REGULATORY REFORM

Changing Speed Bumps into Guardrails

The nation needs a new, bipartisan commitment to regulatory reform.

BY MICHAEL ARCHBOLD, HOLLIS HART, AND JOSEPH MINARIK

To some Americans, regulation is a dead weight hanging on the economy. To others, it is the last bulwark against exploitation of the citizenry at large.

Although many Americans on the surface appear to have limited direct contact with regulation, the real but less-than-obvious effects of regulation on the daily lives of citizens are extensive. Food, clothing, and shelter are subject to food safety inspections and nutrition labeling, permanent-care labeling, and environmental standards for dry cleaning, as well as mortgage disclosure regulations and zoning and structural code restrictions, among many others. Health care is regulated through occupational licensing and state insurance regulation, plus standards set by the 2010 Affordable Care Act. Transportation is affected by fuel economy and highway safety standards. Workplace conditions are determined by wages and hours regulations and occupational safety standards. Recreational and school facilities face safety codes. The bed to which Americans return at the end of the day must meet flammability standards. In short, regulation touches the lives of typical citizens every hour of every day. (See "A Regulated Day in the Life," Summer 2004.)

THE GOOD, THE BAD, AND THE UGLY

There is a positive side to this. Regulation addresses problems about which our society cares. Episodes of food- and water-borne disease and airway and highway accidents arouse public concern. Worker safety regulations are controversial for business and labor alike, but workplace injury and illness have been financially costly and have taken a serious human toll.

There are also negatives. Even if a regulation has a large net positive effect, it comes with costs and those costs often fall disproportionately. Those who enjoy the benefits of some regulations may not even recognize them and certainly do not feel the costs; those who bear the costs may not directly enjoy the benefits. An affected business cannot balance its regulatory costs with the societal benefits on its own balance sheet. That leaves Americans at loggerheads over the value of regulation.

The fundamental tool of regulatory evaluation is benefit–cost analysis. Regulation is worthwhile for society as a whole if the benefits exceed the costs, but even regulations that pass a benefit–cost test can leave regulated businesses and individuals worse

MICHAEL ARCHBOLD is a former CEO of GNC Holdings and currently a trustee of the Committee for Economic Development (CED) of The Conference Board. HOLLIS HART is a former president of international franchise management at Citi and currently a CED trustee. JOSEPH MINARIK was chief economist at the Office of Management and Budget under President Bill Clinton and currently senior vice president and director of research at the CED. They are co-authors of *Smart Regulation: Changing Speed Bumps into Guardrails* (CED, 2019).

off. And measuring benefits and costs is exceedingly complicated.

Regulation affects businesses, large and small, directly in levels of wages and numbers of jobs they can create. The collective voice of "business" seems to only be raised when it is objecting to regulations. Feeling the brunt of regulation makes businesses more cautious about investing or risk-taking more generally. Regulations come from different agencies and even from different levels of government: federal, state, and local. The business resources that are devoted to compliance with regulations are diverted from other endeavors that could make the businesses more competitive and more successful—and sometimes even safer.

Smaller businesses, without the economies of scale to employ specialists to deal with regulation, have their own unique problems. For example, rigorous benefit–cost analysis is reserved for "economically significant" rules—those with large aggregate economic effects. But regulations with smaller total effects that focus on small businesses can affect them crucially, yet those rules may not be subject to benefit–cost analysis.

Regulation now touches all aspects of our daily lives, and the total cost of regulation—administration, compliance, and so on—imposes an economic burden on the nation. Economists provide widely differing estimates of the annual burden of regulation, ranging between several hundred billion dollars and $2 trillion. The high-end estimate equals 10% of U.S. gross domestic product and exceeds the total amount of income tax collected by the federal government.

