The **Mercatus Center** at George Mason University is an education, research, and outreach organization that works with scholars, policy experts, and government officials to bridge academic theory and real-world practice. The center's Regulatory Studies Program works within the university setting to improve the state of knowledge and debate about regulations and their impact on society. More information about the center can be found on the Web at www.mercatus.org. For the latest federal regulatory developments, visit www.regradar.org.

EU Chemicals Policy

STATUS: Legislation under review; comment period closed July 10.

The European Commission recently drafted legislation for a new European chemicals policy governing the manufacture and import of chemicals in the European Union. The commission hopes to make the legislation law by 2005.

The proposed legislation, based on a 2001 European Commission white paper, calls for the establishment of a testing and registration process for 30,000 new and existing chemicals on the market. The, program, called REACH (Registration, Evaluation and Authorization of Chemicals), is intended to protect human health and the environment from the toxic effects of chemicals while strengthening the competitive position of the EU's chemical industry. It is unlikely to achieve its aims, however.

To start with, the costs are staggering. Testing 30,000 substances over 11 years will cost $2.4 billion by the EU's own estimates; others put the figure as high as $8 billion. The high fixed costs of obtaining government approvals will likely drive small and medium-sized manufacturers out of business. Because the returns to innovation will be reduced, chemical companies that weather the initial costs will cut back on research and development, denying the public of benefits from new chemicals technology.

Based on the Precautionary Principle, REACH switches the burden of proof. Instead of the government having to show a given substance poses a risk, the manufacturer must prove it is safe. In the absence of scientific proof, the substance may be banned.

This approach is a rejection of scientific risk assessment. Risk assessment estimates and characterizes risk, specifying the probability of certain outcomes. The Precautionary Principle does not assess risk, but assumes hazard where evidence is lacking. (See "The Paralyzing Principle," by Cass Sunstein, Winter 2002.) The result is a confusion of real and assumed risk, making it impossible for the risk manager to weigh the merits of alternative decisions and implement the policy that maximizes benefits to the public.

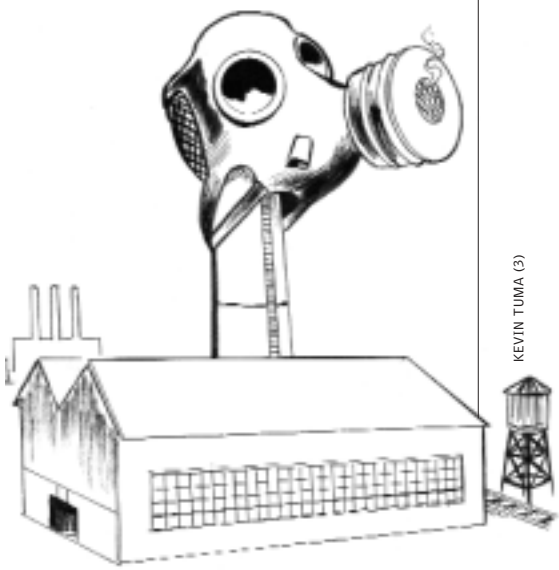
The EU does not need to base its chemicals policy on a bad idea; it is possible to establish a testing framework for chemicals without using the Precautionary Principle. Chemical testing and risk assessment can be made the responsibility of industry and not government authorities without rejecting the principles of scientific risk assessment. Regardless of who conducts the risk assessment, the objective should be to elicit an accurate and unbiased estimate of risk. Neither an "innocent until proven guilty" rule nor a "guilty until proven innocent" rule will advance that objective.

8-Hour Ozone Standard

STATUS: EPA examining options.

In this proposal, the Environmental Protection Agency requests comment on alternative approaches to implementing the 8-hour national ambient air quality standard (NAAQS) for ozone that it promulgated amid controversy in 1997. At that time, EPA's analysis recognized that the standard would impose costs on Americans far in excess of the value of any health benefits achieved. Other reviewers, including scholars at the Mercatus Center, showed that even without considering the costs of the standard, the negative health effects of reducing ozone would outweigh the positive health effects.

