Mercatus Reports

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FPG INTERNATIONAL - BENELUX

Arsenic in Drinking Water

STATUS: Public comment requested.

Last January, the outgoing Clinton administration finalized a rule that would lower the allowable concentration of arsenic in drinking water systems from 50 micrograms per liter (µg/L) to 10 µg/L. On July 19, the Environmental Protection Agency (EPA) issued a notice requesting comment on whether data and technical analyses support setting the allowable level at a different standard – perhaps 3 µg/L, 5 µg/L, or 20 µg/L.

EPA has delayed the effective date of the 10-µg/L rule to allow the agency to review and update analyses of health data, cost of compliance estimates, and benefits. The agency will also examine issues specific to small-system implementation, such as affordability, availability of financial assistance, treatment options, and extended compliance schedules.

Following its January release, the rule came under significant criticism from some lawmakers and utilities officials who charged that the money needed to purchase and operate arsenic-reducing equipment would provide more public benefit if it were put to other uses, such as school construction, emergency services, or traffic safety. The critics requested that EPA reevaluate the risks, benefits, and tradeoffs involved in adopting the rule.

The 10 µg/L limit is not set to go into effect until 2006. For more on the new arsenic rule, see "The Arsenic Controversy," pp 42-54.

Ergonomics

STATUS: Options under consideration for addressing ergonomics injuries .

Last November, the Occupational Safety and Health Administration (OSHA) finalized sweeping new ergonomics regulations that are intended to eliminate or control musculoskeletal disorder (MSD) hazards. Because of the extensiveness of the new regulations and their projected cost to employers, OSHA's rulemaking came under sharp criticism. Congress, acting under the Congressional Review Act, ultimately passed a resolution that voided the regulations.

Both employers and employees have an interest in improving the ergonomic design of the workplace and increasing workplace safety. Yet organized labor and management have become polarized over the new rules. As a result, OSHA faces a difficult challenge: It is prohibited from issuing a rule "substantially similar" to the one Congress overturned, yet it is under pressure to take some action.

OSHA has documented that (1) ergonomics injuries impose significant costs on employers, which should offer ample incentive to reduce their occurrence, (2) employers are, in fact, developing programs and other initiatives to reduce ergonomics injuries, and (3) ergonomics injuries have been steadily declining since 1994.

Moreover, OSHA studies suggest that the reason ergonomics injuries persist is not a lack of motivation on the part of employers and employees, but a lack of information and knowledge on causation, and on viable, cost-effective solutions. As OSHA and the National Academy of Sciences have underscored, a complex interaction of many different factors — related to individual physical and psychological characteristics, as well as work environment — contribute to ergonomics injuries.

In order to establish acceptable policies to combat MSD injuries, OSHA has held public hearings around the country, and asked commentators to address three questions:

- What is an ergonomics injury, and how can the definition of that injury be established in such a way that OSHA, employers, and their employees can understand and apply it?

- How can OSHA, employers, and employees determine whether an ergonomics injury was caused by work-related activities or non-work-related activities? Moreover,

what should be done about injuries that result from a combination of the two?

- What are the most useful and cost-effective types of government involvement to address workplace ergonomics injuries — rulemaking, guidelines, best practices, publications/conferences, technical assistance, consultations, partnerships, or a combination of such approaches?

The agency is now reviewing the information gathered from those meetings.

PHOTODISC

Air Conditioner Efficiency Standards

STATUS: Public comment requested.

In the last days of the Clinton administration, the Department of Energy (DOE) finalized new energy conservation standards for residential central air conditioners and central air conditioning heat pumps. The final rule, officially issued on January 22, requires all residential central air conditioners and heat pumps sold after January 23, 2006, to consume less energy (between 13 and 30 percent less, depending on the model) than was required by the previous set of standards, enacted in 1992. DOE now proposes to withdraw the new rule and instead amend the 1992 standards, raising the minimum energy efficiency levels by 20 percent.