Whatever the size, this hidden tax burden ultimately falls on consumers because businesses ultimately must pass on much of the taxes they pay to consumers (including in consumers' capacity as owners of businesses) if they are to survive. This likely results in price increases to the consumer, making corporations the unwitting accomplice to this hidden taxation. Further, these incremental costs are largely embedded in consumer pricing. As incremental consumer price increases are disproportionately borne by low-income consumers, regulation is a highly regressive form of taxation.

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BIPARTISAN HISTORY

Each of the seven most recent presidents attempted to address excessive and inefficient regulation, usually to little avail. Interestingly, the stated objectives of these presidents are closely aligned, despite the presidents being of different political parties and apparent ideological orientations.

In an effort to regulate the regulators, the Paperwork Reduction Act of 1980 was signed by President Jimmy Carter. Among its provisions was the establishment of the Office of Information and Regulatory Affairs as part of the Office of Management and Budget to monitor regulation.

In 1981, President Ronald Reagan issued Executive Order 12291, which gave OIRA a formal role in monitoring regulation. It also mandated that regulations

- be based on adequate information concerning the need for and consequences of regulation,
- have potential benefits to society that outweigh the potential costs,
- maximize the net benefits to society,
- select the regulatory alternative involving the least net cost to society, and
- be based on regulatory priorities with the aim of maximizing the aggregate net benefits to society.

Unfortunately, the capacity for OIRA to accomplish all this was missing. OIRA is composed of approximately 50 individuals. That small platoon now seeks to rein in more than 300,000 regulators, at seemingly insurmountable odds at 6,000 to 1.

To reduce the workload and improve the odds, President Bill Clinton issued EO 12866, which limited OIRA review to "significant" regulations (those with an estimated economic effect greater than $100 million or that have important policy implications). This resulted in a reduction in the number of regulations reviewed from greater than 700 in 2003 to 415 in 2015, but still resulted in an undesirably long average of 88 days for a review.

On January 30, 2017, President Donald Trump signed EO 13771, "Reducing Regulation and Controlling Regulatory Costs." It specified that whenever an executive department or agency proposes a new regulation, it must identify at least two existing regulations to be repealed. The order also specifies that the incremental total cost of all new and repealed regulations (without considering any benefit resulting from the regulations) must be less than zero. In future years, each agency will have a budgeted amount (which may be positive or negative) for the net cost (again, without regard to any benefit) of new and repealed regulations.

A second Trump order, EO 13777, dated February 24, 2017, builds on the first. "Enforcing the Regulatory Reform Agenda" holds that each agency is to name a regulatory reform officer and a regulatory reform task force. Each task force is to identify agency regulations that

- eliminate jobs or inhibit job creation;
- are outdated, unnecessary, or ineffective;
- impose costs that exceed benefits;
- create a serious inconsistency or otherwise interfere with the president's regulatory agenda;
- rely on data that are not publicly available (or similar criteria); or
- were called for by past EOs that have since been rescinded.

Notably, having costs that exceed benefits is a sufficient condition for a regulation to be nullified, but it is not a necessary condition. Meanwhile, the order would potentially target for repeal other regulations whose benefits do exceed their costs.

We are encouraged that U.S. regulatory policy is receiving an energetic review. There is enormous potential to improve regulatory outcomes in terms of both achievement of the intended outcomes of existing regulations—more competition, greater safety, and so on—and at lower costs, with consequent lower prices and stronger economic growth. The nation can achieve these objectives not just by rescinding regulations (though in some instances that would be constructive) or adding more regulations (though in some instances those are needed), but also by smarter regulation.

History shows that broad regulatory reform has resulted from bipartisan effort. In the 1970s, Congress struck down rules that prevented railroads from combining shipments by multiple customers on the same freight trains. This reform allowed the then-struggling railroads to attain efficiency savings that they could pass onto their customers and thus price-compete with freight trucking. Trucks, in an analogous situation, were regulatorily prohibited from finding loads they could carry on the return trips after one-way hauls, driving up their operating costs. Again, in an increasingly competitive freight-hauling market, these regulations prevented savings for freight customers. Meanwhile, passenger air carriers were restricted from pursuing new routes and adding new flights in markets that might be underserved by incumbents, and their ticket prices were held above technologically obsolete minimum levels.

