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WASHINGTON, DC

Public Interest Comment<sup>1</sup> on

The Office of Management and Budget's Document

Marginal Excess Tax Burden as a Potential Cost under Executive Order 13771

Docket ID No. OMB-2017-0002

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The George Washington University Regulatory Studies Center improves regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on the Office of Management and Budget's query on including marginal excess tax burden as a potential cost under Executive Order 13771 does not represent the views of any particular affected party or special interest, but is designed to evaluate the effect of OMB's proposal on overall consumer welfare.

## Introduction

The Office of Management and Budget (OMB) has requested advice on incorporating a measure of "marginal excess tax burden" (METB) as a potential cost under the regulatory cost accounting system mandated by Executive Order (E.O.) 13771.<sup>3</sup> This public interest comment begins by making some general observations about the use of METB in the context of budgetary, tax, and regulatory policy. It then offers responses to the eight specific questions listed in the OMB notice.

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<sup>1</sup> This comment reflects the views of the author, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at <http://regulatorystudies.columbian.gwu.edu/policy-research-integrity>.

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<sup>3</sup> Docket ID: OMB-2017-0002, <https://www.regulations.gov/docket?D=OMB-2017-0002>.

## **General Comments on Using METB for Spending, Taxing, and Regulation**

The METB is a major component of the cost of government, and its broader use can help promote better decisions about government spending and regulation. OMB should certainly proceed to incorporate METB estimates into its accounting reports under E.O. 13771. This aggregated reporting will be of limited use, however, if OMB does not also encourage its use in the analysis of spending decisions, tax policy decisions, and individual regulatory decisions.

### ***Spending***

For decades, Circular A-94 has prescribed the use of a 25 percent METB for estimating the true cost of government expenditures. In practice, however, the METB is rarely used. For example, as an Environmental Protection Agency (EPA) official in 2007, I was asked to mediate a dispute between OMB and the Army Corps of Engineers on the benefit-cost analysis of Corps projects. The Corps used a “hurdle” benefit-cost ratio of 1.0 when reporting candidate projects to Congress for funding, whereas OMB wanted a hurdle ratio of 1.5 or greater, without explanation. When I raised the METB as a logical way to resolve the dispute, I was surprised to learn that (1) the Corps (including very senior officials, as well as analysts) had never heard of the concept, and (2) OMB, including the Corps budget examiner and the PAD, had never heard of the concept either. The METB ought to be a routine component of the analysis of budgetary expenditures, so that the real cost of federal funding is always apparent.

The consistent use of the METB will help advance other budget objectives, like the adoption of user fees. The METB does not apply to user fees, and so projects that are funded by user fees – such as navigational improvements by the Corps of Engineers – will look more favorable compared to similar projects that draw on general revenues.

Note that there is also an excess burden associated with the downstream distribution of transfer payments. As a consultant to the Federal Emergency Management Agency (FEMA) in 1995, I investigated the barriers that were impeding federal hazard mitigation funds from reaching the localities where they were intended to be used. One problem I discovered was that the funds passed through a FEMA regional office, which seemed to accomplish nothing in particular but entailed an additional administrative burden of approximately 20 percent of the funds being transferred, simply to move money from Washington, DC, to a state capital.

### ***Taxation***

In recent years OMB’s Office of Information and Regulatory Affairs has begun to review regulations from the Internal Revenue Service (IRS), which had previously been exempted from review under E.O. 12866. Here I think the METB is a logical focus of the regulatory analysis and OIRA review, in order to make the tax code more efficient by minimizing the excess burden of each provision. In this context, however, assuming a uniform METB does not make sense. Instead, the goal should be to examine the incremental change that each IRS regulatory decision might entail.

Note that some taxes – notably Pigovian taxes, such as a tax on greenhouse gases – will not necessarily entail an METB. They do not get a free pass, since there are administrative expenses for them, too. But the analysis should do an accurate estimate of favorable, as well as unfavorable, consequences caused by the tax.

