Regulation: Costs, Incentives, and the Need for Reform

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October 2016
SUMMARY

Why does government regulate the private sector seemingly without regard to the significant costs? Not that long ago, the standard answer from an economics perspective would have been that “market failure” existed, and therefore, government must take corrective action. However, improved analytical thinking on the economics of government, coupled with a better understanding of economic history, have provided a more realistic assessment on the costs and effectiveness, or lack of effectiveness, of government’s regulatory undertakings. It turns out that the government failure generated by regulations often turns out costlier than the so-called market failure targeted for correction.

• Hyper-Regulation Under President Obama. Overreaching government regulation is not a recent development. For example, the 1930s, and much of the 1960s and 1970s were periods of heavy government regulation. In recent years, the United States has been caught in another era of active – even hyper-active – regulatory undertakings, especially since 2008.

• The Costs of Regulation. Assorted studies make clear the significant costs imposed by the U.S. regulatory system in terms of lost GDP, costs imposed on small businesses, declining entrepreneurship, reduced job creation, and reduced or restrained investment and productivity. Studies over the past 25 years have consistently found that the cost of regulatory compliance disproportionally affects small firms. Indeed, overly burdensome and complex regulations, along with high costs and uncertainties impact business decisions.

• Regulation Gone Awry: The Great Depression Example. It was long held that excesses of the free market caused the Great Depression, and our economy was rescued by government action. That has changed, with various economists and historians more seriously considering the impact that government activism, including regulation, had in triggering, deepening and extending the Great Depression. Clearly, regulatory costs and uncertainty discouraged investment, hiring and risk taking, thereby undermining recovery. As one economist put it: “New taxes had been imposed, and some were then removed; increasing regulation of businesses had reduced businesses’ ability to act independently and raise capital; and new legislation had reduced their freedom in hiring and employing labor.”

Recent parallels to the Great Depression are unnerving. It’s clear that increased regulation, along with misguided tax increases and other government escapades raised costs, created uncertainty, deepened the 2007-to-2009 recession, and helped make the subsequent recovery one of the worst on record.

• The Incentives to Regulate. Given improved understandings of the costs of regulation, then why do elected officials and their appointees partake in regulatory activism? The answer is the incentives at work in politics and government. For example, few incentives exist for voters to understand the extent and cost of regulation, while incentives are strong for special interests to spend heavily and vote based on the regulatory actions they seek. There is a strong bias among elected officials to regulate, as opposed to taking other types of action or no action at all. Also, significant incentives for government bureaucrats exist to
expand agency goals, and push for larger budgets, increased power and control, and bigger staffs.

- **Institutional Reforms Needed.** What can be done to correct this bias towards regulation? Unfortunately, under the current incentive structure, any positive gains from deregulation, for example, almost seem destined to be short-lived. Instead, institutional and constitutional limitations, or checks and balances, are needed to achieve greater balance when it comes to imposing regulations. These include:

  * **Improving Analysis of Regulatory Impacts on Small Businesses.** Regulatory agencies should be required to examine not just regulations’ direct economic impacts on small businesses, but also their indirect effects, such as higher energy and commodity prices that can result from onerous rules. Regulators must also seek the input and feedback of small businesses at the very start of rulemakings, and all agencies should be required to engage with the small business community during the rulemaking process.

  * **Independent Congressional Regulatory Analysis.** Rather than relying on analyses from the Office of Management and Budget or agencies themselves, Congress needs an independent means to analyze rules and regulations, such as subjecting them to rigorous cost-benefit analysis, especially for the consideration of regulatory legislation, and for purposes of evaluating existing rules and regulations.

  * **Congressional Approval of Rules and Regulations.** Given that Congress has incentives to pass regulatory measures, but leave the actual details of creating and imposing rules, mandates and regulations to agency bureaucrats, the system amounts to regulation without representation. It is critical to establish full responsibility for regulating to Congress. Therefore, before being finalized and imposed, all rules and regulations – at least “major rules” - should be subject to votes in Congress.

  * **Sunsetting Rules and Regulations.** All new and existing rules and regulations should have a definitive lifespan, so that Congress is required to re-evaluate regulations after a certain period of time.

  * **Greater Use of Formal Rulemakings.** For rules that impose significant costs to the economy, federal agencies should be required to engage in so-called “formal rulemakings.” These are similar to court proceedings, in which bureaucrats, and the scientific and other economic claims they invoke, are scrutinized and cross-examined by opposing parties.

  * **Strengthening the Integrity of Scientific Data and Increasing Transparency.** Agencies such as EPA should be required to publicly disclose any scientific studies or data used to justify a federal rulemaking before it can be proposed, disseminated, or finalized. Agencies should ensure that such studies are the best available and their conclusions fully reproducible.

