Principles for Constructing a State Economic Analysis Unit

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Federal regulatory agencies produce economic analyses of the likely impacts of their largest regulations—a requirement of executive branch agencies that was formalized throughout the 1970s and early 1980s. Since then, states have also experimented with enhancing their analytic capabilities. However, the states are far behind the federal government when it comes to incorporating technical analysis and evidence into regulatory decision-making.

We outline some principles, primarily derived from the federal regulatory process, that can guide the creation and structure of an economic analysis unit operating within a state government. The federal process for analyzing and reviewing regulations offers valuable insights into best practices for an economic analysis unit within state government. Namely, the process by which regulations are created should help ensure that any regulation proposed focuses on solving a real problem and that all feasible solutions are considered. The economic analysis itself should be objective and subject to third-party review.

Furthermore, while these lessons are directly relevant to the creation of a unit whose task is to produce economic analyses of new regulations, lessons can also be extended to other analytical tasks, such as analyzing the budgetary impacts of proposed policies or retrospective (i.e., backward-looking) analysis of legislation, regulation, or other policies that are already in place.

BACKGROUND ON FEDERAL REGULATORY ANALYSIS AND REVIEW

The federal regulatory process has included requirements for economic analysis since the 1970s, although the use of benefit-cost analysis in the federal government has roots that trace back as far as the 1930s.[1] Gerald Ford was the first president to issue executive orders requiring economic analysis for some regulations.[2] This tradition was continued when, in 1978, President Carter issued Executive Order 12044,[3] which required regulatory agencies to perform economic analysis for major regulations and to weigh their prospective economic consequences. The order also tasked agencies with conducting a review of their existing regulations on the books. In 1980, with the signing of the Paperwork Reduction Act, the Carter administration also oversaw the creation of what would become the centralized review office for regulations—the Office of Information and Regulatory Affairs (OIRA)—that was housed within the Office of Management and Budget (OMB).

Although OIRA was originally tasked primarily with reviewing paperwork-related aspects of regulation, subsequent executive orders, such as Executive Order 12291 issued by President Reagan,[4] broadened the scope of OIRA's mission to include review of regulations and their accompanying analysis. The OMB had already been playing a less formal role in reviewing regulations throughout much of the 1970s,[5] but the Reagan order made this role more explicit.

The executive order that currently governs the US regulatory analysis and review process is Executive Order 12866, issued in 1993 by President Bill Clinton.[6] The order, which remains in effect, requires that "significant" regulations undergo review by OIRA and that regulations with an annual impact of over $100 million be accompanied by a regulatory impact analysis (RIA).

OIRA review helps ensure the quality of regulations and their economic analyses by acting as an external reviewer, providing feedback, and recommending changes to analysis and rules.[7] Even though it is applied to only a small percentage of all new regulations, OIRA review—and the concept of independent review of regulations in general—offers a model that could be implemented or expanded upon in other contexts.

1. Jim Tozzi, "OIRA's Formative Years: The Historical Record of Centralized Regulatory Review Preceding OIRA's Founding," *Administrative Law Review* 63, Special Edition: OIRA Thirtieth Anniversary (2011): 37–69.
2. Exec. Order No. 11821, 3 C.F.R. 926 (1975); Exec. Order No. 11949, 3 C.F.R. 161 (1977).
3. Exec. Order No. 12044, 3 C.F.R. 152 (1978).
4. Exec. Order No. 12991, 46 Fed. Reg. 13193 (February 17, 1981).
5. Jim Tozzi, "OIRA's Formative Years."
6. Exec. Order No. 12866, 58 Fed. Reg. 190 (1993).
7. Patrick A. McLaughlin and Jerry Ellig, "Does OIRA Review Improve the Quality of Regulatory Impact Analysis? Evidence from the Final Year of the Bush II Administration," *Administrative Law Review* 63 (2011): 179–205.

PRINCIPLES FOR HIGH-QUALITY REGULATION

In its role as reviewer, OIRA tries to ensure that regulations are based upon sound, up-to-date, and credible evidence. OIRA's role and principles of rulemaking outlined in Executive Order 12866 merely reflect a bipartisan consensus around the commonsense notion that regulations should solve real problems at an acceptable cost.

