Regulation

By Robert Litan

Businesses complain about regulation incessantly, but many citizens, consumer advocates, and nongovernmental organizations (NGOs) think it absolutely necessary to protect the public interest. What is regulation? Why do we have it? How has it changed? This article briefly provides some answers, concentrating on experience with regulation in the United States.

Regulation consists of requirements the government imposes on private firms and individuals to achieve government’s purposes. These include better and cheaper services and goods, protection of existing firms from “unfair” (and fair) competition, cleaner water and air, and safer workplaces and products. Failure to meet regulations can result in fines, orders to cease doing certain things, or, in some cases, even criminal penalties.

Economists distinguish between two types of regulation: economic and social. “Economic regulation” refers to rules that limit who can enter a business (entry controls) and what prices they may charge (price controls). For example, taxi drivers and many professionals (lawyers, accountants, beauticians, financial advisers, etc.) must have licenses in order to do business; these are examples of entry controls. As for price controls, for many years, airlines, trucking companies, and railroads were told what prices they could charge, or at least not exceed. Companies providing local telephone service are still subject to price controls in all states.

“Social regulation” refers to the broad category of rules governing how any business or individual carries out its activities, with a view to correcting one or more “market failures.” A classic way in which the market fails is when firms (or individuals) do not take account of the costs their activities may impose on third parties (see externalities). When this happens, the activities will be pursued too intensely or in ways that fail to stem harm to third parties. For example, left to its own devices, a manufacturing plant may spew harmful chemicals into the air and water, causing harm to its neighbors. Governments respond to this problem by setting standards for emissions or even by requiring that firms use specific technologies (such as “scrubbers” for utilities that capture noxious chemicals before steam is released into the air).

Another kind of market failure arises when firms fail to supply sufficient information for consumers or workers to make informed choices. Disclosure requirements solve this problem, at least in principle. Examples include “truth in lending” disclosures of interest rates and other pertinent features of bank loans, and required disclosures by pharmaceutical companies of the possible side effects of the drugs they sell. Although truth-in-lending disclosures seem to work well, other disclosures work less well. Few people, for example, read the voluminous package inserts that come with the drugs they take. When policymakers conclude that individuals may be unable to effectively process or act on the information that is disclosed, governments may mandate certain rules or practices. The prime examples are limits on certain chemical exposures to workers in manufacturing plants.

A large body of economic research over the past several decades has focused on regulation, and a surprising degree of consensus has emerged on several propositions. Somewhat surprisingly, policymakers have gradually paid attention to what economists have recommended and changed regulation accordingly. To be sure, policymakers have acted for other reasons, as well—because of pressure from certain segments of the business community or from NGOs. But economists have played an important role in providing intellectual justification for the changes that have been made.

First, economists have urged that price controls be confined to situations in which a market may be dominated by one or perhaps two firms. Otherwise, if markets are reasonably competitive, there is no place for price regulation. Consistent with these propositions, the federal government in the late 1970s and early 1980s began dismantling price regulation of various transportation services, where there are multiple firms and thus choices for consumers (see airline deregulation and surface freight transportation deregulation). Still, there are pockets of economic activity—insurance is one notable example—where some kind of price regulation remains, even though the underlying markets are fundamentally competitive.

Similarly, economists have encouraged policymakers to reduce entry controls so that any firm or individual can enter any market, except in situations where they judge that low quality should not be tolerated. For example, bank regulators no longer closely scrutinize the need for new banks before handing out charters (and instead limit their scrutiny only to whether banks have adequate initial capital and whether their owners are reputable). Licensing systems still remain, however, for doctors, lawyers, accountants, nuclear power plants, and the like because some policymakers believe that the potential damage from low-quality providers can be substantial or irreparable (see consumer protection for another viewpoint).

Second, economists have urged regulators to design more efficient social regulations so that a given goal—such as clean air—can be achieved at least cost. In practical terms, this means not telling firms exactly what technologies to use (i.e., setting design standards), but instead simply giving them a standard to meet and letting them decide how to meet it (i.e., setting performance standards). In addition, economists have urged regulators to allow firms to trade their compliance status with other firms. For example, a firm that, because of a cheaper technology, can reduce the emissions of a noxious chemical to a level below the standard would be able to sell the rights to emit that shortfall to another firm whose cost of complying is higher. This reduces the total cost for a given reduction of overall emissions.

In fact, regulators have taken this advice to heart. The federal agencies governing the safety of automobiles, industrial workplaces, and the environment all have moved in the direction of regulating by performance rather than by design. The U.S. Environmental Protection Agency (EPA), in particular, has implemented emissions-trading programs for sulfur dioxide and other pollutants.

Because even a well-functioning economy will have market failures, however, there will always be a case for some regulation. In some of these cases, it is useful to think of regulation as an alternative to direct government expenditures or tax incentives. For example, to ensure cleaner air or water, the government itself could pay for or subsidize technologies to prevent emissions in the first place and then pay to clean up any residual mess that firms and individuals may leave behind. In large part because governments are unwilling to increase taxes to follow such policies, and in part because of pressure from environmental NGOs, governments tend to embrace regulation instead. For example, the EPA has introduced and enforced a series of standards for various kinds of pollutants.