Each phase of this regulatory reform was accomplished with strong bipartisan support. In fact, the 1995 legislation that abolished the Interstate Commerce Commission was approved by voice votes in both the House and Senate, indicating agreement so broad that there was no interest in formally tallying support and opposition.

Meanwhile, the courts attacked AT&T's monopoly over telecommunications, breaking it up into regional companies. This ushered in an enormous wave of communications innovation that continues to this day. This was again accomplished with strong bipartisan cooperation implementing legislation for reform.

President Carter oversaw the beginnings of transportation deregulation. He also oversaw the dismantling of business regulation of the petroleum industry. An often-forgotten achievement of the Carter years was the deregulation of the beer industry. In 1978, the United States had only 44 domestic breweries. At the end of 2017, there were 6,372, of which 6,266 are characterized as smaller "craft" breweries. Because the larger breweries of bygone decades were constrained to produce their product for a mass audience, perhaps uncharitably thought to be the "least common denominator," today's smaller breweries can produce an arguably higher-quality product that can satisfy more eclectic tastes.

President Reagan saw this round of regulatory streamlining through to its completion, including accelerating the deregulation of oil and gas. And one of the most important legislative-branch leaders in the effort was Sen. Ted Kennedy (MA). Thus, these efforts were truly bipartisan, with a result that the public was better and more efficiently served, with faster shipping at lower costs.

SMART REGULATION: THE BIPARTISAN OPPORTUNITY

We believe that smart regulation, while a value in itself, will be a broader step forward for the body politic. Both Democrats and Republicans can—should—agree to a process that achieves the original objectives of the regulations, while using rules that are less of a drag on employment and the economy. And Republican and Democratic cooperation to achieve something—anything—for the good of the country will be a veritable revolution in the way our federal government works today. We are optimistic that this can happen because it has been done before. This process can begin if Americans talk to one another, accept each other's good intentions, and find ways to achieve our shared objectives. Regulation is a good place to start.

Our nation can improve its collective well-being by improving regulation—not necessarily with more regulation or less regulation, but with better regulation. There is much at stake. For the prosperity of the nation and its people, and for America's position of leadership in the world, regulation must allow our economy to stay on the cutting edge of global competition. This is not a stationary target; the world is changing constantly in many dimensions, technology and demographics among them. As technology advances and the rest of the world becomes more productive and competitive, U.S. regulation must remain in step.

How can we accomplish that? Below we offer some general observations for regulatory reform.

At the basic level and above all, markets work. Market-driven competition improves efficiency and benefits consumers. Regulation should intervene only when markets fail (or ideally before they do). And sometimes markets do fail—but market failure should be a firm test, honored diligently. Its categories encompass true monopoly, depletion of common resources (like fish populations) or proliferation of public "bads" (like pollution), and threats to public safety by a "race to the bottom" on product quality or a lack of consumer information. All of these may require regulation if the costs of the regulation do not eclipse the benefits.

But if an industry is generating jobs and incomes without causing such problems, then regulation is not necessary. It should not be used either to protect or penalize success. It should not be used to break up a large and successful firm simply because the firm is deemed "too big," nor to protect struggling firms simply because they have trouble competing.

An example where regulation is back-firing is regulation intended to constrain "payday" lending. Despite the regulations, individuals are still seeking to borrow; but now they are turning to lenders that are more expensive than mainstream firms and whose collection methods are far more ruthless. A well-intentioned regulation has created more harm than good. (See "Are Payday Lending Markets Competitive?" Fall 2012.)

