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.

## Urban Empowerment Zones

**STATUS: HUD considering public comment on new EZ criteria.**

Congress created the Empowerment Zone (EZ) program in 1993 to revitalize communities and alleviate poverty by designating certain communities as eligible for federal incentive packages. Communities that receive EZ status can review applications from area businesses, and with the Department of Housing and Urban Development's blessing, distribute federal grant money and other incentives. In June 2005, HUD released the proposal, "Empowerment Zones: Performance Standards for Utilization of Grant Funds," which sets standards for what sorts of business projects are likely to get HUD's blessing. Contrary to its title, however, the proposal does not establish performance standards for the EZ program, but rather *ex ante* criteria that EZ projects must meet in order to qualify for Empowerment Zone grants.

This rulemaking creates two sets of standards: a "Resident Benefit Standard" and an "Economic Development Standard." HUD's goal with the resident benefit standard is to ensure that EZ funding benefits the residents of EZ communities. Candidate businesses can meet one of several criteria, all relating to the percentage of the project's "direct benefit" that would accrue to community residents. Essentially, local EZ officials would have to show HUD that EZ residents would receive the majority of the direct benefits or 35 percent of the jobs created by a proposed project. If a project does not qualify under those criteria, HUD could still allow EZ funding in proportion to the percentage of direct benefits expected to accrue to EZ residents.

If a business cannot meet any of the standards, EZ communities can still offer it federal funding under the "exception criterion." According to this clause, if local officials demonstrate that a candidate project would "contribute to [the EZ's] strategic plan in a critical way," HUD may provide EZ benefits for the project on a case-by-case basis.

In addition to establishing standards that businesses must meet in order to qualify for EZ grants, HUD specifies the activities for which it allows approved businesses to utilize EZ grants. This is the "economic development" standard, a standard that HUD designed to ensure that funded projects contribute to economic development in the impoverished area. A project qualifies as being "in conjunction with economic development" if the action has to do with activities such as job placement, educational training, business expansion, etc. Yet, HUD again includes another exception clause that allows it to determine, on a case-by-case basis, whether a project constitutes "economic development."

Between FY 1999 and FY 2004, Congress distributed $359 million in total appropriations for Round II urban zones, the zones of concern in this rule. This amounts to roughly $23 million per EZ.

Unfortunately, despite a decade of experience with EZs, HUD has offered no evidence that those monies are having their desired effect. If it is to help revital-

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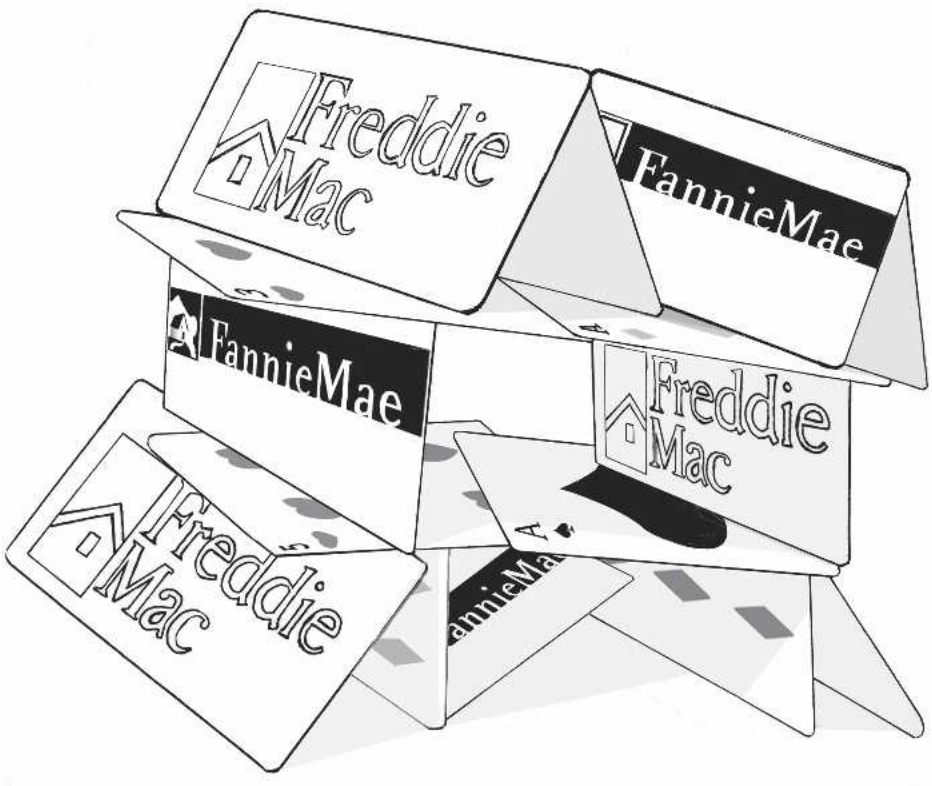


ize communities or alleviate poverty, HUD must identify measurable, goal-oriented outcomes, such as a reduction in the number of EZ residents who are living in poverty, rather than blindly designing *ex ante* regulatory standards to screen applicants. After all, if the concept behind the program is flawed, regulating who can participate in the program is not likely to produce much public benefit.