### ***Regulation***

Applying the METB to regulations is a complex undertaking. Certainly it should be used to adjust the on-budget impacts of regulatory decisions. However, it is not straightforward to apply the same METB to private expenditures, even when those private expenditures take the form of transfers to other entities. For example, the EPA’s Renewable Fuels Standard effectively imposes a tax on gasoline and diesel fuels, in order to provide a subsidy to ethanol and biodiesel fuels. Such transfers by regulation are likely to impose distortions that are similar to those caused by taxes, but assuming that they incur the same marginal excess burden would not be realistic. Regulatory transfers are unlikely to be as efficient as the tax system, so that the standard METB might be regarded as a floor on the deadweight loss.

One final complication is that, for tax programs, the METB typically uses government revenues as the denominator. This makes sense because the magnitude of realized revenues is easily observed. Thus a 40 percent METB means that \$1.00 in revenue collection imposes \$1.40 in total costs on the economy. But this convention does not easily adapt to regulatory transfers where the revenues are not collected, and where the frictional losses can be much greater. For example, in cases where rent-seeking consumes most or all of the intended transfer, the METB would be infinite. This was the case, for example, during oil price controls during the 1970s; very little of the benefit ever reached consumers. But an METB of that magnitude is confusing. Instead, it may make more sense to use the economic cost as the denominator, so that an METB of 40 percent would be stated as a friction loss of 28 percent ( $\$0.40/\$1.40$ ). Then in those cases where rent-seeking and other inefficiencies consume most or all of the intended transfer, we would present that as an METB (or frictional loss) of 100 percent, rather than infinity. This will avoid confusion, and will make it easier to account for deadweight losses across a range of different fiscal and regulatory contexts.

### **Responses to Specific Topics**

In its request for comment, OMB sought input on eight specific questions about the use of METB. I have reproduced the questions below, and offered some answers.

*Q1: Of the range of available METB scaling factors (25% per Circular A-94, 50% per the 2019 Economic Report of the President, etc.), which estimate should be highlighted as primary? Does one rule of thumb suffice across regulations and agencies? Should the same METB scaling factor be applied for impacts experienced by federal, state and local governments? How might context, such as deficit spending vs. balanced budgets, affect the choice of an METB estimate?*

Estimates in the economic literature suggest that Circular A-94's METB of 25 percent is too low, and that most western democracies tend to have an METB closer to 40 percent. Circular A-94 should be revised to reflect the most recent empirical research. It does make sense to use a single METB across all spending programs that draw from the federal treasury. But exceptions should be made for programs that have a different source of funds, such as the user fees for navigation improvements discussed above.

State treasuries face a different set of constraints, and their fiscal situation (evidenced, e.g., by bond ratings) can vary. In theory, one could use an METB that varied for each fiscal entity. There is some precedent for this. As a Virginia official in 1997, I drafted regulations governing grants from the Commonwealth's Water Quality Improvement Fund (WQIF). Those regulations required localities that did not meet their pollution-reduction commitments to repay their grants, with interest, back into the Fund. Another state agency had already assessed the fiscal condition of localities and assigned appropriate interest rates, so the WQIF regulations used those same interest rates to calculate the amount of the required repayment. Note, however, that those varying interest rates were not designed to capture the risk or the excess burden associated with each locality; rather, they were designed to give fiscal relief to localities that were under particular stress. The lesson I would draw from this precedent is that any attempt by OMB to assign different METBs to different states and localities would likely get entangled in arguments about the implications of those numbers, from many different perspectives other than that of simply giving an accurate accounting of costs.

Therefore, I would advise against assigning different METBs for each state and local government. Given that all are drawing from the same tax base, and given the degree of fiscal interdependence across levels of government, it seems a reasonable approximation to apply the federal METB to state and local expenditures as well.