Market competition can be the best regulation. Competition cannot solve every problem; it will not replenish an overfished waterway, for example. But there is no better remedy for abuse of market power than an entrepreneur with a competing technology. For instance, regulators should see if the development of renewable energy—especially if it can be distributed rather than centralized—can solve both the enduring environmental concerns of pollution and the headaches of public-utility rate setting.

Regulators should take seriously the option of not regulating, especially recognizing when there is no good regulatory option. Not regulating does not necessarily mean not acting. In some instances, the best response to a market failure might be another tool. For one example, our society has determined that smoking is a public health hazard. The tobacco tax has been a rousing success at discouraging smoking, especially among the younger population that is more sensitive to price. There are other instances where tax policy can be an important contributor to public policy, with less of an administrative or compliance burden and less distortion of economic behavior, than regulations would cause.

Regulation should, wherever possible, be based on defined objectives and be tied to outcomes and performance. Properly implemented, broad principles are better than narrow rules. Regulatory goals work best if they are defined in terms of quantitative targets (which is not always possible). Consider pollution: a regulatory goal of limiting emissions to a certain level is much more effective than, say, mandating the use of a certain type of emissions control technology.

What matters is results: substance, not form. Micromanaging rules will encourage form rather than substance—that is, getting the box checked without the effort and expense of ensuring that performance hits the target. And when one market player finds the loophole in the detailed rules, others will drive through it in a race to the bottom because those who exploit the loopholes will succeed, but in the wrong game.

Principles can be exploited as well. Perhaps the greatest concern is that regulators will overstep their bounds by seeing any action as in violation of poorly interpreted principles. Regulators may even be rewarded for playing "gotcha." That is why quantitative targets, when they can be formulated in clear and objective terms, are best. Meeting the well-defined objectives can be a safe harbor, not subject to misinterpretation or to process requirements that preclude efficiency and innovation.

The regulatory burden is greater than the sum of its parts. When regulations are piled upon one another, it can be hard for market stakeholders to understand all that is required of a regulated entity. This becomes all the more problematic when federal regulations are added to state regulations, and collide with the regulations of our global trading partners. The mass of regulations can easily be intimidating, depending on the situation of a particular business, for example. Policymakers should be conscious of this problem.

A current and relevant example would be the failure to be flexible in dealing with emerging technologies. The current practice of trying to load all the regulatory baggage of a traditional legacy institution on the FinTechs, RegTechs, Blockchain, Sandboxes, crypto-currencies, ICOs and the like has meant that technological development is inconsistent and oversight fragmented. Other countries are significantly more advanced in this regard and the potential now exists for there to be major market failures and losses in the United States, with the costs often falling disproportionately on the most vulnerable people in the population.

The regulatory process provides special treatment to "significant" regulations—generally those that entail at least $100 million in aggregate costs. But regulatory costs well below $100 million can sink a lot of small businesses and even some comparatively large ones. Regulators need to decide whether the problems they seek to solve are truly material. Not regulating should always be an option, and the effect of one more regulation on the total mass of regulations needs to be considered as a cost in benefit–cost analysis. Further, regulators and lawmakers should be conscious that even in a regulation where the benefits exceed the costs, the benefits may not go to those who bear the costs and therefore may not help those who bear the costs to pay them.

This point is especially important in social regulation. When the regulatory process pursues small benefits that are hard to measure in monetary terms, regulators should take great care. This is not to say that social regulations are not justified, only that we must be sure that they are truly material.

Do not try to regulate on the cheap. Good regulation costs money, but regulating sensibly can save much more than it costs. Regulating agencies need good personnel, with strong leadership and training, so that they can learn from the past even without having lived it. Regulatory agencies need to be sure that individual regulators are rewarded for sound decisions, not for issuing citations or imposing fines through overly narrow interpretations of the rules. Regulators with the sound judgment to use (and not abuse) regulatory principles, and who seek to make their regulatees and the markets in which they operate stronger and better, will get the best results.