The regulatory process should help regulators achieve this goal, and therefore its design incorporates a few basic instructions and principles towards that end:

1. Regulations should solve a real, widespread problem;
2. Multiple alternative forms of regulation (and alternatives to regulation) should be considered;
3. Policymakers should aim to provide the most benefits to the public for the least cost; and
4. Regulations should not unfairly benefit some groups or technologies at the expense of others.[8]

Despite widespread agreement on these principles, however, they are inconsistently followed, both by OIRA and by regulatory agencies throughout the federal government.[9] This highlights how good intentions and good instructions are not enough to ensure sound decision-making and high-quality regulation. In order for the principles of good rulemaking to be followed, the body that produces or reviews analysis must be designed in such a way that these principles and objectives are not only achievable, but are actually achieved.

8. These general principles and others can be found in Jerry Ellig, "Ten Principles for Better Regulation" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2013). They are based on principles set forth under Executive Order 12866 as well as guidelines from the OMB.

9. As evidence, the Mercatus Center's Regulatory Report Card evaluated the quality and use of agencies' regulatory impact analyses from 2008 to 2013. Quality of RIAs varies widely, and most RIAs are incomplete in the sense that they do not include one or more critical elements of analysis, as outlined in Executive Order 12866 and OMB guidelines on regulatory analysis. See Mercatus Center at George Mason University, "Regulatory Report Card," accessed February 21, 2018, https://www.mercatus.org/tags/regulatory-report-card.

GUIDELINES FOR THE CREATION OF A STATE ECONOMIC ANALYSIS UNIT

Independence and Objectivity

Despite bipartisan consensus about the merits of economic analysis and third-party review of regulations, the federal process is far from perfect. For example, analysis is often constructed after a decision to regulate has already been made, a problem that is sometimes referred to as the "ready, fire, aim" problem in rule-making.[10] A clear danger of crafting analysis too late is that it will be used as a tool to justify regulations, rather than to inform how regulations are designed.[11] This is especially relevant when considering that the heads of regulatory agencies are political appointees, so the chain of command ensures that regulatory decisions are necessarily political.

Some have argued that granting analysts independence from politics could lead to more apolitical regulatory decision-making, for example, by separating analytic responsibilities from the program offices that design and execute regulatory programs. Agencies like the Occupational Safety and Health Administration, the Mine Safety and Health Administration, and the National Highway Traffic Safety Administration rely on economists in an autonomous departmental office.[12] But given that these agencies are still run by political personnel, it is likely that analytic functions will need to be more insulated from politics than this, perhaps by completely removing analytic functions from regulatory agencies or perhaps even from the executive branch. However, even a perfectly independent economic analysis unit would still likely require some form of third-party oversight, as we discuss below.

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10. Jerry Ellig, "'Ready, Fire, Aim!': A Foundational Problem with Regulations," Economic Perspectives, Mercatus Center at George Mason University, November 6, 2015.
11. We know that this problem exists because interviews with federal agency economists reveal that they are sometimes tasked with producing analysis to justify, rather than to inform, regulatory decisions. See, for example, Stuart Shapiro, *Analysis and Public Policy Successes, Failures and Directions for Reform* (Cheltenham, UK: Edward Elgar Publishing, 2016); and Richard Williams, "The Influence of Regulatory Economists in Federal Health and Safety Agencies" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2008).
12. Stuart Shapiro and Laura Stanley, "Economists in the Bureaucracy: A Question of Autonomy" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, 2016).

Timing

Aside from politics, an additional reason why analysis may be overly political or may not be used in decision-making relates to timing. Analysis needs to be produced early enough in the rulemaking process so that it can inform decisions. Too often, analysis is crafted too late to be useful. Colorado, for example, has demonstrated the capability to produce or commission quality analysis at times.[13] However, the requirements for analysis in the state are only triggered after a regulation is formally proposed.[14] This backwards process practically invites analysis to be used to justify a predetermined decision.

Even requiring analysis alongside a proposed rule may not be early enough. At the federal level, it is not uncommon for agencies to analyze just one alternative—the regulation being proposed or finalized—which suggests that no other alternatives were seriously considered.[15] A simple way around this problem is to tie analysis to an advance notice of proposed rulemaking (ANPRM) that occurs prior to a regulation being formally proposed. In the ANPRM, the regulating agency could present multiple regulatory options it is considering, along with an accompanying analysis of those options, and would then seek public feedback on this information before moving forward with a proposed rule.