With that said, a modification of HUD's proposed standards might help to check some of the unintended consequences of this rule. Given HUD's desire to ensure that benefits from the EZ program accrue to EZ residents, the agency should not base the resident benefit standard on the percentage of direct benefits that accrue to EZ residents; this ignores the possibility that a project could conceivably provide substantial benefits to the EZ but not meet the percentage requirement. For example, there might be a project that confers large benefits widely, such that people in the zone only get 20 percent of the benefits. This project would fail to qualify for EZ money even though it produces more total benefits for zone residents than some smaller project whose benefits go entirely to people in the EZ.

Perhaps more significantly, though, both the resident benefit standard and the economic development standard contain exception clauses, or loopholes, that invite interested parties to manipulate local EZ plans and capture grants at the expense of potential EZ improvement. In the case of the resident benefit exception clause, HUD has implicitly allowed projects to receive grant money even if there is no direct benefit to the EZ. The proposal contains a similar exception for the economic development criterion. These haphazard exception criteria dilute already questionable standards by allowing HUD to authorize grants, on a case-by-case basis, for projects that cannot meet weak standards. In the absence of installing solid performance measures, HUD should remove these loopholes. Both of the standards invite rent seeking, while providing little assurance that EZ residents will be better off. With exception clauses in place, one can easily envision how city politicians might persuade EZ officials to subsidize various pet projects. Indeed, ribbon-cutting city officials sometimes serve as local EZ representatives, so this lobbying process might not require much more than self-encouragement.

While granting flexibility to localities (as HUD does with its exceptions) is likely beneficial in an environment where performance measurement is present, flexibility can be detrimental in situations where such measurement and accountability are absent. Though installing more appropriate screening standards is the most viable option in the near-term, real progress cannot occur until HUD generates performance measures indicating that the EZ program achieves a consistent goal and that it does so better than other initiatives. In this case, regulations that restrict program participation serve to check waste and rent-seeking, at best. While these are worthy intermediary objectives and while HUD's main statutory obligation is to prohibit abuse of the program, creating performance measures would allow HUD to determine if its program is helping EZs.

Though it is easier to issue this regulation than it is to scrutinize the program's successes, if HUD were to partake in the latter, it might allow communities and the impoverished a better opportunity to advance.

**—John Shoaf**

## GSE Reform

**STATUS: House bill moving to chamber floor.**

A U.S. House of Representatives committee recently forwarded to the main body reform legislation for government-sponsored enterprises (GSEs), including home loan giants Freddie Mac and Fannie Mae. The House bill contains several important correctives, including a formal receivership mechanism (i.e., legal procedure to close down an insolvent enterprise). Regretfully, the bill does not address the worrisome $1.6 trillion in mortgage-related holdings currently on the balance sheets of Freddie Mac, Fannie Mae, and the Home Loan Banks.

Fortunately, the U.S. Senate appears to be willing to take on the hard work that the House bill leaves undone. Sen. Richard Shelby (R-Ala.), chair of the Senate Banking Committee, has indicated that a Senate version of the bill to reign in the GSEs may be tougher than the current House version, especially with respect to GSE mortgage holdings.

The House's weaker-than-expected

bill is especially disappointing, because Rep. Richard Baker (R-La.), chair of the House subcommittee that oversees Freddie Mac and Fannie Mae, has been a long-time and courageous critic of the GSEs and their risky business practices. Given the longer and more consistent attention paid this issue by the House, one might have expected a firmer bill to have emerged, but the political process has a way of upsetting such expectations.

The real danger in not addressing the mortgage holdings issue lies in the risks such a concentration represents. Significant mortgage holdings on the GSEs' balance sheets put a lot of financial tinder in one place—tinder that could easily ignite if things go less than perfectly in the housing or financial markets.

Chief among those risks are credit risk (the chance that a mortgage borrower may not pay back the principal and interest owed) and interest rate risk (the chance that changes in market interest rates will adversely affect interest-sensitive assets and liabilities). As more homebuyers opt for lower equity levels—through interest-only loans or cash-out refinancings, for example—the chance of default increases because borrowers have smaller equity cushions and relatively less equity to lose. (In the second half of last year, more than 60 percent of borrowers chose interest-only or adjustable rate mortgages.)

