

Shining a Light on Regulatory Costs

What counts as a cost under E.O. 13771?

Abstract

President Trump's Executive Order 13771,¹ *Reducing Regulation and Controlling Regulatory Costs*, has caused some confusion among the analysts, inside and outside federal agencies, who forecast the economic effects of regulations. Which effects should count as costs and which as benefits? It sounds like it should be an easy question, but it is not. Here are some wrinkles to consider.

Why isn't Benefit-Cost Analysis sufficient? Why do we need additional constraints on rules?

In theory, a benevolent and all-knowing philosopher prince would need only benefit-cost analysis (BCA) to make decisions. In the real world, however, large organizations suffer from imperfect (and *imperfectible*) knowledge, conflicting incentives, and other pathologies that need to be managed. Consider the budget: The Army Corps of Engineers has been doing BCA for more than a century, yet no one seriously proposes that the Corps should have a blanket authorization to spend an *unlimited* amount of taxpayer money, as long as they think the benefits of their projects will exceed the costs. In addition to meeting a BCA test, the Corps must live within its budgeted means.

Through rulemaking, regulatory agencies have been expending real resources without a budget constraint. In such an environment, their incentive is to exaggerate the net benefits of regulation, and to commandeer a growing share of the private economy – effectively spending resources without limit. Something more is needed to constrain regulatory growth.

¹ Executive Order 13771. “Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs.” January 30, 2017. <https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling>

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President Trump said during the campaign that there are too many regulations and that, collectively, they cost too much.² But how many regulations are there? How much do they cost? We can acknowledge that these are difficult questions to answer, and still be confident in saying: too many, and too much. Like all of his recent predecessors, the President has asked agencies to do something about the overburden of existing regulations. Unlike his predecessors, he has told them that he is going to monitor their progress.³ He has told the Office of Management and Budget (OMB) to count regulatory actions and to measure their costs at the margin to see if agencies are making progress. The metrics may be crude, but they are needed.

Why is it difficult to measure costs?

Benefit-Cost Analysis generally uses the Kaldor-Hicks “Net Benefits” criterion:⁴ Benefits minus costs should be greater than zero. Both benefits and costs, in this framework, are meant to measure the effect on individuals’ welfare, as defined by their willingness to pay for one outcome vs. another. As artificial persons, businesses do not themselves have “welfare” and thus do not experience costs or benefits in the BCA sense. Instead, businesses serve as intermediaries for benefits or costs—or both—whose ultimate incidence is on people: consumers, workers, investors, or property owners. Costs to business are a proxy for costs that are actually borne by people.

In the Kaldor-Hicks formula, it doesn’t matter whether any particular item is classified as a benefit or as a negative cost (cost saving); nor does it matter if an item is considered a negative benefit or a positive cost. Different analysts may classify things differently, or measure from a different baseline; but the bottom line should remain the same. So, odd as it may seem, BCA has been conducted for more than a century without ever having to come up with an unambiguous definition of “cost,” by itself, distinct from benefits.

In market transactions it is much easier to make this distinction, because each participant defines “benefit” and “cost” from their own perspective. This “point of view” distinction is of no help in BCA, since it is intended to make an assessment of collective welfare. When dealing with physical things, we can find easy shortcuts to make the distinction. If the Navy builds a ship, costs are what we are left with if it sinks on its maiden voyage. The benefits—which would have been delivered by the physical object—are lost. In complex regulatory programs, it can be more challenging to find such shortcuts.

² Chris Kaufman, “Republican Trump says 70 percent of federal regulations ‘can go,’” Reuters, October 7, 2016. <http://www.reuters.com/article/us-usa-election-trump-regulations-idUSKCN12629R>

³ Brian Mannix, *Public Citizen v. Trump: Roadmap for the Resistance*, Liberty Law Forum, February 21, 2017. <http://www.libertylawsite.org/2017/02/21/public-citizen-v-trump-roadmap-for-the-resistance/>

⁴ Brian Mannix, *Does Benefit-Cost Analysis Attempt the Impossible?*, Liberty Law Forum, November 4, 2016. <http://www.libertylawsite.org/2016/11/04/does-benefit-cost-analysis-attempt-the-impossible/>

Other countries have used some form of administrative burden (transaction costs) in their programs to constrain regulation⁵—as has the U.S. under the Paperwork Reduction Act. The Trump order is clearly meant to capture something more than that. OMB has said it will include opportunity costs, but will not include foregone benefits. These are ambiguous terms and will doubtless engender later arguments, in the context of particular rules, over what counts and what does not.