  * **Regulatory Budget.** More information and greater transparency regarding federal regulations is desirable, and a regulatory budget, if properly done, could be a tool to achieve such goals.
Supermajority Votes. Given the costs of regulatory burdens on businesses, entrepreneurs, workers, and investors, requiring a supermajority vote (such as 60 percent in each chamber of Congress) to pass bills imposing major regulations on businesses, entrepreneurs and investors would be a check on the bias to regulate.

INTRODUCTION

Why does government regulate the private sector? Or, perhaps the more relevant question is: why does government regulate the private sector seemingly without regard to the numerous and significant costs?

At one time – indeed, not that terribly long ago – the standard answer from an economics perspective would have been that some kind of “market failure” existed, and therefore, government must take corrective action, thereby increasing or even maximizing social welfare.

The underlying assumption was that regulation would improve matters. The idea and possibility of “government failure” rarely, if ever, entered into the equation for many economists, not to mention for far too many politicians.

Fortunately, improved analytical thinking on the economics of government and government action, coupled with a better understanding of economic history, have provided a more realistic assessment on the costs and effectiveness, or lack of effectiveness, of government’s regulatory undertakings. Quite simply, it turns out that the government failure generated by regulations often can turn out to be costlier than the so-called market failure that the regulations are meant to correct.

As we shall see, even though the costs of government over-regulation, or misguided regulation, are substantial, political and governmental incentives still favor increasing regulation, and therefore, institutional reforms are needed to correct for this pro-regulation bias.

HYPER-REGULATION UNDER PRESIDENT OBAMA

Overreaching government regulation is not a recent development. For example, the 1930s (as we shall see), and much of the 1960s and 1970s were periods of heavy, activist government regulation. In recent years, the United States has been caught in another era of active – even hyper-active – regulatory undertakings, especially since 2008.

For example, in the latest edition of “Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State,” published in May 2016, Clyde Wayne Crews Jr. explained that the Federal Register serves as government’s “depository of all proposed and final federal rules and regulations,” and its number of pages has long served as a rough measure of the scope of federal regulation. That being the case, Crews pointed out, “Of the seven all-time high Federal Register page counts, six have occurred during the Obama administration.” In fact, the Obama administration has been particularly activist when it comes to “economically significant” rules,
that is, those imposing an annual cost on the economy of at least $100 million. As noted by Crews, “the overall number of ‘economically significant’ rules in the pipeline during the current administration is considerably higher than earlier in the decade. President George W. Bush started an uptick; President Obama continued it, increasing the flow of costly economically significant rules at the completed and active stages.” And a bit later, it was pointed out: “For completed economically significant rules, the average for Obama’s seven years so far is 67; George W. Bush’s average over his eight years was 49.”

As for a broader regulatory measure, Crews noted: “President George W. Bush’s administration averaged 63 ‘major’ rules (a broader category than ‘economically significant’) annually during his eight years in office. President Obama’s seven years so far have averaged 81, or a 29 percent higher average annual output than that of Bush. Obama has already issued 570 major rules during his seven years, compared with Bush’s 505 over eight years.”

Crews also offered historical data on pages in the Federal Register (again, a measure of regulatory activity) going back to the mid-1930s. It is worth noting that immediately after World War II, the adjusted page count declined, and then rose slightly but unevenly in the 1950s. It increased notably in the 1960s (nearly doubling on an annual basis when comparing the late 1950s to the late 1960s), and then exploded in the 1970s. For example, the annual page count more than tripled from 1970 to 1980. During the 1980s, there was a sizeable decline – a drop of nearly a third. That was the only extended period of sizeable declines in Federal Register pages post-World War II. Since 1990, the page count has risen notably, though unevenly, with a noteworthy move up post-2009.

Again, the Obama years have been a period of high regulatory activity.

James L. Gattuso and Diane Katz noted in a May 2016 Heritage Foundation report (“Red Tape Rising 2016: Obama Regs Top $100 Billion Annually”): “The number and cost of federal regulations increased substantially in 2015, as regulators continued to tighten restrictions on American businesses and individuals. The addition of 43 new major rules last year increased annual regulatory costs by more than $22 billion, bringing the total annual costs of Obama Administration rules to an astonishing $100 billion-plus in just seven years.”

Looking ahead, it was reported: “The 2015 regulatory surge could be exceeded in 2016 if the Administration fulfills its regulatory agenda—in which more than 2,000 rules are either in the proposal stage or in the process of being finalized. Of these, 144 are expected to have an impact on the private sector of $100 million or more annually, including yet more energy-efficiency mandates for home and commercial appliances, additional food-labeling requirements, Obamacare requirements, greenhouse gas limits for trucks, and more Dodd–Frank financial regulations.”