In addition, with the Fed tightening short-term interest rates, the possibility of an adverse interest rate environment increases. Rising interest rates increase both credit risk and interest rate risk as borrowing costs increase (for the GSEs and for homebuyers with adjustable rate loans). At the same time, the gap between short- and long-term rates is narrowing, which in turn narrows the GSEs' profit margins.

The considerable concentration of risk on just three balance sheets is a recent and untested development. For the first several decades of their existence, the GSEs followed Congress's original intent to operate mainly as conduits between loan originators and loan investors. In this conduit role, the GSEs were vehicles for dispersing mortgage-lending risks rather than concentrating them. In 1994, for example, the GSEs (Fannie, Freddie, and the Home Loan Banks) held only a little more than $300 billion in mortgage-related assets on their balance sheets. Since the mid-1990s, however, the GSEs increased their mortgage holdings fivefold and, at the same time, outstanding residential mortgages roughly doubled. It is not surprising that, over the period, Fannie and Freddie in particular earned significantly higher returns on equity than were earned by other financial services firms. Risk and return, after all, do move together.

The GSEs claim they are adequately hedged against risk, but (given their past assurances about earnings quality or accounting rule interpretations, for example) skepticism of their reassurances about risk is probably warranted. Even if the GSEs are correct that, from today's perspective, they are well-hedged, hedging by its nature does not eliminate risk from the system as a whole—it merely transfers risk from one party to another.

Circumstances change, often in ways that are unforeseeable. The GSEs, like other firms, are composed of human beings who make mistakes. Fallibility suggests that they may be (or end up being) wrong about interest rates, the credit quality of borrowers, or any of a host of other factors that affect mortgage-lending risks. If their mistakes prove serious enough, taxpayers likely will have to clean up the resulting mess.

Persistently unsound financial practices committed in the name of advancing an admirable policy objective (homeownership) weaken us financially. Ultimately, unsound financial practices undermine the objective's achievement. Barring a return to more freely competitive conditions in mortgage finance (an outcome that seems unlikely), Congress should install a competent and independent regulator to address the risks presented by the GSEs.

**—Jay Cochran, III**

# The Regulators' Growing Budget

**By Susan E. Dudley,** *Mercatus Center*
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In 1978, Murray Weidenbaum observed in this magazine that "government regulation of business is one of the growth areas of the U.S. economy" ("On Estimating Regulatory Costs," May/June 1978). He attempted to measure that growth by examining the costs incurred by the federal government to operate regulatory agencies.

The Center for the Study of American Business, which he started at Washington University (later renamed the Murray Weidenbaum Center on the Economy, Government, and Public Policy) has continued over the years to track the growth in the administrative costs of regulation. Today, the Weidenbaum Center has teamed up with the Mercatus Center at George Mason University to continue Weidenbaum's path-breaking analysis. Their annual reports examine the Budget of the U.S. Government presented by the president to Congress to track the expenditures of federal regulatory agencies and the staff needed to run them. Last June, the centers released the 27th annual "regulators' budget" report, entitled *Upward Trend in Regulation Continues: An Analysis of the U.S. Budget for Fiscal Years 2005 and 2006*.

It is interesting to compare today's regulators' budget with the data that led Weidenbaum to remark on the growth in regulation in 1978. He examined the budgets of 41 regulatory agencies; today, we track 68 regulatory departments and agencies. He estimated that the federal regulatory apparatus employed 215,024 full-time people in fiscal year 1979; today we estimate that it employs 242,376. Most dramatic, though, is the almost 10-fold increase in the total regulators' budget: Weidenbaum pegged it at $4.8 billion in 1979, and in fiscal 2006 it will reach $41.4 billion.

**TYPES OF REGULATION** When Weidenbaum began the process of putting together an analysis of the costs and staffing of federal regulatory agencies, he explicitly made some distinctions between regulation and other powers of government. Activities that are not considered regulatory in the annual report include tax power, credit power, procurement power, and transfer payments. Although the agencies involved in those activities issue regulations that affect the private sector, their end purpose is not to regulate but to aid in such activities as collecting taxes and distributing revenue.

Weidenbaum separated the data into two major categories: economic regulation (e.g., regulation typically carried out by such agencies as the Securities and Exchange Commission and the Federal Trade Commission) and social regulation (e.g., regulation typically carried out by the Environmental Protection Agency and the Occupational Safety and Health Administration). Regulations were then broken down into such subcategories as consumer safety and health, energy and environment, etc. As regulatory priorities have changed, subsequent reports have identified additional regulatory subcategories and have expanded coverage. We now divide the social regulation category into six subcategories:

- Consumer safety and health
- Homeland security
- Transportation
- Workplace
- Environment
- Energy

The economic regulation category is divided into three subcategories:

- Finance and banking
- Industry-specific regulation
- General business regulation

**CONTINUING GROWTH** The latest report tracks both staffing and spending from 1960 to the present. Figure 1 graphs the changes in inflation-adjusted regulatory expenditures since 1960 (using 2000 dollars). While spending has generally increased over time, the rate of growth has varied depending on the philosophies of elected officials in the executive and legislative branches of the federal government. In the early years of the Reagan administration, for example, regulatory expenditures declined.