Currently, there are air conditioners on the market that meet both the standards set by the rule finalized in January and the standards that DOE now proposes to adopt. But consumers generally shy away from purchasing the units because of their significantly higher purchase prices.

DOE estimates that consumers will actually save money over the life of the more efficient appliances because of the lower energy costs. However, that analysis does not adequately consider different usage patterns, the value consumers place on reliability, performance, or size, or the fact that once the initial investment is made, lower operating costs will encourage more usage of the unit, possibly leading to increased energy use.

New Source Review

STATUS: Regulatory and enforcement options under consideration.

EPA has taken an aggressive posture in the review and enforcement of air quality standards on new and recently modified emissions sources. Critics have charged that such aggressiveness is counterproductive because it discourages emitters from upgrading or otherwise altering their facilities – even if the alterations would improve efficiency or decrease emissions.

Under the direction of its new national energy plan, the Bush administration has directed EPA to review and analyze the effect that New Source Review (NSR) has on investment in the oil refining and power production industries. Critics of NSR are hopeful that the review will lead to policy changes that effectively decouple new source review and enforcement from facilities modifications.

It has been suggested that, instead of reviewing and enforcing new standards on recently modified plants, EPA should instead require that new, lower emissions rates be implemented after a fixed amount of time. That way, companies could plan their investment decisions around a known regulatory requirement and deadline, without fear of stumbling on a "tripwire." For its part, EPA would ensure that the largest existing sources of emissions would not continue indefinitely, but would be abated after an agreed-upon interim period.

Such a policy could be further augmented by the liquidation of excess emissions during an interim period – that is, if the emissions are deemed "offsets" that are available to be used, banked, or sold. That would provide additional flexibility, not only to the affected existing sources, but also to the entire NSR program and to the economic incentive program as it applies to offsets in non-attainment areas.

Greenhouse Gas Emissions

STATUS: Petition under review.

The International Center for Technology Assessment (CTA) recently petitioned EPA to regulate certain greenhouse gas emissions. That petition is now under review.

A number of criticisms have been leveled against the petition, including the following:

- Legal controversy exists over whether greenhouse gases are air pollutants, and thus subject to regulation, as defined by Section 202(1) of the Clean Air Act (CAA).

- The evidence regarding global warming and human contribution to it is mixed, and as forecasts of anthropogenic warming have become more refined, the predictions of warming have become less extreme.

- Petitioners base most of their arguments for the need for greenhouse emissions regulation on the potential negative effects of increased global temperatures. However, the effect of higher temperatures is the subject of considerable scientific debate. Some

researchers claim that global warming could have positive effects because it would lessen the extreme cold of winter — when most temperature-related deaths occur— and would prolong the growing season. (See "The Way of Warming," *Regulation,* Vol. 23 No. 3.)

- Congress has repeatedly examined the question of whether to regulate greenhouse gases as air pollutants, and has explicitly decided against regulation.

Basel Capital Accord

STATUS: Proposed rule under consideration.

The international Basel Committee on Banking Supervision recently proposed a new framework that bank supervisors must use to evaluate operational risk. While most all observers agree that supervisors should give more careful consideration to operational risk, critics are charging that the committee's proposed framework is seriously flawed.

According to the critics, the committee's reliance on capital charges to mitigate unexpected operational losses undermines the other two pillars of supervision: supervisory review and market discipline. The critics claim that a combination of well-designed systems and controls, and insurance that satisfies minimum requirements, is a reasonable substitute to regulatory capital for mitigating operational risk. What is more, the critics say, their preferred alternative would be far less expensive for supervisors to implement and would give market-based assessments of the level of risk at each institution.

Registration of Broker-Dealers

STATUS: Proposed rule under consideration.

The Commodities Futures Modernization Act of 2000 amended the Commodity Exchange Act to allow trading of futures contracts on individual equity securities and narrow-based indices of equity securities. According to the act, such trading is to be regulated by the Commodity Futures Exchange Commission (CFTC) and the Securities and Exchange Commission (SEC).

