Bureaucrats and the Cost-Benefit Chameleon

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ONE OF THE Reagan administration's chief goals has been to curb regulatory growth—in particular, to produce optimum regulation by putting an end to policies whose social costs outweigh their social benefits. In pursuit of this goal, the administration promulgated Executive Order 12291, which requires the executive agencies (so far as their enabling legislation permits) to apply cost-benefit analysis to all their "significant" proposed regulations. The order is also the model for bills currently before Congress (S. 1080 and H.R. 746) to give the cost-benefit requirement statutory force and impose it on all significant federal rulemaking.

Since President Reagan took office, regulatory growth has slowed down, and in some areas regulation has actually decreased. Supporters of the executive order attribute this slowdown, at least partially, to cost-benefit analysis, arguing that it provides both an internal standard for guiding agency behavior and an external standard for measuring and controlling that behavior. But is the order really the cure-all its supporters claim it is? Should Congress expand the effort to all federal agencies? And can cost-benefit analysis actually guide or control the patterns of bureaucratic behavior? It is this last question that provides my focus here.

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Cost-Benefit Analysis as Internal Standard

Whether cost-benefit analysis will provide an effective internal standard for bureaucratic behavior depends on what goals bureaucrats—the regulators—are pursuing and how cost-benefit analysis affects that pursuit. There are four different, though not mutually exclusive, theories of bureaucratic behavior.

The "Public Interest" Model. The first of these theories, which was popular among policy analysts until the late 1950s, holds that regulation grows out of a need for government to secure the public interest: regulators conscientiously apply their expertise to further statutorily defined notions of the public interest. In its modern form, this theory holds that statutes and their implementing regulations come into being as corrections of so-called market failures.

The notion that regulators could apply their expertise to public problems had its heyday in the New Deal era. President Roosevelt and his "New Dealers" believed that public administrators could produce scientific coordination of resources and policies where private markets would otherwise produce inequities and inefficiencies. Perhaps unsurprisingly, the agencies

born in the New Deal era turned more or less eagerly to cost-benefit analysis in the next generation—helped in that direction by the programming techniques military analysts developed during World War II. Cost-benefit analysis fitted in with the emphasis on expertise characteristic of the traditional form of the public interest model.

So, under this theory, bureaucrats will conscientiously use cost-benefit analysis as their internal standard for decision if it shows (all other things being equal) that a particular regulation will benefit one group without damaging others or that it can correct a severe market failure without damaging very many others very much. But if the public interest regulator's function is something other than correcting market failures—say, changing citizen preferences or redistributing income—then some other analytical technique will be employed. In other words, to the believer in the public interest theory of regulation, cost-benefit analysis is a useful tool, albeit a limited one.

The "Capture" Model. Unfortunately, though we would all like regulators to pursue the public interest, an outpouring of theoretical literature in the 1960s began to show that regulation often does not correct market failures and that regulatory agencies frequently act as though they have some other goal in mind. The critics contended that agencies designed for serving the public interest are in fact serving—are captured by—the private interests they are supposed to regulate.

In this "capture" model, bureaucrats administer regulatory programs for the benefit of strategically placed and well-organized interests at the expense of the general public. This view is quite similar in theory, though not in history, to the "public choice" view of regulation, the difference being that the public choice view does not assume capture as a historical fact. It could equally well be the case that the regulatory agencies were initially designed to serve the interests of the regulated. In any event, the main point is that private interests expect profit from political activity, that the regulators themselves have private interests, and that an internal cost-benefit dynamic affects all participants in the regulatory process.

The capture theory indicates that when the benefits of a proposed regulation will be widely diffused, it will rarely be rational for those who benefit to invest in political activity, since the expected return for each beneficiary would be small. (Of course, a "free-rider" problem results since some will hope to benefit from political activity carried on by the others.) By contrast, when the benefits of a proposed regulation are concentrated on a few beneficiaries, they will have greater incentives toward political organization. Because their per capita stake is higher, they will be more likely to pay the organizational and lobbying costs necessary to gain their legislative and regulatory goals.

The capture theory thus predicts that the more diverse the group, the less likely it will be to commit resources to influence regulatory proceedings. Agencies will then either lack the information necessary to determine what is the greatest social good for the greatest number, or (more likely) they will ignore available information because to do otherwise would bring the wrath of an effective organization whose ox was being gored. Agencies will favor the small, well-organized group whose most obvious exemplar is the regulated industry. Agencies will not—so this theory goes—regulate in the public interest, and they will be correspondingly reluctant to engage in the kind of cost-benefit analysis designed to maximize net social welfare.

