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REGULATORY ACCOUNTING

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Testimony of Susan E. Dudley

Director, Regulatory Studies Program,
Mercatus Center, George Mason University
Adjunct Professor, George Mason University School of Law[1]

Chairman Ose and Members of the Subcommittee, thank you for inviting me to testify on the important issue of regulatory accounting.

American citizens generally know how much they pay in taxes each year. But taxes, and subsequent spending, are but one way the federal government diverts resources from the private sector to accomplish its goals. The other is through regulation of private entities – businesses, workers, and consumers. While taxes, and associated spending, are tracked annually through the fiscal budget, there is no corresponding mechanism for keeping track of the off-budget spending accomplished through regulation.

The annual "Regulatory Accounting Reports" required by Congress represent an important step toward tracking these off-budget taxes and expenditures. These reports can be valuable, not only for informing Americans generally about the costs and benefits of regulation, but also for helping policy makers allocate limited resources to those activities that provide the greatest net benefit to American citizens.

The annual reports could be integrated more fully into the fiscal budget process.

A better understanding of regulatory performance and results will help appropriators allocate budgets toward those agencies and activities that produce the greatest net social benefits. Studies reveal that a reallocation of current spending from lower risk to higher risk hazards could greatly increase the life-saving benefits of regulations designed to reduce health and safety risks and achieve other social goals. If agencies and Congress better understand the benefits and costs of different programs, they can then assess how to reallocate resources from initiatives that are less effective to those that are more effective.

[1] These remarks do not represent an official position of George Mason University.

Congress and the Executive branch must always consider, implicitly if not explicitly, the costs and benefits of different programs as part of the budget process. Just as integrating Government Performance and Results Act measures into the fiscal budget process shows promise for improving accountability and outcomes, integrating OMB's Regulatory Accounting Report will allow policymakers and appropriators to allocate our nation's resources more efficiently and effectively to achieve greater benefits from our regulatory programs.

Comments on 2004 draft report

I strongly support efforts by OMB and the respective agencies to assess regulatory costs and benefits, and am encouraged by the transparency with which OMB has presented the regulation-by-regulation estimates back to 1993. I also found the literature review and discussion of the relationship between regulation, freedom, and economic growth interesting and valuable. However, 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.

The 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.

These figures will be reported in the press without caveat, even though 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."[2]

I have several concerns with the reported estimates.

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 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

[2] Draft Report 2004, p. 6.

rule has an annual impact of $100,000,000 or more,[3] 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 $3.1 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. The value forgone when resources are thus redirected represents real costs to society, which economists refer to as "deadweight losses" or "excess burdens." 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 real resource costs.[4] OMB should investigate and report these costs.

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 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 impose some discipline on agencies' estimates of 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

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[3] 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.

[4] Gordon Tullock. "The Welfare Costs of Tariffs, Monopolies and Theft" *Western Economic Journal*, 5, pp. 224-232. (1967).

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.

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

EPA's estimates of the benefits and costs of its 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.[5] 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.[6]

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

Conclusions and Recommendations for Improving Regulatory Accounting

In conclusion, for over thirty years, the White House has maintained, in one form or another, a centralized mechanism for executive branch oversight of regulations issued by federal agencies. President Clinton's Executive Order 12866 and legislative initiatives over the last decade have continued this tradition, reinforcing the philosophy that

[5] 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.

[6] The Congress needs an accurate picture of the benefits and costs of regulation; not only to evaluate the performance of existing regulatory programs, but also to make important decisions about future legislation. 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 in 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.

regulations should be based on an analysis of the costs and benefits of all available alternatives, and that agencies should select the regulatory approach that maximizes net benefits to society, consistent with the law.

These 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.

I have three key recommendations for improving regulatory accounting.

- **OMB can improve the quality of information in future reports by holding agencies accountable for complying with new guidelines.**

First, 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. 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.

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 mean time, 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.

- **A legislative branch review body could provide a more independent assessment of regulatory costs and benefits.**

It is not clear that the Office of Information and Regulatory Affairs, from its location within the Executive branch, is in a position to provide the necessary check or independent assessment of costs and benefits. A Congressional or other outside review body might be in a better position to report benefits and costs honestly and without deliberate bias.

While OMB should continue to enforce the principles of Executive Order 12866 and hold agencies accountable for ensuring proposed regulations do more good than harm, Americans may also benefit from a legislative branch oversight body. Indeed, Congress has authorized a Congressional Office of Regulatory Analysis to be housed in the General Accounting Office, but it has not been funded. Such a body could provide Congress and U.S. citizens with an independent assessment of the total costs and benefits of regulation, and also help ensure that statutes are being implemented so that the benefits to Americans outweigh the costs.

- **Congress could explore further ways to treat regulatory expenditures in a manner similar to on-budget expenditures.**

An annual Regulatory Accounting Report issued with the federal budget is an important first step toward providing the same scrutiny to regulatory impacts as on-budget impacts. It may be fruitful to explore further the analogy between the budget process and regulatory process. For federal spending to be dedicated, Congress must first authorize an activity, and then appropriate the necessary resources. Regulatory spending (the cost consumers, workers and employers pay to comply with regulatory requirements), on the other hand, is authorized in statute – often in broad terms – with little follow-on action. In fact, regulatory spending is usually authorized in perpetuity, without a clear understanding of the commitments demanded or outcomes received.

As envisioned in H.R. 2432, Congress could explore ways to treat regulatory expenditures in a manner similar to on-budget expenditures, recognizing that regulations, like on-budget federal programs funded by taxes, divert private resources to broader national goals. A more explicit recognition of the expected costs as well as expected benefits of achieving regulatory goals will help policy makers allocate scarce resources to activities that will produce the greatest net social benefit.