The act includes Section 203, "Regulatory Relief for Intermediaries Trading Security Futures Products." The section prescribes a mechanism by which registered intermediaries in either the futures or the securities markets can attain the status of dual registrant with both the securities regulators of the SEC and the futures regulators of the CFTC. The mechanism is intended to avoid duplicative registration and reporting processes required of the respective regulators.

Despite the intent of the act to expedite the registration process, the SEC has proposed a registration format that would result in time-consuming duplication of registration procedures for futures commission merchants and brokers already duly registered with the CFTC.

In addition, the proposed procedure denies futures intermediaries the ability to obtain notice registration if their intention is to trade security futures products on a registered national securities exchange. The SEC proposes that futures registrants who intend to trade security futures products should register as full broker-dealers with the SEC subject to all the costs and regulations thereof, or otherwise effect and clear their transactions through a full broker-dealer registered on the securities exchange.

By subjecting futures intermediaries to redundant and burdensome registration requirements, the SEC proposal threatens to increase the intermediaries' costs, as well as the costs for customers and the public. In sharp contrast, the CFTC approach to implementing the same requirements appears to follow the intent of the act to avoid duplicative requirements.

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Bert McLachlan

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Bringing JAVA to the CAFÉ

By Brian F. Mannix
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At the end of July, after a couple of premature leaks, the National Academy of Sciences (NAS) finally released a report advocating higher Corporate Average Fuel Economy (CAFÉ) standards for new automobiles sold in the United States. Changing the CAFÉ standards will require action by Congress, which for several years has kept them frozen at 27.5 mpg for cars and 20.7 mpg for light trucks. With automobile manufacturers apparently ambivalent about tighter standards, it seems likely that Congress and the Bush administration will soon raise the bar.

The report is as good as can be expected from the NAS, which is to say that it is very, very good. Chaired by Resources for the Future president Paul Portney, the panel has produced an exemplary, state-of-the-art policy analysis — far better than those typically produced by regulatory agencies themselves.

Many readers will bristle at the notion that a panel of experts can make better decisions about consumer purchases than consumers themselves, and rightly so. But perhaps reliance on customer choice and free markets is not something one can expect from an NAS panel. Putting aside, for a moment, the panel's willingness to override consumer preferences, there is much to commend in the report:

- It takes seriously the question of whether government action is warranted. The answer — that the need to slow global warming requires government intervention — is unsatisfying, but that is a criticism better aimed at a different NAS panel.

- It explores alternatives, including a cursory look at broader policies like a gasoline tax, as well as a close look at variations on the basic CAFÉ scheme.
- It acknowledges tradeoffs, including the "blood for oil" sacrifice implicit in the safety penalty that CAFÉ standards cause.

- It recognizes unintended side effects, such as Chrysler's installation of a removable back seat in its popular PT Cruiser that allows the vehicle to be classified as a "truck."

- It disposes of some red herring arguments such as "technical feasibility" as a useful guide to setting standards, and international trade effects that appear to be spurious.

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- It strives to give unbiased estimates of risk.

- It recommends market-like reforms to the current CAFÉ scheme.

- It defers to legislators to make the critical decision of how much to harm consumers in pursuit of gasoline savings.

Limiting choice Consumer harm is a central consideration in the analysis of CAFÉ standards. Cars have many attributes that consumers care about, including mileage, price, safety, reliability, performance, and so forth. By constraining the corporate average mpg, CAFÉ standards "put a thumb on the scale," tipping the balance more in favor of mileage and away from other desirable attributes. In order to comply with the CAFÉ standards, manufacturers must redesign their product line, and must price cars so that consumers will buy a mix that meets the required standard. The result is that consumers are worse off. That is the tradeoff the government makes for pursuing gasoline savings beyond the point that consumers want to pursue it.