Regarding the recent rise in regulation, Gattuso and Katz correctly pointed out: “This unparalleled burden spells a decline in economic freedom, replaced by political influence and gamesmanship—all of which inhibits innovation and investment, increases prices, and limits consumer choice.”
THE COSTS OF REGULATION

Unfortunately, this recent regulatory hyper-activism, on top of decades of rising regulations, translates into sizeable costs being imposed on the economy, including small businesses.

While estimated real costs of federal regulation declined from the late 1970s to the late 1980s,\(^1\) costs have relentlessly increased subsequently. Consider various cost estimates:

- **Lost GDP.** Economists John Dawson at Appalachian State University and John Seater at North Carolina State University looked at the impact of federal regulation on economic growth (“Federal Regulation and Aggregate Economic Growth,” January 2013), and offered some breathtaking findings. They reported: “Regulation’s overall effect on output’s growth rate is negative and substantial. Federal regulations added over the past fifty years have reduced real output growth by about two percentage points on average over the period 1949-2005. That reduction in the growth rate has led to an accumulated reduction in GDP of about $38.8 trillion as of the end of 2011. That is, GDP at the end of 2011 would have been $53.9 trillion instead of $15.1 trillion if regulation had remained at its 1949 level.”

Another study published in April 2016 by the Mercatus Center at George Mason University (authored by Bentley Coffey, Patrick McLaughlin, and Pietro Peretto) looked at the impact that regulations have on investment choices, and therefore, on innovation and economic growth. The authors reported that since 1980, the cumulative effects of regulation slowed the real economic growth rate in the U.S. by 0.8 percentage points per year. If regulation had been held at 1980s levels, the U.S. economy would have been $4 trillion, or 25 percent larger, than it was in 2012. That translated into the loss of $13,000 per capita.

- **Annual Regulatory Cost.** In the 2016 edition of “Ten Thousand Commandments,” Crews reported, “Based on federal government data, past reports, and contemporary studies, this report highlights regulatory compliance and economic impacts of federal intervention of $1.885 trillion annually.” That equals 11 percent of U.S. GDP.

- **Small Business Costs.** In a September 2014 study titled “The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business,” written by economists Nicole V. Crain and W. Mark Crain and published by the National Association of Manufacturers, it was reported, “U.S. federal government regulations cost an estimated $2.028 trillion in 2012 (in 2014 dollars), an amount equal to 12 percent of GDP… Considering all federal regulations, all sectors of the U.S. economy and all firm sizes, federal regulations cost just less than $10,000 per employee per year in 2012 (in 2014 dollars). Small firms with fewer than 50 employees incur regulatory costs ($11,724 per employee per year) that are 17 percent greater than the average firm. The cost per employee is $10,664 for medium-sized firms and $9,083 for large firms. These estimates are consistent
with prior studies completed during the past 25 years, which have shown that the
cost of regulatory compliance disproportionately affects small firms.”

Regarding those earlier studies, it was noted: “This study seeks to update previous
estimates of the comprehensive cost of federal regulation. Since 1992, the U.S.
Small Business Administration’s (SBA) Office of Advocacy has commissioned
four studies to examine the impact of federal regulations on small firms. As part
of the analysis required to estimate this impact, total regulatory costs were
estimated. The most recent study issued in 2010 estimated the total costs at $1.91
trillion in 2008 (in 2014 dollars).”

In “The Impact of Regulatory Costs on Small Firms” (U.S. Small Business
Administration, Office of Advocacy, September 2010), economists Crain and
Crain reported: “Thomas Hopkins (1995) estimated annual federal regulatory
costs to be $777 billion. Mark Crain and Thomas Hopkins (2001) estimated the
annual costs to be $876 billion (both numbers are converted here to 2001
dollars…). More recently, Crain (2005) estimated the annual costs to be in excess
of $1 trillion (again in 2001 dollars).”

**Lost Entrepreneurship and Jobs.** In a September 2015 study titled
“Regulating Away Competition: The Effect of Regulation on Entrepreneurship
and Employment,” economists James Bailey and Diana Thomas found that
“more-regulated industries experienced fewer new firm births and slower
employment growth in the period 1998 to 2011. Large firms may even
successfully lobby government officials to increase regulations to raise their
smaller rivals’ costs” and that “regulations inhibit employment growth in small
firms more than in large firms.” Specifically, they concluded, “We find that a 10
percent increase in regulation leads to a 0.5 percent reduction in new firm births
and a 0.9 percent reduction in hiring. Over the period 1998 to 2011 that we study,
RegData shows that the overall level of federal regulation increased by 24
percent. Thus, our results suggest that from 1998 to 2011, increased federal
regulation reduced the entry of new firms by 1.2 percent and reduced hiring by
2.2 percent.”

