set of rules governing this topic be simplified without increasing risk?
6. Duplication: Is the rule duplicative? Can the rules in the regulatory program be combined to simplify the program?

**3. Mr. Pierce asserted that the Canadian approach to regulatory budgeting does not consider benefits. Is that correct?**

No, it is not correct. The Canadian approach focuses on identifying and eliminating red tape, using a one-in, one-out regulatory budget as the mechanism to achieve that. When an agency produces a new regulatory requirement in Canada, the agency must find and eliminate the equivalent in red tape—defined as burdensome and often unnecessary government administrative processes and regulatory requirements. It becomes the job of the agencies to identify red tape that can be eliminated without compromising the regulatory system's contribution to the protection of health, safety, security, the environment, and the economy. In fact, this commitment to preserving the benefits of regulation is formally enshrined as the first of the five principles guiding the application of the Canadian regulatory budget.[4]

How do Canadian agencies differentiate red tape from effective regulation? They perform retrospective analysis, rather than assuming that all regulatory requirements must be effective.

**4. Mr. Pierce asserted that the current process, characterized as benefit-cost analysis performed by agencies and reviewed by OMB, is in itself a regulatory budget. Do you agree?**

I strongly disagree. The benefit-cost analysis contained in regulatory impact assessments performed by agencies and reviewed by OMB should not be confused with a regulatory budget. Regulatory impact assessment (RIA) as currently used in the American regulatory process can be a useful tool for its intended purposes, but it cannot provide a reliable baseline to which future changes can be compared, for several reasons.

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[4] President of the Treasury Board, "Controlling Administrative Burden That Regulations Impose on Business: Guide for the 'One-for-One' Rule" (Government of Canada, 2012), § 4.

First, it may be worth clarifying that OMB's annual report to Congress on the benefits and costs of regulations offers nothing close to a complete picture, by OMB's own admission.[5] Agency RIAs that are reviewed by OMB represent only a small number of the total body of regulations promulgated each year. My colleagues Richard Williams and James Broughel found that over the 10-year period from 2004 to 2013, agencies promulgated 37,022 new rules.[6] Only 3,040 of these, or 8 percent, were reviewed by OMB. Only 116, or 0.3 percent, had RIAs that were found to contain estimates of both costs and benefits. That is not sufficient information to produce a budget.

Second, RIA as conducted by agencies in the federal government is only prospective, not retrospective. More reliable benefit and cost estimates could be produced with retrospective analysis, if for no other reason than the fact that retrospective analysis involves examining data after regulatory changes have been realized.[7]

Third, agencies produce regulations in response to legislation. For example, the Railroad Safety Improvement Act of 2008 required the Federal Railroad Administration to produce several new safety regulations. Imagine if the RIAs produced by the Federal Railroad Administration for the years before 2008—before the new legislation induced new rulemaking—were used as a regulatory budget for that agency in the years following the new act. Insofar as a budget is a tool that helps project future action or expenditure, such a budget would greatly misinform the public.

A regulatory budget needs to produce a reliable baseline as well as informative projections of future costs. Regulatory impact assessments, as currently executed, do not produce either. Furthermore, if the regulatory budget is to be used as a tool to control the growth of the regulatory burden, the existing process offers no mechanism to achieve this goal.

**5. You classified the approaches for regulatory budgeting into agency-centric and legislation-centric. Could you discuss the advantages and disadvantages of these approaches from the economics perspective?**

To briefly reiterate, agency-centric methods of regulatory budgeting focus on actions of the agencies themselves, as if the agencies are independent of other branches of government. Legislation-centric methods focus on authorizing statutes passed by Congress as the wellspring

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[5] For example, OMB warns, "Because these estimates exclude non-major rules and rules adopted more than ten years ago, the total benefits and costs of all Federal rules now in effect are likely to be significantly larger than the sum of the benefits and costs reported in [this report]. More research would be necessary to produce current estimates of total benefits and costs for all agencies and programs, though some agencies have developed valuable assessments of the benefits and costs of their programs." Office of Management and Budget, *2015 Report to Congress on the Benefits and Costs of Federal Regulations and Agency Compliance with the Unfunded Mandates Reform Act*, 2015, 18.
[6] Richard Williams and James Broughel, "OIRA Quality Control Is Missing for Most Regulations," Mercatus Center at George Mason University, October 1, 2014.
[7] The fundamental difference between prospective and retrospective analysis is their ex ante versus ex post natures, and this is the biggest reason that retrospective analysis would offer an improvement to the state of knowledge about regulations' benefits and costs. A good analogy is election polling, performed before elections and always with uncertainty, versus election results. But there are other reasons to worry about the reliability of prospective analyses produced by the same regulatory agencies that produce the regulations themselves. The most prominent of these other reasons is the conflict of interest inherent in a structure where economic analysis (prospective or retrospective) is performed or overseen by agency employees who also have incentives to ensure that a rule is created.

of agency regulation. The most obvious advantage of one over the other is in predictive ability: an agency-centric budget may not be very predictive of the next year's regulatory costs if it does not somehow take into account acts of Congress that may have changed agency missions or required agency actions. A legislation-centric budget would focus on authorizing statutes, thereby capturing such changes.