It is worth exploring whether the METB might be adjusted from time to time to account for the nation's fiscal condition, but this is a complex topic. When the deficit is large, for example, should the METB be raised (like a shadow price) to reflect the scarcity of revenue? Or should it be lowered to reflect the countercyclical benefits of federal spending? For now, I would suggest that the safest bet is to keep the METB stable until there is a better theoretical and empirical foundation for a number that varies.

*Q2: Agencies implement, often on a yearly basis, very large spending amounts associated with statutory programs that may overwhelm the impacts currently tracked through E.O. 13771 (which to date has primarily focused on private sector mandates). Only including discretionary changes may usefully focus agency deregulatory efforts where they have discretion. On the other hand, the omission of statutorily mandated METB costs would be inconsistent with the handling of other categories of costs already included in E.O. 13771 accounting. If METB is included in E.O. 13771 accounting, should only the portion associated with agency discretion be included, or should the statutorily-mandated portion be included as well? If inclusion is limited to*

*discretionary METB, what general guidance can be provided in cases where there is ambiguity regarding the extent of agency discretion?*

In regulatory analysis, the general practice is to analyze all the costs and benefits, regardless of whether they arise from statutory mandates or discretionary factors. Similarly, when sensible alternatives exist they should be included in the regulatory impact analysis (RIA), even if they are not authorized under the statute. The reason is that RIAs are meant to inform not only the cognizant agency and OIRA, but also the public, the Congress, and the courts. Similarly, aggregated reports like the E.O. 13771 accounting can help guide Congress as it makes prospective legislative decisions about spending and regulatory programs.

A prerequisite, however, is the consistent use of METB in the fiscal budget. It will not be possible to construct an internally consistent EO 13771 accounting without that. METB costs are incurred whenever expenditures are made, whether because of some regulation, a spending decision, some military action, a treaty obligation, or whatever. It would be misleading to suggest that METB distortions are only associated with regulatory actions.

*Q3: What guidance can OMB provide to agencies to facilitate assessment of the portion of compliance costs or costs savings that are experienced by the government and that are manifested as budget changes?*

On this question, I want to offer just one caveat about the different ways that governments look at cost accounting. The following illustration demonstrates the importance of clear guidance for instructing agencies on how to attribute cost estimates to regulatory requirements.

As an EPA official in 2007, I was asked to mediate a dispute between the agency and the Environmental Council of the States (ECOS). EPA's enforcement office had found that there were chronic compliance problems with certain types of regulated facilities, but only in certain states – those states that inspected the facilities less often than biannually. So the agency issued a rule requiring states to inspect at least once every two years. A few states had to increase the frequency of inspections, and EPA counted those added expenses as a cost. But most states had been inspecting annually and, after the rule was issued, reduced the frequency of their inspections. This entailed an even greater reduction in costs, which EPA applauded but did not take credit for in its RIA. Fast forward a few years, when ECOS did a retrospective study of compliance costs. All of the states now pointed to the EPA rule requiring biannual inspections, and counted the full cost of performing those inspections as a federally mandated cost. This resulted in a much higher cost than EPA had estimated in its RIA. Was EPA's cost estimate biased? Clearly, these are two different types of cost estimate, using different baselines. EPA quite properly used the *status quo ante* (i.e., with no requirement for inspections) as the baseline for the benefit-cost analysis of its rule. And the states used a very different cost accounting, which is what you would expect of state officials attributing budget costs to different federal requirements.

I offer this example just to illustrate that the attribution of costs to regulatory requirements can get very complex and contentious, and OMB will need to give clear guidance to the agencies.

*Q4: Should OMB supplement our guidance for standardizing E.O. 13771 accounting, particularly on time horizons (currently required to be perpetual), to help extrapolate from the shorter time periods often used for budget spending analysis?*

Yes, OMB should supplement the guidance for standardizing E.O. 13771 accounting. For some suggestions, see a paper<sup>4</sup> by some of my colleagues at the GW Regulatory Studies Center.