The CAFÉ standards apply to the average fuel efficiency for all automobiles sold by a manufacturer, and not to each individual vehicle that the manufacturer makes. Thus, the standards permit a range of vehicles to be marketed, as long as the overall fuel efficiency goal is met. That flexibility is intended to let the market find the least-costly method of meeting the standard. To some extent, we can observe the compromises that automakers are forced to make because of the standards, like reduced vehicle size, weight, and safety. But many of the compromises are not easily observed; we simply know that consumers are not permitted to buy what they prefer and therefore must be worse off.

DARIO LOPEZ-MILLS/AP

CAFÉ standards "put a thumb on the scale," tipping the balance more in favor of mileage and away from other attributes. Government pursues gasoline savings beyond the point that consumers want to pursue it. That leaves consumers worse off.

In some places, the NAS report seems to forget that fundamental truth. For example, the report engages in an extensive "breakeven analysis" to determine what degree of technological improvement in mileage would pay for itself in fuel savings, while holding other attributes of vehicles constant. That exercise is irrelevant; there is no free lunch. Such analyses assume that differences between what looks achievable on paper and what actually is achieved in the real world can be attributed to consumer ignorance or some inefficiency in the market. But the differences are simply limitations of the analysis. Anyone who thinks he can produce cars that dominate what is now on the market should go out and make them for real and not try to force others to do so.

For the most part, however, the report recognizes that CAFÉ standards hurt consumers, that the costs should be minimized by making the standards as flexible as possible, and that the costs must be justified by some payoff — lessening future climate change — that is external to the market. The report even calculates the benefits of reduced gasoline consumption to equal about 30 cents per gallon.

Market-like reform Economists will welcome some of the proposed reforms to the CAFÉ regime. One such suggestion is to allow the trading of CAFÉ credits, denominated in "saved gallons," among manufacturers. Such trading would enable the market price of the credits — a measure of the marginal cost of CAFÉ standards — to be observed and compared to the supposed 30 cent-per-gallon benefit. That would provide an important feedback to policymakers. And, by offering to sell additional credits at that price, the government could ensure that the costs of the CAFÉ standards did not outgrow their benefits.

Trading credits among manufacturers — "Joint Automaker Vehicle Averaging," or JAVA (the author's pun; not the panel's) — has other benefits. As proposed by the NAS, the program would allow one manufacturer to specialize in limousines while another specializes in subcompacts. As long as their combined fleet meets the standard, there is no reason to insist that both manufacturers be part of the same corporation — as the current "corporate average" standards effectively do.

Further JAVA benefits Unfortunately, the committee did not go so far as to recommend erasing the boundary between cars and light trucks. That is surprising, because the distinction becomes unnecessary with JAVA in place. Moreover, the "tiered" standards that now exist distort consumer choices in the direction of trucks. To see that, consider the effect of the CAFÉ standards on vehicle pricing.

In the language of linear programming, the regulatory constraint has a "shadow price" — a dollar cost that measures how "binding" the constraint is. While the shadow price does not, by itself, represent a real resource cost for manufacturers, it does have a real effect on the market price of vehicles: Those that do not meet the standard will be made more expensive, and those that do meet it will be made less expensive. That internal "cross subsidy" is necessary to get consumers to buy a mix of vehicles that meets the regulatory constraint. In effect, attributes that tend to reduce fuel economy are taxed, and those that tend to improve it are subsidized.

New wrinkles Disappointingly, the NAS panel recommends some new wrinkles to the CAFÉ program that would add further distortions to the marketplace. For instance, the panel recommends considering a two-stage adjustment to the standards for the weight of a vehicle. The goal of the adjustment is safety — the panel wants to compress the range of vehicle weights on the road by discouraging extra-heavy vehicles while not encouraging extra-light vehicles.

Even if the scheme is successful, however, it would only trade visible costs for invisible costs that are likely to be greater. One can understand the reluctance to trade lives for gasoline, but trying to suppress the safety penalty that CAFÉ standards impose would further limit consumer choice and force car buyers to make other sacrifices they find more onerous.

When the government has its thumb on the scale in favor of fuel economy, it is tempting to add a finger or two in pursuit of some other worthy-sounding goal. But a finger here and a finger there, soon becomes a heel. R