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Subject: 2004 Draft Report on the Costs and Benefits of Regulation

We are submitting the attached comment in response to OMB's request for comment on the Draft 2004 Report to Congress on the Costs and Benefits of Federal Regulations [Federal Register: February 20, 2004 (Vol. 69, No. 34)].

Please direct questions about this comment to Susan Dudley, Senior Research Fellow and Director, Regulatory Studies Program, Mercatus Center at George Mason University (sdudley@gmu.edu; 703-993-4934). If you have any problems with this transmission, please contact me (cmorrett@gmu.edu; 703-993-4944).

We appreciate the opportunity to comment and hope that consideration of these comments will enhance the quality of the final report.

Thank you.

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REGULATORY STUDIES PROGRAM

Public Interest Comment on

The Office of Management and Budget's
2004 Draft Report to Congress on the Costs and Benefits of Regulation¹

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. OMB's seventh Draft Report to Congress on the Costs and Benefits of Federal Regulations offers an important opportunity for government policymakers and the public to gain a better understanding of the impact of federal regulations. RSP's comments on this report do not represent the views of any particular affected party or special interest group, but are designed to protect the interests of American citizens.

This year, in addition to providing estimates of major regulations issued over the last decade, OMB's report summarizes studies on the effect of regulatory policies on economic growth. The different studies suggest that countries with less regulation and government intervention in the market place enjoy higher economic growth and per capita income—economic indicators that, in turn, are correlated with longer life-expectancy, and improved health.

Regulatory policies that secure, rather than diminish, property rights and minimize interference in competitive markets encourage entrepreneurship and innovation, and improve the quality of life.² U.S. policymakers should heed the results of these studies. The regulation-by-regulation analyses in OMB's annual regulatory accounting report can identify for Congress and the public how well regulations, individually and in the aggregate, protect property rights and encourage entrepreneurship.

¹ Prepared by Susan E. Dudley, Director, Regulatory Studies Program. This comment is one in a series of Public Interest Comments from the Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University.

² For a discussion of criteria for achieving economic freedom and prosperity, see the Mercatus Center's "The Millennium Challenge Account: Property Rights and the Entrepreneur as the Prime Mover of Development," Public Interest Comment On the Millennium Challenge Corporation's Report on the Criteria and Methodology for Determining Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004. Available from the Mercatus Center's Global Prosperity Initiative, at <http://www.mercatus.org/globalprosperity/subcategory.php/205.html?menuid=3>.

This comment first reviews and raises concerns regarding the cost estimates presented in the draft report. Section II addresses OMB's request for comment on reforms specific to the manufacturing sector. Section III concludes the comment with recommendations for improving the report.

I. OMB Could Improve Its Regulation-by-Regulation Cost Estimates

OMB and the respective agencies are taking important steps toward assessing regulatory costs and benefits. The transparency with which the draft report presents regulation-by-regulation cost and benefit estimates back to 1993 will facilitate other researchers' efforts assess the size of regulation. However, for reasons we have outlined in comments on previous reports, the data as presented are still inconsistent and fragmentary and may not offer the American public an accurate picture of the benefits and costs of regulation.³

OMB's draft report estimates that the annual benefits of regulations issued between October 1, 2002 and September 30, 2003 range from \$1.6 billion to \$4.5 billion. Annual costs for regulations issued over this period are estimated at \$1.9 billion. The draft report estimates that for regulations issued over the last ten years (October 1, 1993 to September 30, 2003), annual benefits range from \$62.1 billion to \$168.1 billion, and annual costs range from \$34.2 billion and \$39.0 billion.

The report states that its "citation of, or reliance on, agency data in this report should not be taken as an OMB endorsement of all the varied methodologies used to derive benefits and cost estimates."⁴ It also recognizes that "total costs and benefits of all Federal rules now in effect (major and non-major, including those adopted more than 10 years ago) could easily be a factor of ten or more larger than the sum of the costs and benefits reported in Table 2."⁵

We recommend that in future reports, OMB address these caveats by (1) explicitly identifying (and adjusting estimates for) methodologies which are not endorsed by OMB, and (2) providing a more realistic estimate of the total costs and benefits of regulation. The following sections address specific concerns with the reported estimates.