Another difference relates to the issue of benefits. A legislation-centric approach permits Congress to decide how much the benefits delivered by regulation are worth. A legislation-centric regulatory budget essentially puts a price tag on different regulatory options, alongside information about whether those options have been or are likely to be effective in delivering legislation's intended outcomes. Congress then must choose how much the delivery of those intended outcomes is worth. This puts the central question in the regulatory process—the valuation of benefits—squarely in Congress's control. Rather than relying on a rulemaking process that lacks democratic accountability, Congress would evaluate benefits with its constituents in mind, and authorize regulatory cost expenditures to regulatory programs that are deemed worthy and effective.

**6. There is a rigorous debate within Congress on whether or not agency regulations actually reflect legislative intent. Your testimony touches on a legislation-centric regulatory budget. How could such a budget mechanism assist Congress in evaluating whether or not agency regulations are achieving the outcomes that Congress intended to achieve through public laws? What role would costs and benefits have in such a system?**

No agency can issue a regulation unless Congress has enacted legislation that empowers the agency to do so. Unfortunately, when Congress considers authorizing legislation, no organized process ensures that legislators know the root cause of the problem the legislation seeks to solve, the effectiveness of alternative solutions, or the costs of alternative solutions. Even when a desired outcome is specified in authorizing legislation, agencies often promulgate regulations without demonstrating—with evidence—that the authorized regulation is in fact likely to accomplish the outcome. The act of making a regulatory change is often assumed to deliver the desired outcomes.

A legislation-centric regulatory budget would solve this information gap by tying agency regulations to the public laws that authorized them. First, it would require that prospective analysis be performed on the economic impact of proposed legislation, which Congress could use to inform voting. Congress would have to operate with broader and deeper knowledge of the economic effects of legislation, including an assessment of whether there is a genuine problem and a reasonable estimate of the economic costs that regulatory intervention would precipitate. The argument for requiring the formal consideration of regulatory costs by Congress follows the same logic as the argument for on-budget taxing and spending decisions. For example, the Congressional Budget Office scores congressional bills to produce estimates of how the proposed legislation would affect the national budget. A similar scoring process could produce estimates of the economic effects of the regulations that proposed legislation would authorize. In our proposal, Jason Fichtner and I called this analysis of the anticipated regulatory effects of

proposed legislation "legislative impact accounting."[8] Using the estimates of anticipated regulatory costs association with new legislation, Congress could set legislation-centric regulatory budgets.

Because the social costs induced by regulation would be monitored and possibly constrained by a system that uses legislative impact accounting, an independent cost analysis would be necessary. An independent cost analysis conducted for Congress would ensure that having to work within a social cost budget does not incentivize agencies to underestimate costs.

In addition to requiring analysis of anticipated regulatory costs to accompany new legislation, legislation-centric regulatory budgeting would initiate a feedback loop that would provide Congress with information about regulations created or modified under the authority of legislation. This information would include both the effectiveness of these regulations in delivering desired outcomes and the realized regulatory costs. Congress could then consider this information during the budget process. A new stage of retrospective analysis of regulations could be added to the process. This would permit Congress to reassess the desirability of continuing to appropriate regulatory cost expenditures for programs associated with its legislation. If a program is more or less successful than initially envisioned, or if its costs are higher or lower, Congress could adjust the throttle of the program using the regulatory budget process.[9]

In summary, a legislation-centric regulatory budget would consider both costs and benefits. The budget process would involve Congress allocating regulatory cost expenditures to specific pieces of legislation, which agencies would then spend as authorized. Prospective and retrospective analysis would inform Congress of the likely benefits and costs of the legislation, and Congress would use this information to set the regulatory cost expenditures permitted under the legislation.

I hope this additional information is helpful in the committee's consideration of regulatory budget options. Please feel free to contact me if I can provide any additional information.

Sincerely,

Patrick A. McLaughlin
Senior Research Fellow
Mercatus Center at George Mason University

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[8] Jason J. Fichtner and Patrick A. McLaughlin, "Legislative Impact Accounting: Rethinking How to Account for Policies' Economic Costs in the Federal Budget Process" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, June 2015).
[9] For more details on this type of proposed system, see Fichtner and McLaughlin, "Legislative Impact Accounting."