The 1960s witnessed a growth in regulatory expenditures. Total spending at federal regulatory agencies increased by $3.2 billion between 1960 and 1970. This represents a real annual growth rate of 8.6 percent and a total increase of 127.1 percent over the decade. Most of that growth—more than $2 billion—occurred in social regulatory agencies (which experienced a real increase of 136.9 percent in annual budget over the decade). Economic regulatory programs expanded more slowly, by $0.9 billion or 107.8 percent over the period.

The 1970s brought increased expenditures on federal regulation. Over that decade, real spending at regulatory agencies grew by $7.7 billion, or 134.5 percent (8.9 percent per year on average). Social regulatory expenditures continued to grow rapidly and increased by $7.2 billion (181.2 percent) while economic agencies showed a much smaller increase of $0.5 billion (29.2 percent). Most of the growth occurred in the early part of the decade, when several of the significant social regulatory agencies (particularly the EPA and OSHA) were formed. During the 1970s, social regulations grew from under 70 percent of the total regulators' budget to over 80 percent. Double-digit increases in the first three years preceded much slower growth in the budgets of both social and economic regulatory agencies during the

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latter part of the decade.

This slower rate of growth continued into the early 1980s. Total annual expenditures on regulatory programs declined by 5.2 percent between 1980 and 1985, but rebounded in the second half of the decade, increasing by 31.1 percent overall between 1985 and 1990. Annual spending on regulatory activities at the end of the decade was $3.3 billion more (in 2000 dollars) than at the beginning. Throughout the decade, spending on economic regulation increased at a faster rate—36.5 percent between 1980 and 1990—than spending on social regulation, which grew by 21.8 percent over the same period. On an annual basis, inflation-adjusted spending increased by an average of 2.2 percent per year over the decade.

Regulatory spending continued to increase in the 1990s, for a total increase of 50.9 percent over the decade, or $8.5 billion. The budgets of agencies administering social regulation increased by 53.3 percent over the decade, and those related to economic regulations increased by 40.6 percent. The first few years of the decade witnessed greater percentage increases than the later years—an average of 8.1 percent per year between 1990 and 1992, compared to an average of 3.2 percent per year between 1992 and 2000. Regulators' budgets actually declined in real terms in 1994 and 1996. On an annual basis, the real rate of increase averaged 4.2 percent over the decade.

Between 2000 and 2005, budgets devoted to regulatory agencies increased 41.6 percent in real terms. The FY 2006 budget requests that Congress allocate $41.4 billion for regulatory activities, up from $39.5 billion in 2005. This reflects a 4.8 percent increase in outlays directed at writing, administering, and enforcing federal regulations. The regulators' budget is growing at a faster rate than other nondiscretionary spending, which will increase only 2.1 percent in 2006. Since 2000, we have witnessed an increase in real spending on regulatory activities of $11.6 billion. Though lower over the past two years, the annual average increase of 6.5 percent for the 2000–2006 period is the highest since the 1970s, when Weidenbaum first began tracking on-budget regulatory costs.

Regulatory activities related to homeland security get the largest increases in the FY 2006 budget; the Department of Homeland Security is budgeted to receive an additional $1.1 billion in regulatory funding compared to last year. The regulators' budget also includes large increases in outlays at the EPA ($250 million), the Food and Drug Administration ($191 million), and the Patent and Trademark Office ($351 million). Staffing at the federal regulatory agencies is expected to reach an all-time high of 242,376 in 2006.

**OTHER COSTS** Of course, as Weidenbaum observed in his 1978 *Regulation* article, regulations impose social costs on individuals and businesses beyond the direct tax dollars expended to write and enforce them; the on-budget costs merely provide insights into the trends in magnitude of the hidden tax. At that time, he estimated that, for every dollar of on-budget regulatory cost, the private sector spends $20. In contrast, current comparisons suggest that for every dollar of direct budget expenditure devoted to regulatory activity, the private sector (individuals as consumers, investors, workers, etc.) spends $33 in compliance. (This is based on a comparison of the regulators' budget in 2000 with the Small Business Administration's estimate that the cost of federal regulation on American businesses, workers, and consumers in 2000 was $843 billion per year.)

Weidenbaum's 1978 observation that "government regulation of business is one of the growth areas of the U.S. economy" continues to hold true today. The dramatic increase in agency staffing and spending over the last few years suggests that we are not likely to see a decline in the regulatory state, or the hidden tax regulations impose, in the near future. R

FIGURE 1

## Onward and Upward

Administrative Costs of Federal Regulation