



THE NEED FOR ECONOMIC ANALYSIS IN FEDERAL REGULATION

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FAR TOO LITTLE ECONOMIC ANALYSIS IN RULEMAKING. Federal regulatory agencies rarely conduct complete and thorough economic analyses of the things they set out to regulate, the rules they write, and the actual effects their rules have once implemented. Only about a quarter of “major” rules, principally those with an impact of \$100 million in a given year, and less than half a percent of the more than 3,500 rules in total that federal agencies issue each year are analyzed for their costs and benefits. Moreover, it is common for agencies to perform an analysis only after they have decided what the rules should be and then to understate their costs and overstate their benefits. Once in effect, agencies generally do not analyze the actual economic effects of their rules in the real world.

FEDERAL OFFICIALS CLAIM TO KNOW BEST. Federal regulation is based heavily on the presumption that regulators know when and how to intervene in a market and that the rules they promulgate are in the “public interest.” But while markets may not perform perfectly, neither does the government. In reality, federal officials face basic problems in prescribing outcomes that are better overall than develop in the marketplace:

SYSTEMIC PROBLEMS OF GOVERNMENT REGULATION

- **Principal-agent problem:** Divergent interests between voters (principals) and officials (agents) lead to policies that may not reflect public preferences.
- **Asymmetric information:** Federal agencies, the political parties, and special interest groups interact to make policy based on information that may not be available and considerations that may not be transparent to the public.
- **Incomplete information:** A central authority cannot fully capture, process, or replicate the new information that markets continually generate.
- **Rent-seeking:** Special interest groups seek favorable regulation from government at the public’s expense and waste resources in the process.
- **Organizational problems:** Bureaucratic inefficiency and inertia impose administrative costs and delay, and jurisdictional divisions cause overlap, frictions, or leave gaps in regulation.
- **Monopoly power.** When government officials supplant market outcomes with mandates, they limit choice, competition, adaptability, experimentation, technological development, and the standards for comparison of their performance.

CHOOSING EFFICIENT RULES REQUIRES ANALYSIS. Given the problems of the administrative state, the presumption is unwarranted that federal officials have superior knowledge, motivation, and skills to produce the best outcomes without as much as analyzing the costs and benefits of alternative approaches. Agencies have many different approaches to choose from, and even a partial list suggests it is impossible to know the best one for a given set of circumstances without comparative analysis:

- Improve existing rules rather than issue new ones;
- Better define property and market trading rights;
- Impose fees in place of mandates;
- Improve information dissemination;
- Set performance standards and let the regulated decide how to meet them;
- Prescribe product design and production methods;
- Prohibit production and/or consumption.

Regulatory agencies do not report to Congress as a matter of standard practice on the efficiency of their regulatory regimes or when statutory language may hinder adoption of the most efficient approach to achieve a statutory objective. They should be required not only to conduct comparative analyses and report their findings but also to make recommendations for saving costs to the congressional committees of jurisdiction so that Congress can consider accommodating changes in the law.

UNBOUNDED SOCIAL REGULATION. Economic regulation of price and output had become visibly counterproductive by the 1970s and was pared back in the Carter and Reagan administrations, but social regulation has since ballooned. Social regulation as practiced, such as by the Environmental Protection Agency, Occupational Safety and Health Administration, Consumer Product Safety Commission, and the Consumer Financial Protection Bureau, has no limiting conceptual framework; it can be activated by any condition that is deemed unsatisfactory in some respect and the claim of a “market failure.” Without objective determination of the tradeoffs involved and full consideration of alternative responses, agencies can proceed to impose requirements they simply declare to be in the “public interest.” But, agencies engaged in social regulation especially tend, among other things, to:

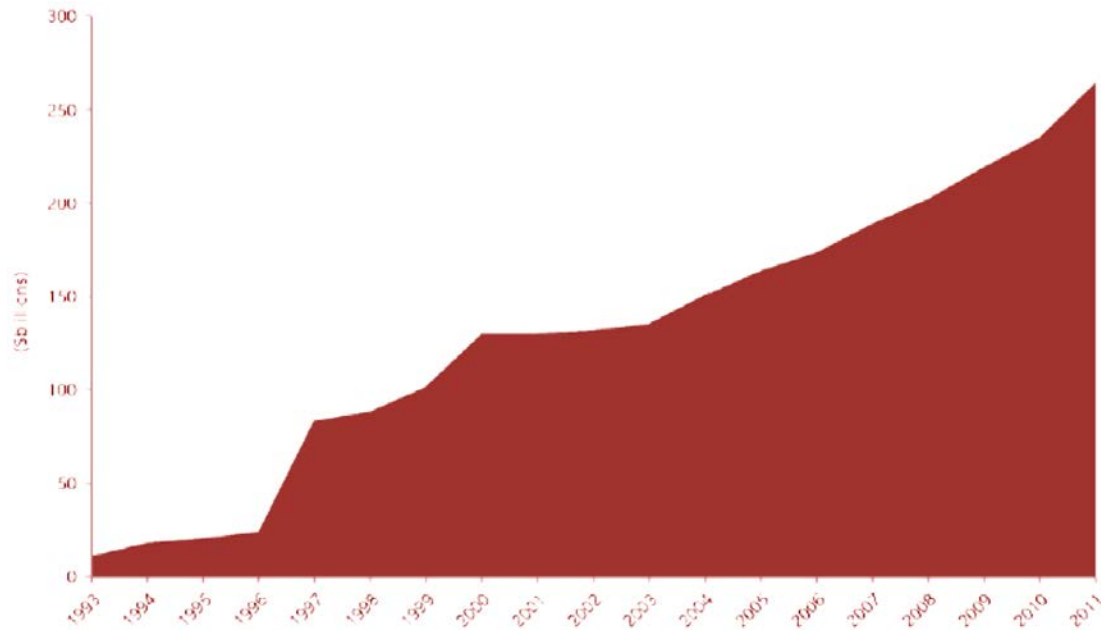
- ignore the government’s own policies as the source of problems;
- confuse social problems with ill-defined property and market trading rights;
- target private choices in addition to public benefits; and
- ignore their rules’ costs in terms of job losses, higher retail prices, impaired international competitiveness of U.S. firms, and limiting the choices of consumers.

GOOD AND BAD REGULATION. The best kind of regulation improves the market’s functioning so that people and businesses can make their own decisions and focus on productive achievement rather than on regulatory compliance or influencing the rulemaking process. The more prescriptive regulation becomes the more discretion it gives to regulators, the more it tends to multiply, the more uncertainty it creates, and the more likely it is to produce unintended consequences and unnecessary costs. Problems with prescriptive regulation—agency capture by the regulated and government looking to make political trades with its rulemaking—long have been recognized by economists, for example, by Nobel

laureate George J. Stigler in “The Theory of Economic Regulation” (1971) and Gordon Tullock in “The Economics of Special Privilege and Rent Seeking” (1989). To protect the public interest, regulation should be stable and generally applicable with rules that are set in advance, known to everyone, and not frequently or arbitrarily changed.

RIISING COSTS FROM REGULATION. A summation of the costs agencies themselves had initially calculated for only a portion of the rules currently in place shows the aggregate cost rising dramatically.

Figure 1: Cumulative Costs of Regulations 1993 to 2011 (Billions of Constant 2010 Dollars)



Source: NERA analysis for MAPI: *Macroeconomic Impacts of Federal Regulation of the Manufacturing Sector*, August 21, 2012.