**Lost Productivity.** In a July 1996 study (“Federal Regulation’s Impact on the
Productivity Slowdown: A Trillion-Dollar Drag,” Center for the Study of
American Business, July 1996), Dr. Richard Vedder estimated that rising
regulations between 1963 and 1993 explained almost half of the nation’s
slowdown in long-run productivity over that period, that is, annual productivity
growth would have been 1 percentage point higher if regulations had remained at
1963 levels, and as a result, by 1993, GDP would have been $1.27 trillion higher.2

**Lost Investment and Growth.** In a cross-country study of economic
performance and regulation, economist John Dawson found “a statistically
significant negative relationship between a broad measure of regulation and
[economic] growth. Similar results are found when measures of credit market and
business regulations are used.”

In addition, “Regulation is also found to be statistically significant in explaining cross-country rates of private and public investment. More regulation is negatively related to private investment and positively related to government investment. These results, combined with those from the growth regressions, suggest that reducing regulation has a positive impact on growth…” For good measure, Dawson looked at the issue of regulatory uncertainty. He reported that “uncertainty in the regulatory environment has a negative impact on growth.” Summing up, Dawson explained, “The combined effect of reducing both the level and volatility of regulation is estimated to be 20 percentage points on growth rates over a 20-year period. Thus, a policy of steadily reducing regulation and then maintaining a stable regulatory program appears to be optimal with respect to promoting future economic growth.”

Beyond or supporting such studies are surveys of small business owners that make clear the significant and real burdens of regulation. For example, Babson College released The State of Small Business in America 2016 survey in June 2016. Part of that survey focused on regulatory costs. Consider how small business owners deal with regulation:

- “At the highest level, nearly 60% of survey respondents identify some level of difficulty understanding and managing government regulations and laws that affect their businesses. Less than one fifth of respondents cite that it is easy to understand and manage government regulations and laws, and just under a quarter are neutral.”

- “Most respondents manage this responsibility in-house, which puts the time burden directly on the business. For the vast majority of all respondents, the owner is primarily responsible for dealing with regulatory issues, with the office manager being a distant second at just over 10%, and less than 10% utilizing outside resources.”

- “How do small business owners learn about regulations? Of all the respondents, nearly two-thirds rely on a professional advisor (e.g. attorney or accountant), with just less than half relying on trade associations, and just over a third searching the internet. This is followed by about 15% of respondents using their local Chambers of Commerce and SBA program offices.”

In terms of particular regulatory areas, it was reported that the tax system ranks as “the regulatory area about which survey respondents acknowledge the highest concern for the impact on their businesses,” with the minimum wage being “another hot topic for businesses.” Consider that more than 80 percent of those paying the minimum wage agreeing that a minimum wage increase would negatively impact their business. Also, 40 percent of respondents said that healthcare regulations negatively affect profitability.

This survey made clear that small business owners see regulation as overly burdensome, and that regulatory costs and uncertainties impact business decisions.
In the end, regulations raise the costs of and create uncertainties for investment, business and entrepreneurship, thereby restraining critical risk taking, along with productivity, economic growth and job creation. In turn, the wages and incomes of workers and families suffer. And in contrast, deregulation and greater regulatory certainty are clear positives for the economy.

THE HISTORY OF REGULATION: THE GREAT DEPRESSION EXAMPLE

In recent years, various historians have acquired a far better understanding of the impact of regulation on the economy. That has been most importantly the case when assessing the Great Depression.

It was long and widely held that excesses of the free market caused the Great Depression, and therefore, our economy and the nation were rescued subsequently by government action, that is, by President Franklin Delano Roosevelt’s New Deal, including increased government controls via regulation. This supposedly was the classic case of “market failure” being rectified by government action, and really has served as part of the foundation for subsequent decades of extensive regulation. Unfortunately, much of the history of that period was initially written by advocates of the New Deal, who not only failed to understand the economics at work, but also turned out to be guilty of extending the politics of the era onto the pages of history.

That has changed, with various economists and historians more seriously considering the impact that government activism, including regulation, had in kicking off, deepening and extending the Great Depression.

Economist Robert Higgs has focused on the role of “regime uncertainty” in producing the Great Depression, the worst economic period in U.S. history. He defines “regime uncertainty” as business people being “distressed that investors’ private property rights in their capital and the income it yields will be attenuated further by government action. Such attenuations can arise from many sources, ranging from simple tax-rate increases to the imposition of new kinds of taxes to outright confiscation of private property. Many intermediate threats can arise from various sorts of regulation, for instance, of securities markets, labor markets, and product markets.”