To be sure, cost-benefit analysis will affect bureaucratic decisions if it shows that a particular regulation will benefit a well-organized group of significant size—assuming the well-organized group has not already made its case and rendered the analysis redundant. But agencies will ignore the results of cost-benefit analysis, even if the analysis is favorable to the group in question, if the group thinks it is not favorable. And cost-benefit analysis will have no effect on agency policy if it shows that a particular regulation will harm a well-organized group, even if the benefits to an unorganized group would far exceed that harm. In short, the capture model (and its various more modern manifestations) paints a gloomy picture of the efficacy of cost-benefit analysis as an internal standard for regulatory agencies.

The "Self-Interest" Model. The capture theory built on the notion that certain constituents demand regulation and that agencies assist in supplying it. Like the public interest theory, the

capture theory assumes impersonal action on the part of the regulator: the goal may be to please a well-organized group or to benefit the public, but the goals of the individual regulator and of the benefited group are one and the same. So students of regulation developed yet a third theory of bureaucratic behavior: the self-interest theory. According to this theory, the most important reason for perversities in regulation is that bureaucrats want to maximize their own individual welfare.

The self-interest theory posits that bureaucrats will be interested in increasing the size of their agencies and in increasing the degree to which they (individually) can influence public policy. They will seek larger budgets, hire more highly skilled personnel, and bargain for greater organizational prestige and influence. Because the agency will exchange a certain service for a certain budget allotment, it will have market power in the public sector—market power that accrues, in some respects, to the individual who has gained the larger budget. Each part of the agency, and thus the agency as a whole, will be a budget maximizer; as a result, it will produce more service and obtain a larger budget than is economically efficient. Cost-benefit analysis, therefore, will scarcely be attractive as an internal guidepost.

The self-interest theory suggests that an agency will use cost-benefit analysis only when it advances the goal of agency power. The agency will concur in cost-benefit findings when those findings indicate, for example, that federal policy should preempt a state policy since this would increase agency power at the federal level. Or the agency will arbitrarily favor one method of cost-benefit analysis over a competing method if the first method calls for activist policy—as when the Federal Trade Commission decided that certain kinds of mergers had greater costs than hitherto believed. Or the agency will doctor its analyses to get a desired result, which reputedly happened in 1976 when the secretary of transportation decided, despite cost-benefit analyses to the contrary, to let the Concorde land in this country. In these types of cases cost-benefit analysis will not be the internal standard that guides agency behavior.

The "Cybernetic" Model. The public interest, capture, and self-interest models all assume that agency actions are either analogous to or are in fact individual actions. This assumption obscures the fact that the "maker" of regulatory policy is often not a single calculating decision maker but rather a conglomerate of groups and individuals. A fourth theory of bureaucratic behavior—a "cybernetic" theory—would view the regulatory agencies as information processors with limited processing capacity, limited information, and—as conglomerates—quite probably conflicting goals. In the other theories, agencies reach socially suboptimal decisions because they do not match regulatory tools to regulatory problems or because they are blatantly serving private or agency interests. By contrast, in the cybernetic model, agencies reach socially suboptimal decisions because they are relatively ill-functioning information processors and must choose "satisficing" rather than optimizing behavior.

This "satisficing" behavior—good enough to get by on, good enough to provide relative consistency and stability, but never really seeking optimal answers—is directly opposed to cost-benefit analysis. Ideally, cost-benefit analysis requires substantial amounts of information on all contingent events, and it assumes, of course, that the decision makers will use this information in choosing among regulatory options. Those who advocate the cost-benefit approach, if challenged, will argue that the analysis facilitates cybernetic decision making by reducing large amounts of complex information into relatively simple decision rules—something very favorable to the cybernetic decision maker. They will also argue that, because cost-benefit analysis provides a determinative norm for decision making, it will require agency decision makers to take all relevant interests into account (in a willingness-to-pay calculation), and not merely the interests of the powerful pressure groups. But this is not the case.

To begin with, agencies will not gather more information if it will upset the bureaucratic environment. Agencies obtain most of their information from outside sources—industry, consultants, and industry critics. But the agency does not control how these outside sources submit this information or how much each submits. Outside sources can create bureaucratic conflict by submitting either too much or too little information. Industry typically has the greatest information advantages,

and any new information demand further increases its ability to manipulate the regulatory process to its advantage. Since cost-benefit analysis is an expensive procedure with great information demands, the agencies would become further dependent on the regulated industry. To the extent that industry would use this dependency to destabilize the regulatory process, agencies will resist cost-benefit techniques and instead prefer to "satisfice" rather than "optimize."