What can OMB do to settle these arguments?

It is likely impossible to anticipate all of the different ways that costs and benefits will be entangled in the variety of regulations that will be subject to review. OMB should follow a general set of principles for resolving those arguments. For example, it makes sense to think that costs, in the context of regulation, *are the things that are compelled*. If a regulated entity is subject to enforcement action for failing to do something or prevent something, there is a cost. Benefits, in contrast, are things that may be forecast to result from a rule, but typically they are not directly compelled.

Following the analogy of the ship that sinks, it may be helpful to construct hypothetical scenarios to disentangle the costs and benefits of rules. If a rule is intended to change the climate, for example, we can ask what would happen if the climate does not change. It is important to emphasize that this hypothetical is not intended to deny the existence of climate benefits; rather, it is meant to allow us to distinguish the climate benefits from all of the other consequences of the rule.

Similarly, if the same rule is meant to produce future energy savings for consumers, we can ask what happens if the energy savings do not materialize. Even if we are confident that there will be nonzero future savings, we can use the hypothetical to make a meaningful distinction between the costs (e.g., of purchasing a washing machine) and the benefits (including reduced future operating costs). We make such distinctions all the time, including on the mandatory label that appliances bear.

In discussing these zero-benefit hypotheticals, OMB should be clear that they are *not* to be used to evaluate the merits of individual rules and the policy options under review. For that, an objective and realistic BCA remains the best analytical tool. Instead, the hypothetical scenarios (like the sinking ship) are being used simply to distinguish regulatory costs from regulatory benefits, in order to measure agencies' success in pursuing the goal of reducing the cumulative burden of regulation. The size and credibility of associated benefits should continue to be given

⁵ Marcus Peacock. "Implementing a Two-for-One Regulatory Requirement in the U.S." *Working paper, the George Washington University Regulatory Studies Center*. December 6, 2016.
<https://regulatorystudies.columbian.gwu.edu/implementing-two-one-regulatory-requirement-us>

equal weight in choosing regulatory policies that are optimal, and this should be true when rescinding old regulations as well as issuing new ones.

Another hypothetical that can be helpful in defining regulatory costs is the on-budget equivalent program. If, instead of regulating, the agency were spending appropriated funds to achieve the same goal, how much would it need? In the absence of an *obligation* to comply, how much would the agency have to pay people to comply with the program's parameters? An on-budget equivalent of a regulatory program may not always make sense, but the exercise of trying to design one can help sharpen the definition of regulatory cost.

What about sunk costs?

When rescinding an old rule, agencies cannot assume that the old analysis of benefits and costs will apply, but in reverse. Many things may have changed—including new information about how the rule works in practice—that may cause a retrospective review to look very different from the RIA developed when the rule was newly proposed.

One difference that needs attention is the treatment of sunk costs. Sunk costs (those already incurred) are, by definition, not recoverable by rescinding a rule. But it is important to ask from whose perspective the costs are sunk. If an auto manufacturer has committed to making only solar-powered cars, its costs may well be sunk. It will not be able to recover those costs if the (hypothetical) “solar car mandate” is repealed. On the other hand, the costs are *not* sunk from the perspective of consumers who have not yet bought a solar car. For them, the option to buy another vehicle still has value—even if the business that may produce or import it does not yet exist.

When imposing new regulatory costs on businesses, agencies are justified in assuming the costs will be passed through to real people—consumers, workers, and owners. When rescinding a rule, the problem of sunk costs can make the analysis more complex. Incumbent businesses may advocate for regulatory outcomes that preserve their ability to pass on costs that, from their perspective, are already sunk. Fairness requires a careful consideration of these arguments, but efficiency requires that agencies also look beyond those arguments to determine the overall social cost of a regulatory action.