Higgs went on to explain:

“Despite the encroachments of taxation, regulation, and other government action at all levels that had been occurring for half a century or more…, as late as 1932 businesspeople in general and investors in particular remained—certainly in retrospect—relatively free of major threats to the prevailing regime of private property rights.

“Then, during the next two presidential terms, the Roosevelt administration proposed and Congress enacted an unparalleled outpouring of laws that significantly attenuated private property rights… As financial economist Benjamin Anderson…, an astute contemporary observer, remarked, ‘The impact of these multitudinous measures—industrial, agricultural, financial, monetary, and other—upon a bewildered industrial and financial community was extraordinarily heavy.’
Higgs added at another point:

“…[G]iven the unparalleled outpouring of business-threatening laws, regulations, and court decisions, the oft-stated hostility of President Roosevelt and his lieutenants toward investors as a class, and the character of the antibusiness zealots who composed the strategists and administrators of the New Deal from 1935 to 1941, the political climate could hardly have failed to discourage some investors from making fresh long-term commitments.”

Higgs also pointed to polls showing that the general public and business executives understood the link between the poor economy and misguided public policies at the time:

“In the spring of 1939 a nationally representative poll by the American Institute of Public Opinion (AIPO) asked: ‘Do you think the attitude of the Roosevelt administration toward business is delaying business recovery?’ In March, 54 percent said yes, 26 percent no, and the rest had no opinion. In May, 53 percent said yes, 31 percent no, and the rest had no opinion… In May 1939, Fortune pollsters asked a national sample of business executives: ‘With which of these two statements do you come closest to agreeing? (1) The policies of the administration have so affected the confidence of businessmen that recovery has been seriously held back; (2) businessmen generally have been unjustly blaming the administration for their troubles.’ Of the executives responding, 64.8 percent agreed with the first statement, 25.6 percent with the second, and 9.6 percent said they didn’t know.”

Economic historian Burton Folsom, Jr. added:

“…[M]any leading industrialists of the 1930s openly explained how the president’s efforts to tax and regulate were stifling the nation’s economic expansion. For example, Lammot Du Pont, who revolutionized the textile industry in the 1940s with the invention of nylon, was one of many businessmen who complained about Roosevelt’s policies. ‘Uncertainty rules the tax situation, the labor situation, the monetary situation, and practically every legal condition under which industry might operate,’ Du Pont protested in 1937. ‘Are new restrictions to be placed on capital, new limits on profits? … It is impossible to even guess at the answers.’”

Economist Gene Smiley has summed up the problem with New Deal activism this way: “New taxes had been imposed, and some were then removed; increasing regulation of businesses had reduced businesses’ ability to act independently and raise capital; and new legislation had reduced their freedom in hiring and employing labor.” Smiley also observed: “The 1930s saw a huge expansion of the regulatory powers and activities of the federal government. The door to this expansion had been opened with the passage of the 1887 Interstate Commerce Act to regulate railroads. But its full flowering did not occur until the 1930s when federal regulation was extended to interstate activities in trucking, busing, airlines, radio, power generation and
transmission, oil and gas pipelines, securities exchanges, coal mining, agriculture, and other sectors.”9

Among historians, the realities of the governmental costs that played central roles in the Great Depression have become more widely recognized. For example, historians Larry Schweikart and Michael Allen observed, “Some in the [Roosevelt] Brain Trust rightly perceived that business had been terrorized… Although in the early 1930s American business had supported some of the relief programs to keep from being the scapegoats of the Depression, by late in the decade, the business community feared that even the most radical social and political reorganization was not beyond consideration by the New Dealers.”10

Author Amity Shlaes wrote the following about what caused the Great Depression:

“But the deepest problem was the intervention, the lack of faith in the marketplace. Government management of the late 1920s and 1930s hurt the economy. Both Hoover and Roosevelt misstepped in a number of ways. Hoover ordered wages up when they wanted to go down. He allowed a disastrous tariff, Smoot-Hawley, to become law when he should have had the sense to block it. He raised taxes when neither citizens individually nor the economy as a whole could afford the change… Roosevelt’s errors had a different quality but were equally devastating. He created regulatory, aid, and relief agencies based on the premise that recovery could be achieved only through a large military-style effort… Where the private sector could have helped to bring the economy back – in the arena of utilities, for example – Roosevelt and his New Dealers often suppressed it.”11

Finally, eminent historian Paul Johnson asked an obvious question: Why didn’t the New Deal work better? Referring to both Herbert Hoover and Franklin D. Roosevelt, he noted the possibility “that both administrations, by their meddlesome activism, impeded a natural recovery brought about by deflation: from the perspective at the end of the century, that seems the most probable explanation. The truth is, the recovery was slow and feeble.”12

The economics regarding the costs of regulation are clear. The history of regulation has gained in clarity as well, especially in recent times.