Second, it is futile to argue that cost-benefit analysis reduces large amounts of information to simple rules if these rules are not the ones which cybernetic decision makers are already following. Cybernetic decision makers reduce their information needs by adopting certain complexes of decision rules as premises. These complexes thereby allow the agency to reduce regulatory conflict. Since cost-benefit analysis does not reveal the political costs of regulatory alternatives, cybernetic agencies will use it only on the happenstance that it does not conflict with the preferences of the powerful groups. Indeed, since increased complexity obscures political costs, agencies will be less likely, rather than more likely, to use the decision rules that cost-benefit analysis offers to solve regulatory problems. No matter what the internal standard of behavior "requires," cybernetic decision makers will consider only the preferences of those who can disrupt the bureaucratic environment.

Cost-Benefit Analysis as Internal Standard—What Chance? In summary, the role of cost-benefit analysis in bureaucratic decision making that these theories portray is not one that a proponent of Executive Order 12291 or of the bills before Congress would favor. Viewed from the bureaucratic perspective, cost-benefit analysis is like a chameleon: it changes colors according to the goals and interests of its bureaucratic designers. In the public interest model, the chameleon takes on the color of efficiency and the pursuit of public values. But students of regulation, almost without dissent, discard the public interest model as inadequately describing the realities of bureaucratic behavior. In the capture, self-interest, and cybernetic models, the chameleon takes on the parasitic interests of the regulators and powerful interest groups. Together these models indicate that Executive Order 12291 and any statutory cost-benefit requirement will be met with much bureaucratic resistance. The chameleon may change colors to match the temperature of the agency, but the agency will resist changing colors to match the design of an objective cost-benefit analysis.

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Cost-Benefit Analysis as External Standard

To its credit, the Reagan administration seems to have anticipated this bureaucratic resistance. Not only does Executive Order 12291 attempt to standardize the criteria by which agencies defend their proposed regulations, but it requires the agencies to submit to the Office of Management and Budget (OMB) any new significant regulatory proposals, *together with supporting cost-benefit analyses*, at least sixty days prior to publication in the *Federal Register*. OMB is directed to review these proposals, conduct its own cost-benefit analyses, and require whatever revisions it thinks necessary (subject to appeal to the Presidential Task Force on Regulatory Relief).

These preclearance enforcement powers give OMB unprecedented access to and control over the development of regulations by the executive agencies. The bills currently before Congress would extend this preclearance power to the regulatory efforts of all federal agencies. But the degree to which this external review process will make cost-benefit analysis an effective monitoring standard for judging agency behavior—applied externally—is subject to debate.

For one thing, we must not forget that OMB is itself a bureaucracy—as is any monitoring agency—with its own goals and directions. These goals may not be well matched either with the broader public interest or with narrower welfare maximization (assuming these latter two terms are themselves not always well

matched). The executive order creates yet another layer of bureaucracy to which the problems of capture, self-interest, and cybernetic influence surely apply, and for which the insufficiency of the public interest theory must be nearly as great (as it is for any other agency). Indeed, OMB's own budget expansion in the Reagan administration's first year has been as noticeable as the budget cuts and regulatory reforms it has proposed for other agencies. In short, OMB may return proposed regulations to the promulgating agencies not because the social costs outweigh the social benefits, but because the proposals conflict with OMB's own organizational goals.

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Second, because cost-benefit analysis requires discretionary judgments in the selection of the proper universe for analysis, in defining and measuring the relevant variables, and in assessing the relevance of various social and economic effects, no single regulatory outcome will clearly be correct, and OMB will have little ground on which to stand to call the agencies to order. What is striking about cost-benefit analysis is its sensitivity to certain assumptions —specifically, the definition of costs and benefits, the appropriate discount rate, the methods of valuing life and human amenities, and the specification of forecasting models. Even if the agencies make these assumptions explicit, OMB does not have the technical expertise to review them. It cannot match wits with the Environmental Protection Agency on acid rain or with the Occupational Safety and Health Administration on benzene, much less with all of the regulatory agencies on myriad regulatory problems.

