

Dear Dr. Graham:

I am pleased to submit my comments on the 2004 Draft Report to Congress on the Costs and Benefits of Federal Regulation and Unfunded Mandates. Overall, I think the report is a useful review of recent federal regulation and appears to be responsive to the applicable statutory requirements. As regards the specific issues posed in your letter, I would note the following:

* The accounting framework presented in chapter 1 is a valuable way of organizing relevant information. At the same time, I note that the text makes numerous references to EPA rules. For example, there is a discussion of the decline in costs and benefits associated with dropping the 1992-3 data (and the corresponding removal of the acid rain regulations from the analysis); the fact that EPA rules 'continue to be responsible for the majority of costs and benefits...during this [ten year] period'; the potential for negative net benefits of water regulations; the importance/controversy associated with fine particles; and others. Arguably, the focus on of EPA rules is somewhat disproportionate to the Agency's contribution to regulatory costs or benefits. Despite this EPA emphasis, however, there is no discussion or explanation of the relatively small share (15-20 percent) that EPA rules contribute to costs and benefits in the most recent year, as shown in table 1. In my view, this section should be revised to address this latter issue while, at the same time, presenting a better balance across all relevant Agencies.

* The discussion of the overall impact of regulation on economic growth is also quite useful. My understanding is that the bulk of the regulatory activities referenced in the cited literature are what would be described as economic as opposed to social regulation. If so, it would be most helpful to make this distinction more explicit, since a reader unfamiliar with the economics literature might be confused between the earlier claims of net benefits attributed to recent social regulation in the U.S. and the implied GDP growth reductions associated with the economic regulation described in this section.

* The literature review on the impact of regulation on manufacturing contained in Chapter II is incomplete and potentially misleading in at least one major respect—namely, the findings reported from two particular articles. One paper, of which I am a co-author, was published in the Review of Economics and Statistics in November 2001 (MPS). The other, by Joshi, Krishnan, and Lave (JKL), was published in The Accounting Review earlier the same year (April 2001). Both papers rely on Census data. However, they arrive at quite different conclusions. As the OMB draft notes, MPS find no evidence of understatement and some evidence of overstatement of costs, based on their preferred model. JKL find extensive evidence of understatement. The principal difference lies in the empirical model. As MPS demonstrate, the finding of significant cost understatement hinges on the use of a so-called pooled model. When one adopts a less restrictive, fixed effects model (the preferred MPS approach), the apparent cost understatement disappears, and possibly reverses. The model choice involves a tradeoff between model flexibility (fixed effects) and the use of substantial cross-sectional identifying information (pooled). While the main point of MPS is to highlight this choice and argue for the flexible approach (with another, unpublished paper by Gray and Shadbegian similarly

highlighting the choice but arguing for the pooled approach), JKL completely ignore this issue. Note that the JKL paper appeared much earlier in draft and was, in fact, part of the motivation for the MPS paper.

What to do? Ideally, the OMB report should present enough information so that the reader could make an informed judgment about the issue of model choice. If space or other limitations prevent this, an alternative option would be to present the earlier JKL work in the sequence in which it appeared in the literature, and then introduce the MPS paper as a later piece that focused more carefully on empirical assumptions. Either option would be preferred to the current presentation which is silent on the reason for the differences and, at a minimum, may leave the (incorrect) impression that these two estimates have not been reconciled-exactly the point of the MPS paper.

A smaller point concerns the possible confusion in the treatment of average vs marginal costs in the two papers. Although there is some reference to this issue in the OMB discussion of the JKL paper, it should be noted that when Gray and Shadbegian used a pooled model, their average results were on the order of 2-3 times direct costs. The finding of 10 times direct costs emphasized in the OMB report (as reported in JKL) applies in the very restrictive case involving both a pooled model and marginal (as opposed to average) costs. Regardless of the ordering of the discussion or the technical detail presented in the OMB report, these distinctions need to be further clarified to avoid confusing the readers.

* An editorial point. The reference in the document to Joshi et al is actually to the earlier (unpublished) paper. The correct reference to the cited paper is: Joshi S., Krishnan R. and Lave L. 2001 "Estimating the Hidden Costs of Environmental Regulations," *The Accounting Review*, v 76, no. 2 (April), pp. 171-198.

I hope these comments are helpful.

Sincerely,

Richard D. Morgenstern