As for recent history, the parallels to the Great Depression are unnerving. That is, it’s clear that increased regulation, along with misguided tax increases and other government escapades (such as bailouts, increased government spending and debt, lack of leadership on trade, and loose monetary policy), by raising costs and creating uncertainty, deepened the 2007-to-2009 recession, and have played key roles in the subsequent recovery being one of the worst on record.

**WHY REGULATE? UNDERSTANDING THE INCENTIVES**
Given improved understandings of the costs of regulation, via both economics and history, then why do presidents, members of Congress and their appointees partake in regulatory activism whereby the costs and burdens of regulation so obviously exceed any possible benefits?

To answer this critical question, one must turn to the public choice school of economics. What is public choice?

Gordon Tullock, a leading public choice thinker, has stated quite simply: “Public choice is a scientific analysis of government behavior and, in particular, the behavior of individuals with respect to government.”

Economists James Gwartney and Richard E. Wagner further explained:

“Public choice, which has now developed to the point where one of its founders, James M. Buchanan of George Mason University, was awarded in 1986 the Nobel Prize in Economics, is often described as representing the application of economic reasoning to politics. Just as economic reasoning holds that people are predominantly self-interested creatures, so public choice holds that political processes are likewise dominated by self-interest… A pivotal implication of public choice scholarship is that political outcomes will depend importantly on how political institutions and constitutional rules influence the incentives people face and not just on who in particular is elected or appointed to political office.”

It was James M. Buchanan who captured the essence of public choice economics, as opposed to the study of political science, by referring to public choice as “politics without romance” or “government without the romance.” That is, while political science, in many ways, remains trapped in the fiction that market failure can always be solved by government action, public choice looks at the actual incentives at work in politics and government, including the incentives at work for voters, politicians, government appointees and special interests. It turns out that the incentives in politics and government often lead to wasteful and inefficient government actions, that is, government failure.

In fact, it is the incentives at work in politics and government that answer the question about the continued imposition of regulations that impose excessive costs and burdens.

Consider some key points about the political process that contribute to over-regulation and misguided regulation:

- **Voters.** Since an individual vote is extremely unlikely to decide an election, voters have little incentive to undertake the costs of casting an informed vote. This rational ignorance effect means that most voters will rely on information freely provided by candidates and the media, or many people will simply choose not to vote.

Regulation clearly relates to this issue of rational ignorance, as regulatory costs are largely hidden from the public. Voters clearly have few incentives to do the considerable work of
discovering what regulations are imposed, and what are the cost and economic effects of such regulations.

• **Politicians.** No matter their reasons for running for office, politicians need to attract enough votes to be elected or re-elected. That means, in part, gaining the campaign donations needed for winning elections, which often involves appealing to various special interests. In addition, incentives exist for incumbents to make it more difficult for challengers to be victorious, such as gerrymandering, using taxpayer dollars to aid re-election, and campaign finance reforms that make it more difficult for challengers and other political opponents to raise and/or spend funds on political purposes.

Given this reality, it’s clear that politicians have a bias towards regulating. First, voters can see the negative impact of higher taxes far more clearly than they can the costs of increased regulation. Therefore, there is bias in favor of regulating, whereby politicians can take credit for regulatory actions while leaving it to businesses to figure how to deal with the costs of such regulation, while avoiding the negatives of anger and backlash from voters when taxes are increased. Second, a wide array of special interests provides political support to elected officials and candidates who push their favored regulatory initiatives, ranging from the green movement’s desire for increased environmental regulation, to existing, larger businesses pushing for regulations that would have the effect of undermining or limiting the number of competitors.

• **Government Bureaucrats.** As for government bureaucrats, they have clear incentives to advance and expand their agency’s turf and goals, and therefore, push for larger budgets, increased power and control, and bigger staffs. This effort can be advanced by aligning with the interests of those who provide legislative oversight, and/or aligning with the special interests that support those in political power.

Another set of incentives exists for Congress to pass legislation, and then leave the implementation of the details to the bureaucrats. This allows elected officials to take credit for passing regulatory initiatives, while blaming bureaucrats and agencies if regulation goes awry. These incentives can work to the substantial advantage of those favoring increased regulation.

• **Special Interests.** The benefits from the governmental actions sought by special interests often are concentrated for a select few, while at the same time imposing higher costs on the general public and economy. Special interests have every incentive to spend heavily as they accrue clear benefits, while the wider public, such as consumers or taxpayers, have few incentives to expend the dollars and time to counter a particular issue given the dispersed nature of the costs. Also, voters might be unlikely to toss out elected officials supporting a costly special interest issue since each candidate for office offers a bundle of policy positions, not simply the special interest issue. Meanwhile, elected officials have a strong incentive to support special interests in order gain valuable political support. Again, the bias towards increased regulation is clear.