NERA Economic Consulting estimates the direct cost of compliance with federal regulations was between \$265 and \$726 billion in 2011. Figure 1 shows the lower bound of the range over time. Other regulatory cost estimates are far higher; for example, one by Clyde Wayne Crews, Jr. of the Competitive Enterprise Institute in “Ten Thousand Commandments” (2014) places the cost at \$1.863 trillion. NERA finds that from 1998 through the end of 2011, the cumulative inflation adjusted cost of compliance with major regulations grew by an annualized rate of 8.8 percent, compared with a GDP growth rate of 2.2 percent and physical manufacturing output growth rate of 0.4 percent. U.S. firms’ international competitiveness also is impaired by the surge in regulation, which reduces American exports.

EXECUTIVE ORDERS ARE NOT ENOUGH. Ever since President Reagan institutionalized cost-benefit analysis in federal rulemaking via executive order, every administration has endorsed it. But the directives in the executive orders (a) have omitted independent regulatory agencies such as the Security Exchange Commission and the Federal Reserve, (b) are enforced based on an administration’s preferences, and (c) are not legally binding. The Office of Information and Regulatory Affairs (OIRA) has developed elaborate instructions for regulatory cost-benefit analysis, but in practice they are not applied to the vast majority of rulemakings or the huge volume of existing regulations. (The Code of Federal Regulations had 174,545 pages at the end of 2012.)

MORE PROCEDURAL MEASURES ARE NOT THE ANSWER. There already exist many procedural steps for federal rulemakings (see the “Reg Map” on the OIRA website), but agencies manage to navigate the legal and procedural patchwork of requirements for rulemaking without basing their rules on comprehensive analysis. The need for analysis by objective standards of markets, regulatory options, and existing regulations’ actual effects, however, is heightened by the fact that many difficult tradeoffs have not been settled by statute and increase the role of unelected regulatory officials in policymaking for health care, banking, energy, the environment, and more. The ill effects of inadequate regulatory analysis then also can include contributing to gridlock in litigation after an agency has adopted a rule.

NO VALID OBJECTION TO COST-BENEFIT ANALYSIS. Objections to cost-benefit analysis essentially come down to the difficulties of monetizing certain costs and benefits and making decisions by objectively measurable criteria. But no one questions the need for public accountability with respect to federal spending. A federal budget and appropriations process have been created to provide such accountability. Regulation can induce transfers, move resources, and cause economic gains or losses as has been recognized long ago, for example, by Richard A. Posner in “Taxation by Regulation” (1971). Those affected deserve to know the likely extent. Researchers outside the government analyze the costs and effects of government regulations and special government commissions at times are formed for that purpose; it seems obvious that those who make the rules in the first place should do so as a matter of standard practice.

CONCLUSION. Federal agencies need to do more than declare a market failure, prescribe the outcomes they envision and pronounce their prescriptions to be in the “public interest.” The agencies need to explain the tradeoffs of their pursuits within a coherent analytical framework, and how they can achieve their objectives at minimum cost. The public interest is advanced by the most cost effective means to achieve an objective, and regulators cannot presume to know what they are without analyzing them. Economic analysis can help to develop market process enhancements—such as by introducing property and trading rights where none exist or improving information flow—that are more efficient and stable than proliferating mandates and prohibitions. In the social realm especially, where objective data can be difficult to obtain, regulation should be least strident and restrained from extending boundlessly.

At a Joint Economic Committee hearing entitled “Reducing Unnecessary and Costly Red Tape through Smarter Regulation,” on June 26, 2013, there was bipartisan agreement among the witnesses that: (1) legislation is needed to make cost-benefit analysis a legally binding requirement applicable to all federal agencies; (2) regulatory reviews are needed so corrections can be made to rules that are not working as intended; and (3) independent oversight of agencies is needed to cut down on overlaps in regulation and hold rulemaking to common, objective standards.*

* The witnesses were professor Susan Dudley, Director, Regulatory Studies Center, George Washington University; Dr. Michael Greenstone, Director, Hamilton Project and 3M Professor of Economics, MIT; Dr. Jerry Ellig, senior research fellow, Mercatus Center, George Mason University; and Dr. Robert Kieval, Executive Vice President and Chief Technology Officer CVRx, Inc.