A. The estimates cover a small fraction of federal regulation.

The benefits and costs for fiscal year 2003 are based on agency estimates for only six regulations, or one-tenth of one percent of the final rules published in the Federal Register during the year. Of the 37 economically significant rules reviewed by OMB during the 12-month period, OMB classifies the vast majority (25) as "transfers," and

³ Previous Mercatus Center Public Interest Comments on OMB's annual reports to Congress as well as those filed on the record with various agencies are available by agency at <http://www.mercatus.org/regulatorystudies/pic-topic.php?menuid=2>.

⁴ Draft Report 2004, p. 6.

⁵ *Ibid.*

suggest they simply shift money from one segment of society to another without imposing any net social costs or benefits. Of the remaining twelve “social regulations,” issuing agencies estimated benefits or costs for only six.

These statistics highlight several problems with relying solely on information reported by agencies. The most obvious is the lack of information on the impacts (costs and benefits) of the major rules issued last year. By definition, an economically significant or major rule has an annual impact of \$100,000,000 or more,⁶ yet costs are presented for only fifteen percent of these rules. If each of the 31 rules not included in OMB’s total imposed the minimum cost of \$100,000,000 per year, the totals would be understated by \$31 billion.

Furthermore, there are real costs associated with regulations that effect large “transfers” from one group to another. Regulations involving “mere” transfers alter people’s behavior, either by directly prohibiting or mandating certain activities or by altering prices and costs. Redirecting resources in this way imposes a real cost to society, which economists refer to as a “deadweight loss” or “excess burden.” At the very least, OMB should estimate the deadweight loss associated with these transfers. OMB has estimated the “excess burden of taxation,” including the federal administrative costs and taxpayer burden, at 25 percent of revenues. It would be surprising if transfers effected by regulation had a deadweight loss any less than that. In addition, regulations that transfer wealth are typically the product of lobbying and other rent-seeking behavior on the part of the beneficiaries. Such rent-seeking will dissipate the benefits, so that costs assumed to be transfers may in fact represent additional real resource costs.⁷ OMB should investigate and report these costs.

B. The reported benefits and costs are not based on an independent assessment.

As in previous years, OMB offers no independent assessment of the quality or usefulness of agency analyses and, correspondingly, the estimates presented in this report. The reported benefits and costs are based on agency estimates, without independent

⁶ E.O. 12866 (available at: <http://www.whitehouse.gov/omb/inforeg/eo12866.pdf>) defines a significant regulatory action as one that “is likely to result in a rule that may:

- (1) Have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;
- (2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;
- (3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or
- (4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

⁷ Gordon Tullock. “The Welfare Costs of Tariffs, Monopolies and Theft” *Western Economic Journal*, 5, pp. 224-232. (1967).

verification or any assurance that assumptions and methods are consistent across programs and activities. There is little value added in simply compiling the unverified representations of agency management. Such an approach would be unthinkable when dealing with budget expenditures; OMB should make an effort to provide an independent view of agencies' regulatory expenditures.

OMB's reports to Congress should also provide more detailed information about the assumptions underlying the benefit and cost estimates of the individual regulations that comprise the aggregate figures. OMB is in a unique position to provide some useful analysis; it has access to agency analyses, interagency discussions, and public comments on individual rules. In the course of its own reviews of significant regulations under Executive Order 12866, OMB analysts identify strengths and weaknesses of the methodologies agencies use to estimate benefits and costs. At a minimum, it should include those observations in this report in the form of a "report card" that highlights strengths and weaknesses of each analysis.