• **Shortsightedness Effect.** The shortsightedness effect in politics provides an incentive for elected officials to take actions that offer high-profile, short-term benefits – real or perceived – while downplaying or ignoring costs in the near term and especially over the long run. This plays into the incentive for politicians to take credit for a regulatory action, framing it in the best
possible way, while ignoring the fact that costs will be imposed on businesses, workers and/or the overall economy in the short and long term.

• **Rent Seeking.** The phenomenon of rent seeking involves individuals or groups using government to take wealth from others. When government is open to redistributionist policymaking, and few institutional or constitutional limits on such activities exist, then it will be profitable for individuals or groups to use the government to gain income and wealth. Rent seeking drives many government spending, taxing and regulating activities.

This set of governmental and political incentives – especially those relating to government bureaucrats, special interests, shortsightedness, and rent seeking – makes it clear that even though economics and history make clear that the costs of regulation often are severe for the economy, regulation that raises net costs and does serious economic damage will still persist.

**INSTITUTIONAL REFORMS NEEDED**

So, what can be done to correct this bias towards over-regulation and misguided regulation?

Under the current incentive structure, any positive gains from deregulation, for example, almost seem destined to be short-lived. For example, Congress and President Ronald Reagan worked together during the 1980s to rein in regulatory costs. But that was a unique achievement in recent history, and post-Reagan, the pro-regulation incentives took hold once more, and regulatory activity and costs resumed their growth.

Public choice economists understand that institutional and constitutional limitations, or checks and balances, are needed to achieve greater balance when it comes to imposing regulations. Economists Gwartney and Wagner explained:

> “The challenge before us is to develop political institutions capable of bringing, to the fullest extent possible, the self-interest of politicians, bureaucrats, and voters into harmony with the general welfare of a society. In other words, public choice economists seek to design political structures and procedures capable of directing the political players to serve the general welfare just as Adam Smith’s invisible hand directs market participants to serve the general welfare. With regard to the achievement of this objective, one thing is certain: success rests upon our ability to develop and institute sound rules and procedures rather than on our ability to elect ‘better’ people to political office. Unless we get the rules right, the political process will continue to be characterized by special interest legislation, bureaucratic inefficiency, and the waste of rent seeking.”

Among the possible reforms relating to regulation are the following:

• **Improving Analysis of Regulatory Impacts on Small Businesses.** Regulatory agencies often try to avoid the requirements of the Small Business Regulatory Enforcement Fairness Act (SBREFA), either by simply asserting that a particular rule has no disproportionate impact on small firms, or by seeking end-runs around judicial review when they shirk their legal duty. To
avoid this, the definition of “impacts” on small businesses should be expanded; that is, they should be required to examine not just regulations’ direct economic impacts, but also their indirect impacts, such as higher energy and commodity prices that can result from specific rulemakings (examples include, among many others, EPA’s Clean Power Plan and ozone standards). Moreover, courts should be required to engage in a more searching and rigorous review of agency compliance with SBREFA.

• **Independent Congressional Regulatory Analysis.** Rather than relying on analyses from the Office of Management and Budget or agencies themselves, Congress needs an independent means to analyze rules and regulations, such as subjecting them to rigorous cost-benefit analysis, especially for the consideration of regulatory legislation, and for purposes of evaluating existing rules and regulations. This could be done through the Congressional Budget Office or the GAO, and should be paid for by reductions elsewhere in government spending so as to not create additional tax burdens.

• **Congressional Approval of Rules and Regulations.** Given that Congress has incentives to pass regulatory measures, but leave the actual details of creating and imposing rules, mandates and regulations to agency bureaucrats, the system amounts to regulation without representation. Members of Congress are able to take credit for imposing regulations, and later, if necessary, to blame agencies and bureaucrats if matters go awry.

In a December 2015 report (“Mapping Washington’s Lawlessness 2016 A Preliminary Inventory of ‘Regulatory Dark Matter‘’), Clyde Wayne Crews summarized the extent of this congressional abdication of regulatory responsibility this way:

> “Congress passes and the president signs a few dozen laws every year. Meanwhile, federal departments and agencies issue well over 3,000 rules and regulations of varying significance. A weekday never passes without new regulation. Beyond those rules, however, we lack a clear grasp on the amount and cost of the many thousands of executive branch and federal agency proclamations and issuances, including memos, guidance documents, bulletins, circulars, and announcements with practical regulatory effect. There are hundreds of ‘significant’ agency guidance documents now in effect, plus thousands of other such documents that are subject to little scrutiny or democratic accountability.”