*Q5: Should accounting changes (if any) be phased in, with METB immediately included for rules both proposed and finalized after any revision of the E.O. 13771 implementation guidance and omitted for rules previously proposed (but finalized relatively soon after guidance revision)?*

It may make sense to phase in the broader application of METB. I would suggest that the place to start is with a fuller accounting of deadweight losses in the fiscal budget. With respect to regulations, it may not make sense to start with E.O. 13771 accounting, but with E.O. 12866 accounting – that is, agencies should first be encouraged to use the METB in their RIAs. That will allow the full costs and benefits to be taken into account as regulatory decisions are made. Aggregate accounting in the 13771 reports will then be easier if the agencies have already addressed the METB in their RIAs.

*Q6: Given that regulations can address both collection of government revenue (e.g., rulemaking by the Internal Revenue Service) and government spending, should double-counting be a concern in the presentation of government-wide aggregate E.O. 13771 results? Are there accounting options that might help mitigate such concerns?*

Yes, it is important to avoid double counting. As indicated above, I believe it makes sense for the IRS and OIRA to make specific estimates of the METB for each important IRS rule, focusing on what the effect – positive or negative – of the proposed change is. In contrast, we should use a uniform METB for expenditure decisions and regulatory analysis. When results are aggregated, the METB should be attributed to the programs that spend funds, rather than to the IRS.

Note that it is not possible to avoid double counting entirely. For example, the sum of the METBs for all expenditures will overstate the excess burden for the budget as a whole, because the average burden is lower than the marginal burden (assuming the tax system has rising marginal costs). Nonetheless, since budget and regulatory decisions are made one at a time, it is correct to use the METB in the analysis of any particular spending decision or regulation. OMB

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<sup>4</sup> See, Bridget C.E. Dooling, Mark Febrizio, and Daniel R. Pérez, “[Accounting for regulatory reform under Executive Order 13771](#),” Brookings Institution, *Series on Regulatory Process and Perspective*, November 7, 2019.

should simply include caveats about how to interpret aggregate numbers, such as those that appear in the 13771 accounting.

*Q7: To what extent are there unintended consequences—for example, the shifting of implementation of federal spending programs from notice-and-comment rulemaking to less transparent options—that should be considered in regard to the potential inclusion of METB in E.O. 13771 accounting?*

These distortions should be minimized if OMB is scrupulous and consistent about applying the METB consistently across both spending programs and regulatory programs.

*Q8: Because empirical estimates of METB reflect the amount of distortion existing in the markets where federal revenue is collected—especially the labor market—it may be possible to use METB estimates as inputs into the estimation of deadweight loss (DWL) changes associated with interventions in those markets. For example, if transfers between employers and workers can be quantified as an impact of a minimum wage regulation and relevant labor supply and demand elasticities are known, then via relatively simple algebra, METB’s DWL-to-transfer ratio can be transformed into a minimum-wage DWL-to-transfer ratio and the deadweight loss (or DWL reduction) attributable to the regulation can be estimated. Although the employer-worker transfers would be (and are) omitted from E.O. 13771 accounting, the DWL changes would be included. Beyond this example, how can the METB concept be used to foster innovation in quantifying the distortionary costs experienced in the markets directly affected by regulations (e.g., labor markets)?*

Conceptually, this is correct. And it is similar to what EPA does when it uses “benefits transfer” – i.e., it takes an empirical estimate of environmental benefits in one context and applies it, with appropriate adjustments, in a novel context. At the risk of introducing some confusing terminology, one might call this a “cost transfer.” For another example, see the RFS program discussed above.

## **Conclusion**

It is important to keep in mind that the primary use of benefit-cost analysis of regulations is to improve particular regulatory decisions. The development of improved aggregate metrics of economic burdens should be considered a secondary objective. To this end, OMB’s guidance to the agencies should not simply focus on the construction of a retrospective aggregate analysis, but should encourage them to accurately measure the effects, including METB effects, of the decisions that they are making, at the time that they are making them.