Third, even if OMB had the technical knowhow to review these problems, neither it nor the public could afford the cost of formal cost-benefit analyses for every proposed action. The entire administrative process would come to an abrupt halt if agencies and OMB had to do so. In line with this fact, Executive Order 12291 requires analyses only of "significant" regulations, by which it means those with an "annual effect on the economy of $100 million or more." Such a high threshold, while wise, means that a large amount of regulatory activity can pass unchallenged. Agencies may now try to pass off major regulatory changes as minor adjustments. It is just possible that agencies will disaggregate effects, use unrealistically high discount rates, or otherwise slip statistically through the $100 million teeth of the order. Economists who develop cost-benefit analyses of complex policy-science questions know just how easy it is to make slight alterations in a series of assumptions and thus to make the analyses prove just about anything. And the gap in review becomes even more substantial when one considers OMB's institutional inability to review more than a few regulations in any depth as well as its inherent inability, as a mere reviewer, to affect the rate at which agencies generate regulatory changes.

OMB's report for the order's first year suggests that these are not merely paper objections. The office reviewed 2,803 "significant-effect" rulemakings, of which 2,708 were eventually found consistent with Executive Order 12291 and 95 were either withdrawn by the agencies or returned to them by OMB for reconsideration. These figures do not, of course, say anything about the efficiency of the regulations. But they do indicate that the effect of the order has been marginal. Granted that OMB may have flagged or discouraged the most inefficient proposals—or the ones most inconsistent with its own goals—but these are precisely the proposals that any form of review should have flagged or discouraged. The point is not that OMB should have its review powers withdrawn. The point is that the small number of regulations flagged suggests that cost-benefit analysis does not add much to the control of

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It should also be noted that extreme cases of regulatory inefficiency tend to be the cases that arouse the most public or private opposition. It is possible that OMB cost-benefit analysis is little more than a duplication of the efforts of others. Private interests that challenge the agencies in the rulemaking process, in the courts, and in Congress may be using cruder weapons on a slightly different battlefield, but the war is much the same. Moreover, providing cost-benefit grounds for attacking agency decisions may deflect the attacks—or at least divert the resources needed for such attacks—on more important grounds, as (for example) whether the agency should exist at all, or whether its current statutory mandate is of the proper dimensions.

Misconceptions and Regulatory Reform

Supporters of Executive Order 12291 share a misconception that is analogous to a popular misconception about chameleons. Most people think (incorrectly) that the chameleon changes its color to match its background. The reality is that the color change is determined by such environmental factors as light and temperature, as well as by emotions such as fright and those associated with victory or defeat in battle with another chameleon. So, too, supporters of the executive order incorrectly believe that agencies will change (or can be made to change) their behavior to conform with a certain analytic approach to decision making. Like the chameleon, the reality of agency behavior has much more to do with environmental factors—pressure groups, subcommittee oversight, and internal organizational influences—than with the forms in which decisions must be justified. It is too early to gather the necessary empirical data for definitively judging the real and lasting effects of the order. But my own guess is that the current slowdown in federal regulatory efforts is due more to changes in these environmental factors—through strategic administrative appointments and through a general noninterventionist attitude on the part of the Reagan administration—than to changes resulting from cost-benefit analysis.

Nevertheless, there are two ways in which the executive order may lead us toward successful regulatory reform. If neither of these is exactly what was originally in mind, both still hold promise.

First, by giving form to a certain skepticism about bureaucratic incentives, the order raises for a wider public the important issues relating to agency failure, and particularly the extent to which centralized planning tools (like cost-benefit analysis) can properly be used to improve the performance of the market economy, or can properly be used to improve the performance of regulatory agencies trying to improve the performance of the economy. Regulatory reformers would do well to question the assumption that analysts can, through centralized planning, determine how to improve regulatory and economic performance. Though a decision *not* to interfere in the market is as centralized as a decision *to* interfere, a greater emphasis on the decentralized approach—using marketable permits, effluent taxes, and so on—would obviate subsequent centralized judgments and lessen the problem of agency bias.

Second, by responding to the problem of agency bias through OMB review, the order recognizes that oversight and delegation are key issues in regulatory reform. If my assessment of OMB cost-benefit analysis is correct, transforming an intra-bureaucratic problem into an inter-bureaucratic one does not provide a complete solution, at least so long as the authority resides in a single branch of government. Intra-branch solutions will never provide complete political checks and balances. Proponents of the bills before Congress would do well to place less emphasis on the internal decision processes of the agencies and more on ways for overseeing and guiding the decisions those agencies are asked to make. Indeed, reformers should begin by rethinking the tasks that agencies are asked to perform and by determining what would be proper legislative reforms.

If the Reagan administration is to make true and lasting regulatory reform, it must start with learning more about organizational, institutional, and behavioral bases of regulatory decision making. Only by seeking this specific knowledge can reformers begin to address the chameleonic nature of agency behavior and uncover the true causes of bureaucratic color change. ■