C. The reported benefits and costs are dominated by environmental regulations controlling a single pollutant.

The estimated benefits and costs of Environmental Protection Agency regulations comprise over 60 percent of the total benefits and costs reported for the 10-year period (and over 75 percent of the reported upper-bound benefits). The majority of EPA's benefits derive from reductions in exposure to one pollutant – particulate matter (PM). The draft report summarizes the uncertainties associated with benefits attributed to PM reductions, and many commentators have questioned the methodology EPA uses to derive these high benefits.⁸ The fact that the benefits reported by OMB are so dominated by the questionable analytical approach used to value reductions in one pollutant illustrates the problem with relying uncritically on agency estimates.⁹

It is understandable that agencies try to portray their programs and initiatives in the best possible light. Because health-benefits estimation is subject to considerable uncertainty, there is typically a wide margin between what an agency thinks is "best" for public relations and what a statistician would define as a "best estimate" (most reliable estimate) for scientific purposes. OMB must work to eliminate these biases, which have a

⁸ In our comments on OMB's 2001 report to Congress, we highlighted problems with EPA's estimates of these benefits, including (1) an unrealistic baseline, (2) uncertainties in the magnitude and causation of effects, (3) improper accounting for latency of effects, and (4) exaggerated valuation of health benefits. Public Interest Comment available at: <http://www.mercatus.org/article.php/69.html>.

⁹ On its web page for the Clear Skies initiative, EPA continues to promote a highly questionable estimate of benefits based on the same flawed analysis of the health effects of PM, claiming that: "The monetized benefits of Clear Skies would total approximately \$113 billion annually by 2020, substantially outweighing the annual costs of \$6.3 billion." On further reading, one learns that \$110 billion of this is from an estimate of health effects, that an alternative estimate of these same health effects is only \$21 billion, and (in a footnote) that even the \$21 billion may be too high. See <http://www.epa.gov/air/clearskies/benefits.html> accessed February, 18, 2004.

disturbing tendency to persist and “bioaccumulate,” even as caveats and footnotes tend to disappear.

D. Other studies of regulatory costs can provide a check against which to assess OMB estimates.

To provide Congress and the public a more comprehensive picture of the benefits and costs of regulation, OMB’s annual reports to Congress should provide a review of the available literature. The draft report notes that actual estimates “could easily be a factor of ten or more larger than the sum of the costs and benefits” it reports, and suggests “[m]ore research is necessary to provide a stronger analytic foundation for comprehensive estimates of total costs and benefits by agency and program.”¹⁰

While OMB’s regulation-by-regulation approach to estimating benefits and costs contributes a valuable dataset for regulatory accounting, other studies (some of which apply other approaches) can provide useful data points for understanding the impact of regulations.

The draft report does refer to a recent Small Business Administration report, by Professors Mark Crain and Thomas Hopkins, which pegs the annual cost of regulations at \$843 billion in 2000.¹¹ This suggests that OMB’s cost range of \$34 to \$39 billion may be low by a factor of 20, rather than 10. A revised SBA report is forthcoming later this year.

Two new Mercatus Center studies build on a regulation-by-regulation approach to estimate the costs of water regulation.

- A recently released working paper by economist Joseph Johnson, Ph.D. utilizes a cost estimation method similar to that used in the past by EPA to update and extend past estimates of the costs of regulations implementing the Clean Water Act (CWA). The report estimates that the costs of complying with water quality regulation totaled \$93.1 billion in 2001. While this figure is based on conservative estimates of regulatory costs, it is significantly larger than the upper end of the cost or benefit estimates presented in OMB’s report for the Office of Water (\$3.3 billion and \$8.4 billion, respectively).¹²
- A forthcoming Mercatus working paper on the costs of regulations implementing the Safe Drinking Water Act (SDWA) suggests that annual costs of SDWA rules

¹⁰ Draft Report, p. 6.

¹¹ W.M. Crain and T.D. Hopkins, “The Impact of Regulatory Costs on Small Firms.” Report prepared for the Office of Advocacy, U.S. Small Business Administration, 2001. Available at <http://www.sba.gov>.