In a number of countries, regulators and regulatory bodies are either given special support and status (Japan and Korea are examples) or the regulators are compensated at full market standard (Singapore and Hong Kong do this). This means that not only do the regulators have full market experience and credibility, but they have adequate if not robust staffs and access to technology and training—something that U.S. regulators rarely have. It would be beneficial to study both the comparative compensation levels in key regulatory bodies of global competitors and the turnover levels for both the general regulatory population as well as the key positions. Just as with an airline pilot or a ship's captain, both the crew and the passengers are safer if the leadership team has a solid level of relevant experience. (This would mean full business-cycle experience and relevant technology experience.) The United States is not doing this today, and it shows when we repeat mistakes such as the savings-and-loan mortgage errors of the 1980s, the collateralized mortgage organization mistakes of the early 1990s, and short-term funding errors; each of those historical mistakes was repeated in some form in the 2008 crash. If the seasoned regulators had still been around, perhaps the U.S. experience would have been mitigated.

Draw on the experience of public stakeholders. Public comment on proposed rules is a part of the regulatory process. But there is evidence that regulators do not fully capitalize on this resource. Internet technology does allow a flood of superficial comment and complaint, but it also allows the identification of genuine experience and insight in the comment process. Regulated entities know what makes compliance easy or hard. Truly using such public input can yield better results.

Review and revise continuously. Because of constant changes in technology, regulations—those based on rules and those based on principles—require constant review. Public policy can always be improved as new ideas open new doors and new possibilities. We believe that the regulatory process should include continuous review and revision. This is not a one-time task and it should not be assigned to a part-time commission.

We believe that an informed process of review is best. Timely and accurate data will be needed to facilitate this. If politics cannot provide that systematic process, then we would reluctantly acknowledge that a requirement for automatic sunsets of regulations is necessary. Any sunset process would need to avoid wasted time on opportunistic "hostage-taking"—obstructing the renewal of sound and uncontroversial regulations as political leverage for more controversial policy pursuits. A far better approach would be a formal review process that analyzes the utility of the regulations and then makes modifications that leave behind only the best practices and the most material elements.

Beware of pride of authorship. Two heads are better than one. It can be fruitless to ask the authors of regulations to review their own regulations, even after enough time has passed for the facts and circumstances behind the regulations to change. Fresh eyes and open minds are needed. We suggest that OIRA be expanded to undertake regulatory review independently rather than counting on the agencies that created the regulations to grade their own homework.

Bad regulation entails multiple costs. Bad regulations result in winners as well as losers. Those in a position to take advantage of bad regulations will become vested interests in them. As a prominent example, some stakeholders resisted the aforementioned deregulation of transportation and telecommunications because, even though the reforms benefited most people in society, they disadvantaged the stakeholders. It is preferable to review existing regulations regularly, before they begin to detract from economic efficiency and build politically powerful constituencies.

In addition, bad regulation can divert the regulatory system's attention from real and dangerous problems.