Often government regulates intrusively. The EPA, for example, has compelled firms to install the best available pollution removal control technology rather than allowing firms to meet prevailing standards by changing their input mixes to prevent pollution from arising in the first place. One particularly costly example is the EPA’s requirement that utilities install scrubbers in their plants even if they use cheaper low-sulfur coal to minimize sulfur pollution. Eastern U.S. coal producers lobbied for this requirement because their coal was high in sulfur and the scrubbers made it less worthwhile for utilities to purchase low-sulfur coal from the western United States.1

Unlike direct expenditures or tax incentives, which are recorded as part of the government’s budget, the spending by private firms and individuals to comply with government mandates has not, until very recently, been tallied up and still is not subject to a formal budgeting process. In 2000, the Office of Management and Budget (OMB)—which compiles the budget for direct federal expenditures—tried to add up both the compliance costs and the benefits of almost all federal regulatory activity (with exceptions for regulations issued by “independent” agencies or those not belonging to the executive branch). OMB now does this every year and has improved its methodology over time.

In its regulatory report for 2003, for example, the OMB estimated that the annual compliance costs of all new federal executive branch regulations issued during the decade 1992–2002 ranged from $38 billion to $44 billion (though the cost of preexisting regulations was estimated to exceed $200 billion). By comparison, the OMB estimated the annual benefits of these rules to total between $135 and $218 billion. It would be a mistake, however, to conclude from these aggregate figures that the benefits of all individual regulations exceed their costs. In fact, independent analysts have documented the reverse for many regulations.

To minimize the chances that agencies will issue regulations whose costs exceed their benefits, all administrations since Gerald Ford’s have conducted a White House review of executive branch regulatory proposals before they become final. The institutional homes for these reviews have varied, but since Ronald Reagan’s first term a suboffice of the OMB has overseen the review process. The reviewers try to ensure that regulations pass some kind of benefit-cost test before they become final, subject to the constraint that for some regulations, Congress does not allow or somehow restricts decision makers from balancing benefits against costs. This type of decision making, known as benefit-cost analysis, has been required under successive Executive Orders issued by presidents from both political parties over the course of three decades.

There continues to be spirited debate—largely between economists and noneconomists—about the appropriateness of benefit-cost analysis. On the one hand, economists broadly agree that this type of analysis is necessary not only for regulatory decisions, but also for decisions about other governmental functions (direct expenditures and tax incentives) and for private-sector decisions. But, on the other hand, some benefits of government programs (regulatory and nonregulatory) cannot be quantified or expressed in monetary terms. What is the value, for example, of preserving a certain species of fish or knowing that certain lakes and rivers will not be despoiled? In such cases, advocates of benefit-cost analysis urge analysts at least to tote up compliance costs and compare them with the benefits qualitatively described, and then to decide whether the particular form of regulation is the most efficient way of achieving those benefits. This kind of analysis is called cost-effectiveness analysis.

Critics of benefit-cost analysis offer both moral and technical objections. On moral grounds, some critics argue that many objectives of regulation—such as clean air or water—are priceless, and regulators should endeavor to eliminate all pollutants regardless of the cost. Defenders of benefit-cost analysis reply that the cost of completely clean air and water would be so large that the money spent could have been used to save many lives.

Other critics raise a variety of technical objections. Perhaps the most common are those that question whether regulators can obtain unbiased estimates of benefits and costs of regulatory proposals before they actually are implemented (and even after the fact it may be difficult to sort out what is due to regulation and what is due to market pressure). In reality, however, there may not be large differences, or any difference at all, in at least the cost estimates (though estimates of benefits typically span a broader range). For example, the National Highway Traffic Safety Administration reported no range of costs for regulations governing the stability and control of medium and heavy vehicles in the mid-1990s. Similarly, the EPA reported no range in costs for regulations issued in 2001–2002 governing emissions from recreational vehicles. The OMB also provides information each year about rules for which there is no range in the cost estimates.

Although the various debates over cost-benefit analysis and how it is carried out will surely continue, some sort of centralized review of federal regulation has become sufficiently institutionalized that it is highly likely to become a permanent part of the governmental regulatory process. And as long as this occurs, it is also highly likely that decision makers, whether in the agencies or in the executive office of the president, will compare the pros and cons of regulatory proposals before they are issued. In this sense, government officials are likely to act as ordinary citizens do in their everyday lives.

About the Author

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Questions for “Regulation” by Robert Litan

1. What does regulation consist of?

2. What is the difference between “economic regulation” and “social regulation?”

3. *Critical Thinking*: Government often requires business to disclose important information about their product and its contents. However, people often ignore those disclosures when they purchase a product (think about all the extra papers that come in a package when you buy something). What could government do to make those disclosures more useful to consumers?

4. When do economists believe price controls should be considered?

5. *Critical Thinking*: Should there be a licensing requirement for teachers? Explain your view.

6. What have all administrations since Gerald Ford’s conducted?

7. *Critical Thinking*: How much should we value protecting vulnerable species even when there is no direct monetary value for the species? Explain.

8. What is it highly likely that decision makers, whether in the agencies or in the executive office of the president, will compare before regulatory proposals are issued?

9. *Critical Thinking*: Why do you think different economists and political leaders view regulations of businesses differently in various circumstances (for example, some favor a higher minimum wage while other oppose it)?