It is critical to establish full responsibility for regulating to Congress. Therefore, before being finalized and imposed, all rules and regulations should be subject to votes in Congress.

• **Sunsetting Rules and Regulations.** All new and existing rules and regulations should be sunsetted, so that Congress is required to re-evaluate regulations after a certain period of time. For example, a regulatory measure may have become obsolete due to changes in technology, or transformations of industries. In addition, the basic efficacy of any regulation needs to be periodically reviewed to eliminate or reform regulations that have become outdated, proven ineffective, and/or imposed excessive burdens. Setting a sunset date on regulatory measures makes sense as a check against outdated, inefficient regulation serving as a drag on the economy.
• **Greater Use of Formal Rulemakings.** For rules that impose significant costs to the economy, federal agencies should be required to engage in so-called “formal rulemakings.” These are much more intensive, detailed, and rigorous than the usual “informal” process, which simply involves notice and comment on proposed rules. Instead, formal rulemakings are similar to court proceedings, in which bureaucrats, and the scientific and other economic claims they invoke, are scrutinized and cross-examined by opposing parties. By the same token, the standard of review for courts is far more stringent than what obtains for informal rules, where courts simply defer to agency interpretations of law, so long as they are “reasonable.”

• **Strengthening the Integrity of Scientific Data and Increasing Transparency.** Far too often, government agencies rely on scientific information that lacks rigor and appropriate peer-review. Moreover, agencies often hide shoddy data from public view. As a result, “science-based” regulations often impose enormous costs with little or no meaningful benefits. Agencies such as EPA should be required to publicly disclose any scientific studies or data used to justify a federal rulemaking before it can be proposed, disseminated, or finalized. Agencies should ensure that such studies are the best available and their conclusions fully reproducible.

• **Regulatory Budget.** More information and greater transparency regarding federal regulations is desirable, and a regulatory budget, if properly done, could be a tool to achieve such goals. A regulatory budget would provide an accounting of the annual costs and benefits of all federal regulation, along with additional information of regarding the effectiveness of regulations. The challenge of a regulatory budget, however, is to break away from the incentives for government bureaucrats and agencies to minimize the reported costs and maximize the presumed benefits of regulation. But if a legitimate, independent regulatory budget were established, it could serve as a valuable check on the pro-regulation bias by, for example, having Congress set a cap on the regulatory budget, with costs having to be distributed among agencies and efforts.

In a 1996 study, Clyde Wayne Crews summed up the potential benefits of a regulatory budget: “Regulatory costs imposed on the private sector by federal agencies can never be precisely measured, and a budget cannot achieve absolute precision. Nonetheless, a regulatory budget is a valuable tool. The real innovation of regulatory budgeting is its potential to impose the consequences of regulatory decision making on agencies rather than on the regulated parties alone… Budgeting could fundamentally change incentives. Under a budget, adopting a costly, but marginally beneficial, regulation will suddenly be irrational. Congress would weigh an agency's claimed benefits against alternative means of protecting public health and safety, giving agencies incentives to compete and expose one another's 'bogus' benefits. Budgeting could encourage greater recognition of the fact that some risks are far more remote than those we undertake daily.”

• **Supermajority Votes.** Given the costs of regulatory burdens on businesses, entrepreneurs, workers, and investors, requiring a supermajority vote (such as 60 percent in each chamber of Congress) to pass bills imposing major regulations on businesses, entrepreneurs and investors would be a check on the bias to regulate. This is aligned with proposals to require supermajority votes to impose tax increases, given that regulatory costs are just as real and costly as tax increases to businesses, consumers and the economy.
RESTORING CHECKS AND BALANCES

The U.S. Constitution is rooted in Madisonian principles of limitations, and checks and balances on governmental powers. Public choice economics is rooted in the same principles, and makes clear the need for institutional and constitutional limitations on the power to regulate. The goal of regulatory reform is not to blindly slash regulations – especially given that many regulations have provided clear benefits for the nation – but to bring balance to the regulatory equation, and to limit or check the clear biases that exist, again as both public choice economics and history have shown, to regulate no matter the many and often sizeable costs.

About the Author


About the Small Business & Entrepreneurship Council

The Small Business & Entrepreneurship Council (SBE Council) is a nonprofit advocacy, research and education organization dedicated to protecting small business and promoting entrepreneurship. For nearly 25 years SBE Council has worked to advance policies and initiatives that strengthen the ecosystem for healthy startup activity and small business growth. Our strength and effectiveness are powered by 100,000 members and supporters. This network of supporters, including entrepreneurs and small business owners, state and local business organizations, corporate partners and associations work with SBE Council to strengthen entrepreneurship, investment, innovation and quality job creation.

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