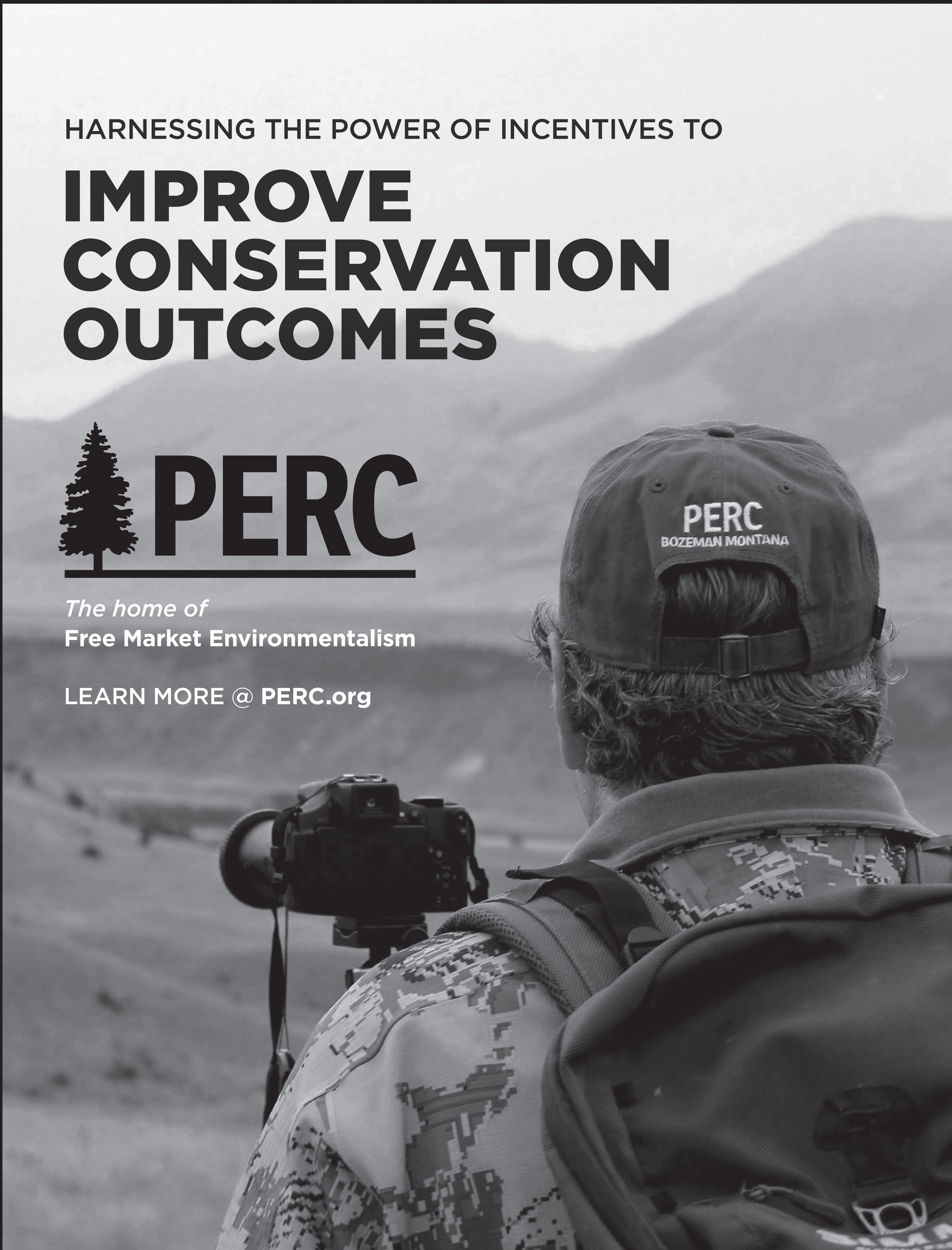
Sound regulation can be bipartisan. Improving regulation will not be easy. It will require a united effort in Washington. But that is one of the most hopeful notes in this story. Regulatory reform once was a bipartisan cause, and the results from the early 1970s through the early 1980s were overwhelmingly positive.

Laws were changed when Republicans and Democrats realized that the nation could do better and that both parties could benefit from that better America. We believe that elected policymakers of both parties could find such opportunities again—and perhaps build upon that effort to work together on other problems that our nation faces today.

CONCLUSION

We remain hopeful and committed to creating "a more perfect union." In years past, when Americans faced adversity, they took a collective deep breath, set aside partisanship, and found ways to work together in their common interest—and in the interest of their children and grandchildren, and of generations to come. We believe that Americans can do that again.

The stakes four decades ago were high. But now, in many ways, they are much higher. Today, our nation's economic leadership is challenged around the world. We cannot lose this leadership—especially in prosperity and commerce—lest we lose our lead in statecraft as well. We need better regulatory policy to maintain our global advantage. We call on our policymakers to meet this imperative. R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