Despite those concerns, the agency overcame a series of legal challenges to the standard, and is now preparing to



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develop regulations to guide states in implementing it. Though net costs are inevitable under the standard, EPA can take steps to minimize those costs. Comments to EPA by Mercatus adjunct scholar Joel Schwartz argue that because already-adopted federal requirements will eliminate the vast majority of remaining ozone precursor emissions during the next 20 years or so, the details of how non-attainment areas are classified and treated under the 8-hour NAAQS rule will have at most a modest effect on future emission reductions. (See Schwartz's "Clearing the Air," Summer 2003.) However, the option EPA selects could have significant impacts on the costs of achieving emission reductions. Thus, the agency should seek to maximize the flexibility non-attainment areas have in developing and implementing state implementation plans to attain the standard. Optimal ozone control strategies will vary from place to place, and EPA should allow states the time and flexibility to find the appropriate strategy.

In many cases, states may find EPA's current focus on large, near-term nitrogen oxide (NOx) reductions is likely to worsen ozone air quality or slow progress in meeting standards. Recent ozone research suggests that under conditions found in many parts of the country, NOx reductions will actually increase ozone concentrations, at least for the next decade or so. Reduction in volatile organic compounds (VOC), on the other hand, appears to be somewhat effective in reducing ozone in many places, and very effective in some populous urban areas. The state of the science suggests that in the near-term, a focus on VOC and carbon reductions entails lower risks and higher returns than NOx reductions.

In addition, EPA should develop realistic emission inventories — current inventories greatly underestimate the fraction of all VOC emissions coming from automobiles, for example — and require states to do the same. Known errors in current inventories continue to misdirect emission reduction efforts. In particular, too little focus has been placed on the potential for rapid, substantial VOC reductions from the in-use automobile fleet. About half of tailpipe VOC emissions come from the worst five percent of vehicles. Remote sensing-targeted repair or voluntary scrappage of those vehicles could achieve substantial, rapid, and relatively inexpensive VOC reductions.

Dietary Ingredients and Supplements

STATUS: FDA comment period closed May 19.

The Food and Drug Administration is concerned that some consumers mistakenly believe it currently regulates manufacturing practices for dietary ingredients and supplements. It is also concerned that other consumers who understand the FDA does not regulate this area wish it would. As a result, it is proposing to implement "current good manufacturing practice" regulations to require firms involved in the manufacturing, packaging, or holding of any dietary ingredient or supplement to ensure that such products are not adulterated or misbranded.

The FDA attempts to justify the proposed rules with surveys that show a large portion of dietary supplement users do not believe the products are safe. However, there appears to be a disconnect between what consumers say and do; if dietary supplement users really do believe the products are unsafe, one wonders why they use the supplements. Instead of examining the puzzle, the FDA proposal simply spins the results to provide pretext for the increase in regulation.

The FDA suggests that federal regulations are necessary to provide a common standard for manufacturing practices, reduce adverse outcomes resulting from adulterated supplements, lower search costs because of imperfect information about the quality of manufacturing practices, and lower variance in product quality.

According to FDA estimates, the expected benefits are twice as large as the costs associated with the proposal. However, the administration's benefit-cost analysis does not adequately examine alternatives to federal regulation such as private initiatives or state and local regulation.

While acknowledging the existence of third-party evaluation and certification of dietary ingredients and supplements, the FDA's proposal does not appreciate that this could address its concerns. Without any analysis of the potential benefits of private certification, the FDA's benefit-cost analysis supporting federal regulation is, at best, incomplete. If consumers actually do harbor significant fear about the safety of dietary products, there are probably sufficient private incentives for firms to submit their products for independent analysis and certification. A rigorous analysis would compare the FDA scheme with a private third-party system, favoring whichever regime maximized consumer welfare.

The FDA also expresses concerns that state and local regulators will bias their procedures in favor of local producers to the detriment of consumers and out-of-state manufacturers. However, such practices surely would not pass court scrutiny under the Commerce Clause of the U.S. Constitution. While the FDA is correct in asserting that it has the authority to regulate those markets, its claim that lower-level oversight would lead to protectionist activities on the part of state authorities is simply disingenuous in the face of settled case law. R

A New Watchdog for Freddie and Fannie?