External Review

Some kind of third-party oversight is likely necessary to limit the influence of politics and to ensure that agencies design regulations based on fact rather than just good intentions. The OIRA model at the federal level partially fulfills these needs, but it has often proven to be insufficient. Another model might be the example of the United Kingdom. As part of its Better Regulation initiative, impact assessments sometimes receive scrutiny from volunteer economists or other experts inside or outside of the government.[16]

Oversight by the courts is yet another option for third party oversight. As Patrick A. McLaughlin, Jerry Ellig, and Michael Wilt recently wrote,

13. James Broughel, "Advancing Evidence-Based Regulation in Colorado" (Testimony before the Colorado House Business Affairs and Labor Committee, Mercatus Center at George Mason University, Arlington, VA, February 1, 2018).
14. James Broughel, "Advancing Evidence-Based Regulation in Colorado."
15. Jerry Ellig and James Broughel, "Regulatory Alternatives: Best and Worst Practices" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, 2012).
16. National Audit Office, *Submission of Evidence: Controls on Regulation*, 2012, 26, 30.

> Judicial review can give stakeholders an opportunity to challenge [economic analyses] that are incomplete or that ignore important evidence in the rulemaking record.
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> Courts currently examine the quality of an agency's regulatory impact analysis or other economic analysis only under specific limited circumstances, such as when the analysis is mandated by statute or the agency itself refers to the analysis as justification for its decisions. Surveying these court decisions, scholars have found examples of courts competently and carefully assessing the agency's treatment of all major elements of regulatory impact analysis: analysis of the systemic problem, development of alternatives, and estimation of the benefits and costs of the alternatives. Agencies typically improved their analysis in response to court decisions that remanded regulations. When appeals courts examine regulatory agencies' economic analysis, they show no pro- or anti-regulatory bias in their rulings, and they actually uphold regulations more frequently than they strike them down.[17]

Thus, there is good reason to believe that analysis will be higher quality when there is a danger that poor analysis will result in a regulation being challenged in court.

CONCLUSION

Regulatory agencies should craft regulations with as much information as is readily available, so they can reasonably anticipate rules' effects. Regulating in the dark should not be an option. To achieve these goals, the regulatory process must incorporate economic analysis in a way that ensures both quality and usefulness. Lessons from both the successes and the failures of the federal regulatory experience offer a potential roadmap for states wishing to establish an economic analysis unit. The principles outlined here can be helpful as policymakers aim to design institutions that serve that public interest and advance the principles of high-quality regulation.

17. Patrick A. McLaughlin, Jerry Ellig, and Michael Wilt, "Comprehensive Regulatory Reform," Mercatus Policy Primer, 2017. Internal citations omitted.

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Broughel has authored numerous policy briefs and reports on regulatory issues. His work has appeared in outlets such as *U.S. News & World Report*, *Real Clear Policy*, *The Hill*, *Yahoo Finance*, the *Louisville Courier-Journal*, the *Washington Times*, and the *Washington Examiner*. He has published in scholarly journals, including the *Harvard Journal of Law & Public Policy: Federalist Edition* and the *European Journal of Risk Regulation*.

Broughel received his PhD in economics from George Mason University in 2017 and his BA and MA in economics from Hunter College of the City University of New York, from which he graduated summa cum laude.

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McLaughlin created and leads the RegData and QuantGov projects, deploying machine learning and other tools of data science to quantify governance indicators found in federal and state regulations and other policy documents. The resulting database is freely available at QuantGov.org, and it has facilitated pioneering empirical research by numerous third-party users on the causes and effects of regulation.

McLaughlin has authored more than a dozen peer-reviewed studies in diverse areas, including regulatory economics, administrative law, industrial organization, and international trade. His book, *The Impact of Federal Regulation on the Fifty States* (with Oliver Sherouse), is available for download here.

Before joining Mercatus, McLaughlin served as a senior economist at the Federal Railroad Administration in the United States Department of Transportation and as a visiting scholar at the Regulatory Studies Center at George Washington University. He holds a PhD in economics from Clemson University.