¹² Joseph Johnson, Ph.D., “The Costs of Regulations Implementing the Clean Water Act.” Mercatus Center at George Mason University, 2004. Available at <http://www.mercatus.org/regulatorystudies/article.php/629.html>.

issued since 1986 are close to \$5 billion per year, with associated capital costs of over \$18 billion.¹³

Another Mercatus Center study, issued in September 2001, estimated the total cost of workplace regulations at \$91 billion annually. This stands in sharp contrast to OMB's estimate of \$800 million in costs and \$1.3 to \$3.6 billion in benefits for Labor regulations issued over the last decade.

Summing our cost estimates for these three types of rulemaking alone (water quality, drinking water and workplace) provides an estimate five times larger than the total cost figure OMB presents for the last decade. The Mercatus studies suggest costs for these three categories of regulation of \$189 billion per year, where OMB presents estimates of the costs of all major rules over the last decade of between \$34.2 billion and \$39.0 billion. While the Mercatus estimate is more comprehensive, both in the time period covered and the number of rules included within the three categories, it is by no means an upper bound estimate of costs. Each of the studies summarized above attempts to be conservative in its derivation of cost estimates.

II. Suggestions for Reform in the Manufacturing Sector

The draft report observes that “[t]he cumulative costs of regulation on the manufacturing sector are large compared to other sectors of the economy.” It therefore, “requests public nominations of regulatory reforms relevant to this sector.”¹⁴

Our research supports OMB's concerns about the regulatory burden on U.S. manufacturers, their employees, and consumers of their products. During the summer of 2001, the Mercatus Center conducted a detailed survey of 100 U.S. manufacturers to understand the scope and cost of regulatory compliance with workplace regulations.¹⁵ The survey suggests that in 2000, U.S. manufacturers spent an average of \$2.2 million per firm to comply with federal workplace regulations, or roughly \$1,700 per employee. The costs of complying with workplace regulations equaled 1.6 percent of gross receipts in the typical manufacturer. An extrapolation of these survey results to the entire manufacturing sector indicates that workplace regulations cost that sector about \$32 billion in 2000. The burden falls disproportionately on small firms, those employing less than 100 workers. The total compliance costs in small firms amounts to about \$2,500 per employee, which is 68 percent higher than the cost per employee in large firms, those with 500 or more workers.

¹³ Robert Raucher, Ph.D. and John Cromwell, “The Costs of Compliance with Regulations Issued under the Federal Safe Drinking Water Act Amendments of 1996.” Mercatus Center at George Mason University. Forthcoming 2004.

¹⁴ Draft Report, p. 1.

¹⁵ W. Mark Crain and Joseph M. Johnson, “Compliance Costs of Federal Workplace Regulations: Survey Results for U.S. Manufacturers.” Mercatus Center at George Mason University, December 2001.

We defer to other organizations with first-hand experience with regulatory impacts on manufacturers to identify individual rules that impose unnecessary costs that interfere with competitiveness. However, our 2001 report does provide insights into the types of workplace regulations that impose the largest costs on manufacturers. We reproduce the key section of that report here:

The survey instrument grouped the twenty-five statutory acts and executive orders that encompass all significant federal workplace regulations into six categories. These six categories are: Worker Health and Safety, Labor Standards, Employee Benefits, Labor-Management Relations, Civil Rights, and Employment Decisions. The survey asked respondents to allocate their compliance activity among these six major types.

Table [1] presents these results. For the overall sample, Worker Health and Safety regulations account for the largest share of compliance costs, 33 percent of all costs, followed by Employee Benefits regulations, which account for 27 percent of all costs. Combined these two types of workplace regulations account for 60 percent of all compliance costs, based on the full sample. Note that the “Large Firm” sample rated Employee Benefits regulations as the most costly, accounting for a 31 percent of total compliance costs. Large firms reported that Worker Health and Safety regulations account for 21 percent of all costs, closely followed by Civil Rights regulations, at 20 percent. Small firms reported that Worker Health and Safety regulations account for 42 percent of their compliance costs.