By Jay Cochran III

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THE CASUAL OBSERVER MIGHT BE EXCUSED for wondering about the recent fuss surrounding Freddie Mac, the 600 lb. gorilla of the secondary mortgage market. After all, if industry observers are right, Freddie might have to restate its recent earnings, *increasing* them by possibly more than $4 billion.

The "possibly" modifier is included because, as of early August, we simply do not know the extent of Freddie's earnings restatement. And that is key to understanding one of the main problems with the government-sponsored enterprises in housing finance: Their financial disclosures can be difficult to analyze accurately. As far as one can tell, Freddie Mac seems to have been using gains from its derivatives and trading operations to smooth prior years' earnings fluctuations and thus produce smoother results than actually occurred in its core business.

Even indecipherable financial statements might not warrant so much attention were it not for the mammoth size of the mortgage GSEs. Since 1995, the balance sheet assets of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have grown from $726 billion to just under $2.4 trillion by the end of 2002, which represents an average annual growth rate of more than 18 percent. By comparison, real GDP over the same period grew by roughly three percent per year, while the overall U.S. residential mortgage market grew by slightly more than nine percent per year.

Risk diversification Rapid growth is not necessarily troublesome so long as general principles of financial safety and soundness are followed. One of the most important principles of sound finance is diversification — not concentrating all of one's eggs in one basket. For the last several years, though, Fannie Mae and Freddie Mac have been placing more of their own eggs in their own baskets. Fannie and Freddie have gone from holding a combined $125 billion of their own mortgage-backed securities (MBS) in portfolio in 1995 to holding nearly $850 billion of their own MBS internally as of year-end 2002 — a growth rate exceeding 30 percent a year. (An MBS represents a claim to the interest income and principal repayments generated by a pool of mortgages. For their part, the GSEs guarantee timely payment of principal and interest — i.e., they insure against default risk — while MBS investors carry any interest rate risk.)

It is important to remember that one of the reasons Congress created the GSEs was to help banks and thrifts off-load and spread the risks of mortgage finance by creating an active secondary market in mortgages through the GSEs. The GSEs, in other words, were originally intended to act as intermediaries between mortgage originators and investors. Yet if the GSEs increasingly hold their own mortgage-related products in portfolio rather than selling them to investors, it means that mortgage-lending risks are concentrating in one place rather than dispersing throughout the economy.

To their credit, the GSEs cite adequate risk protection through hedging activities and other means. However, such claims raise the issue of counterparty risk: Are the institutions on which the GSEs rely for risk-sharing financially sound? And just as importantly, are they likely to remain so during less-than-ideal economic conditions? Beyond the basic question of financial soundness, if banks are important counterparties to the hedging and risk control operations of the GSEs, then in an important (if less obvious) way, the risks attendant with mortgage finance may be quietly re-entering the banking system through an off-balance-sheet side door.

Shifting responsibility In response to the general increase in risks posed by the GSEs' operations, and to the recent

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accounting problems at Freddie Mac in particular, members of Congress have suggested that regulation of the housing GSEs should be moved from the Department of Housing and Urban Development to the Treasury Department. The rationale for the proposed move is Treasury's longer track record of financial safety and soundness regulation. Clearly, Treasury's vantage point in terms of assessing and controlling systemic risk is superior to HUD's. On the other hand, moving GSE regulation to Treasury may perversely serve to reinforce the perception that an implied government guarantee sits behind the GSEs.

In any event, changing regulators still does not address the core problem of institutional design. Freddie Mac and Fannie Mae are quasi-private/quasi-public firms, and under their current charters, incentives exist for them to concentrate risks in order to increase returns available to their shareholders. So long as risks and returns follow expected patterns, all is well. Should the day ever come, however, when expected probability distributions do not match reality or when GSE hedging operations do not work as anticipated, then the costs of any resulting bailout are likely to be passed along to the long-suffering American taxpayer. Changing the GSEs' regulator may postpone that day, but it is unlikely to do so indefinitely because the core problem is one of incentive and institutional design, not of the regulator's executive branch location. R