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TOPIC GUIDE

1. Agencies should routinely include an estimate of the number and types of jobs likely to be lost as the economy adjusts to the higher prices from regulatory changes.
2. Agencies should focus their economic analysis on the indirect as well as the direct effects of regulatory changes.

THE EMPLOYMENT IMPACT OF REGULATION

By Keith Hall

HONESTLY EVALUATING THE impact of regulation on unemployment is not only in agencies' best interests, it's required by law. In 1993, Executive Order 12866 addressed the employment cost of regulation in the requirement that agencies develop an assessment of "any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a quantification of those costs." This requirement was clarified in 2011 when Executive Order 13563 stated, "Our regulatory system must promote public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation." Most recently, in their [Draft 2013 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities](#) (April 2013), OMB states that "job creation is an important consideration in regulatory review."

Unfortunately, the vast majority of agencies have never estimated the employment effects of proposed regulatory changes. Only recently have just a few agencies included employment effect in their Regulatory Impact Analyses. Even then, the analysis is not well done and the methodologies used sys-

tematically underestimate the employment cost of regulatory changes.

BASIC REASONS FOR REGULATING AND REGULATORY IMPACT ANALYSES

REGULATION CAN PLAY an important role in a market economy where there are significant market externalities, incomplete markets, information asymmetries, or public goods. Ideally, regulation identifies and focuses on correcting these market failures with minimal economic cost.

In practice, regulation often intervenes in markets for other, noneconomic reasons. For example, a regulation may be designed to redistribute income or to guarantee access to certain goods and services, such as health care or education. Here, too, the ideal situation is that goals are met with minimal economic cost.

Empirical work has made it clear that ill-designed regulation can cause significant economic distortions that damage investment and entrepreneurship, reduce competition, lower productivity and economic growth, and raise unemployment. Consequently, there has long been an interest in trying to insure that regulation is implemented when it improves social welfare or achieves the desired noneconomic goals with maximum net benefits or minimum net costs to society.

TYPES OF EMPLOYMENT IMPACT FROM REGULATION

THERE ARE THREE types of employment effects from regulatory changes.

- First, there can be **macroeconomic/dynamic effects** of regulation. This includes regulation's impact on such things as job growth, wage growth, and the long-run levels of unemployment and labor force participation. However, since agency analyses often focus on small regulatory changes, there is seldom a labor market impact large enough to estimate. The risk, then, is that we suffer a "death of a thousand cuts," where hundreds of small changes impose small employment costs individually, but the cumu-

lative effect ends up being quite large. There is no simple solution to this as long as the focus is on small changes rather than an overall evaluation of regulation levels.

- Second, **the reallocation of labor has a long-run effect on the level of output** in the economy. Use of labor resources in less-than-optimal ways due to compliance with regulation results in a reduction in the level of productivity and is perhaps the most fundamental part of the economic cost of regulatory changes.¹ This effect works primarily through higher prices paid by purchasing firms and consumers. Much like a tax, the effects are both direct (affecting prices in the regulated industry) and indirect (affecting prices in industries using the regulated good or service or affecting consumer buying power). This is a primary reason why the economic analysis of regulatory changes should, whenever practical, use multimarket models to fully identify the effects.
- Third, there is the economic cost of **job displacement**. Regulation raises the cost of production, which leads to higher prices and reduced output. This causes job loss in the regulated industry. There is significant literature based on data from surveys from going back to 1968 that demonstrates that the economic cost of job displacement is significant and especially large during economically difficult times. The immediate impact of job loss includes lost wages, job search costs, and retraining costs. Further, research shows that even after reemployment it can take as long as 20 years for workers to catch up on lost earnings, largely due to skill mismatches between the jobs lost and the new jobs created in the economy. These losses occur at different lengths of job tenure, in all major industries, and with workers of any age. Recent estimates of earning losses range from 1.4 years of earnings in times of low unemployment to 2.8 years during times of high unemployment. OMB is finally recognizing the potential importance of this impact and has requested comment on the importance of including these impacts in regulatory impact analyses in the 2013 draft report to Congress cited above.

REGULATORY IMPACT ANALYSES

Particular types of regulatory changes that improve the function of specific markets may yield some positive employment impact, but more often ignoring the employment effects results in an underestimation of the economic cost of regulation.

Most major regulatory agencies that are required to conduct regulatory impact analyses simply ignore employment effects. While it might be true that regulatory changes that improve market function may yield some positive employment impact, regulations far more often have negative employment effects. The true economic costs of regulations are underestimated when agencies ignore these negative employment effects.

This is particularly true for regulated industries that have a broad effect on consumers and the economy and during times when unemployment is high and the economic cost of job displacement is large. Agencies can do much better.

- Agencies should routinely include an estimate of the number and types of jobs likely to be lost as the economy adjusts to the higher prices from regulatory changes. This would be an estimate of the “job displacement” cost of regulation. There is now significant literature showing that these costs are high and agencies should be able to develop methodologies to add these costs into their analyses. Recent estimates put the economic cost at nearly three years of lost earnings for every displaced worker during bad economic times (like now).
- Agencies should focus their economic analysis on the indirect as well as the direct effects of regulatory changes. That is, higher prices from regulation will displace workers in the regulated industry, but many more workers may be displaced indirectly from other industries. For example, the EPA itself estimated that a proposed Toxics Rule would raise electricity prices by nearly four percent, and this would raise

costs of production in at least 19 downstream industries. They did not extend their analysis to the employment effects. If they had, they would have found that 11 additional workers each would have lost a job in a downstream industry for every one worker losing a job in the electrical generation industry.

NOTE

1. This can, of course, be a fundamental reason for regulation if the reallocation of labor resources is correcting a market failure and therefore raising the level of productivity.

Regulation University is a series of educational programs designed for congressional staff to provide the skills and information essential to regulatory oversight and to understand the legal and institutional framework that produces and supports federal regulation. For a complete list of programs, please visit www.mercatus.org.

For more information, please contact **Robin Bowen**, Associate Director of Outreach, Mercatus Center, 703-993-8582 or rbowen@mercatus.gmu.edu.

Keith Hall is a senior research fellow at the Mercatus Center at George Mason University. From 2008 until 2012 he served as the 13th commissioner of the Bureau of Labor Statistics. In this role, he headed the principal fact-finding agency in the federal government in the broad field of labor economics and statistics.

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