Table 1. Allocation of Costs by Type of Workplace Regulation in 2000 *

Category	By Firm Size (Number of Employees)			
	All Firms	Less than 100	100 to 499	500 +
Worker Health and Safety	33%	42%	35%	21%
Employee Benefits	27%	28%	24%	31%
Civil Rights	13%	9%	11%	20%
Labor Standards	11%	9%	11%	11%
Labor-Management Relations	10%	9%	12%	9%
Employment Decision Laws	6%	3%	6%	8%

* **Note:** The percentages in the Table 1 reflect the share of compliance costs attributed to each type of regulation. The table reports the mean values for the sample.

In addition, we encourage regulatory agencies and OMB to follow the regulatory analysis guidelines issued in September 2003 when developing new regulations and evaluating existing ones. Before undertaking regulatory activity, it is essential to ask what systemic problem in the market makes the action necessary. If none can be identified, no amount of analysis can produce a regulation that will make manufacturers, employees and consumers better off.¹⁶ As the international studies OMB reviews highlight, policies that undermine property rights or interfere in competitive markets not only hinder the productivity and competitiveness of individual companies or sectors, but also harms the nation's economy.

III. Conclusions and Recommendations for Improving Regulatory Accounting

- 1. The estimates of the total costs of regulation presented in OMB's 2004 draft report to Congress appear to be significantly understated.** Annual cost estimates published by the Small Business Administration are over twenty times higher than those presented by OMB (\$843 billion compared to under \$40 billion). Mercatus Center studies of the costs of regulations issued by EPA's Office of Water are thirty times higher than OMB's estimates (approximately \$100 billion compared to OMB's upper bound of \$3.3 billion).

This is not surprising, given the small fraction of total rules covered by the estimates in this report. The benefits and costs for fiscal year 2003 are based on agency estimates for only six regulations, or one-tenth of one percent of the final rules published in the Federal Register during the year.

- 2. As in previous years, OMB offers no independent assessment of the quality or usefulness of agency analyses, and correspondingly, the estimates presented in this report.** The reported benefits and costs are based on agency estimates, without independent verification or any assurance that assumptions and methods are consistent across programs and activities.

While we have not identified any aggregate estimates of the benefits of regulation for comparison with the figures presented in the draft report, we find it striking that the majority of reported benefits derive from reductions in exposure to one pollutant—particulate matter (PM), particularly because the analytical approaches used to value PM reductions has been widely questioned and criticized.

¹⁶ Our Public Interest Comments on the Department of Energy's energy efficiency standards and the Department of Transportation's corporate average fuel economy standards (available at www.mercatus.org) highlight the problems with regulations issued in the absence of any market failure. These regulations, while sometimes supported by some manufacturers, harm American consumers.

3. Though the increased transparency reflected in OMB's review procedures and in the report itself are welcome improvements to the regulatory process, the benefit and cost estimates in the draft report do not offer the American public an accurate picture of the impact of regulation.

Executive and legislative branch actions, along with extensive academic research, have improved our understanding of the impact regulations have on consumers, workers and companies. However, we still lack a reliable mechanism, analogous to the fiscal budget process, for tracking regulatory expenditures and ensuring they produce desired outcomes. To be comparable in value to the fiscal budget figures, OMB's estimates must reflect an independent assessment of regulatory costs and benefits, and not simply provide a summation of agency estimates.

4. Over the coming year, OMB will be in a better position to hold agencies accountable for conducting analysis to ensure that the resulting benefit and cost estimates are reliable and robust. In September 2003, OMB issued guidelines for regulatory analysis that reflect generally accepted principles for evaluating the impacts of regulation. It is also developing guidelines for meaningful peer review. In the course of E.O. 12866 review, OMB should hold agencies accountable for following these guidelines, and return to agencies regulations not supported by analyses that comport with these guidelines. If it does, it may then be able to rely on agency estimates with confidence.

In the meantime, OMB should identify, in a concise but comprehensive manner, variations in agency methodologies used to estimate benefits and costs of individual regulations. It should present a "report card" for agency analyses that highlights their strengths and weaknesses.