



The Regulatory Reform Act of 1995

Testimony Prepared for Presentation to
Committee on Governmental Affairs
U.S. Senate
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Mr. Chairman and distinguished members. Thank you for inviting me to testify on S.291: The Regulatory Reform Act of 1995, particularly Title IV of that act (Market Incentives and Economically Efficient Regulation) and related sections of S.343. I am pleased to provide you with my ideas and judgments on the issues in these bills, from my perspective as a professional environmental economist, based on fourteen years of experience at Resources for the Future (RFF). RFF is an independent, nonpartisan research and educational organization concerning itself with environmental and natural resource issues primarily from the economics perspective. In addition, I have recently served as a senior economist on the Council of Economic Advisors, with primary responsibility for the environmental and natural resource portfolio. While at CEA, I worked on the administration's revision to the Regulatory Impact Assessment Guidance Document (currently in draft form), which is used to implement E.O.12866. I want to emphasize that the views I present today are entirely my own.

Benefit-Cost Analysis

Before turning my attention to Title IV of S.291, I would like to make a few general remarks bearing on the benefit-cost analysis (BCA) provisions of this bill and also S.343. First, I agree with the language in S.343's key decision criteria section (623), i.e., that regulations should be limited to those where benefits exceed costs. Such words are easy to agree with because they are nearly *tautological*. Who would knowingly do anything where the net result was to make a situation worse?

The real issue is *which* benefits and costs have standing. As an economist who performs benefit-cost analyses in this area, and who recently participated in three major studies to estimate the external costs of electricity (see [note 1](#)), I can say with confidence that a surprisingly large array of health and environmental improvements can be quantified and monetized. At the same time, many important effects cannot even be reliably quantified, let alone expressed in monetary terms. Therefore these effects need to be described in qualitative terms instead. Both S.291 and S.343 appear to recognize this situation, although S.343 is less direct in that the definition section omits mention of nonquantifiable benefits. I also appreciate the need to consider equity and distributional effects in designing regulations and that such effects do not fit neatly into a quantitative CBA framework. This is an issue clearly expressed in S.291 but missing in S.343.

Therefore, I urge that these bills grant standing to all potential benefits and costs, whether quantifiable or not and whether they relate to efficiency or equity benefits. Once such standing is granted, I would argue that most of the relevant language in S.343 is

appropriate (and similar in spirit to S.291), i.e., that the agency must show that the regulation delivers benefits "outweighing" costs and that the approach taken to implement the regulation is likely to provide the largest net benefits. Indeed, the administration's Executive Order 12866, *Regulatory Planning and Review*, says the same thing, using the term "justify" rather than "outweigh" to connote that nonquantifiable factors and equity considerations have standing.

Given that agencies are already supposed to do the analyses that S.291 and S.343 would require them to do, and given the perception, which I share, that many agency rules don't appear to pass scrutiny even in the broadest benefit-cost terms that I am arguing for, the key issue is how to get agencies to take these requirements seriously. That is, how do we get them to (i) routinely use BCA (broadly defined) as an input into the design of regulation and not, as sometimes happens now, as an afterthought, and (ii) hire people with the training to do such analyses and fund these activities at levels appropriate to the seriousness of the work. In this regard, I fully support congressional mandates on agencies to do BCA and integrate them into the regulatory design process for new regulations where such analyses would be consistent with the enabling statute. I would also hope that Congress makes funds available to the agencies to perform high-quality benefit-cost analyses.

The issue of how far to take this integration for the majority of statutes—i.e., the statutes where no mention is made of BCA as a decision criterion (the so-called super mandate issue)—is a difficult one. S.343, which would require that BCA "supplement" the decision process unless expressly prohibited by statute, offers no guidance on how this criterion could mesh with, say, the Clean Air Act's health-based (really equity-based) criterion for setting the National Ambient Air Quality Standards (NAAQS) ("protect the public against adverse health effects with an adequate margin of safety"). S.291's language, which would also bar BCA if it would "by necessary implication" be "inconsistent" with the statute, provides little more enlightenment.

Of course, Congress bears much of the responsibility for the lack of agency attention paid to costs and benefits, as most statutes either are silent on the use of BCA or explicitly prevent its use. This situation needs to change and change quickly. However, using a single law to overwrite most existing environmental and natural resource legislation at one stroke poses huge administrative burdens and deprives the American public of the chance to debate the role that BCA should play vis-à-vis the other criteria that have found broad public acceptance in the past. Unless the meaning of "supplement" can be made clear and acceptable to the public, on balance I favor a statute-by-statute approach to rewriting legislation to include the BCA criterion.

Similar arguments also underlie my opposition to the provision in S.343 permitting any previous rule to be opened up to a BCA by petition. Also, this provision would encourage "fishing expeditions" to overturn rules that were implemented according to the provisions of the enabling statute, after appropriate consideration under the Administrative Procedures Act (APA) and due process. Procedures for petitioning agencies to reopen rules on the basis of new information already exist (Section 553(e) of

the APA). Why should agencies be subject to a kind of retroactive liability for their actions that many in Congress believe is so problematic when applied to the private sector under Superfund? In addition, private parties staying out of the fray would be deprived of the regulatory certainty they need to do business.

Market Incentives

Let me now turn to the issues in Title IV of S.291 and the corresponding elements in S.343. Both of these bills charge the agencies to meet environmental and natural resource protection goals at minimum cost, taking the use of market mechanisms much more seriously and deemphasizing use of command-and-control policies. I fully support this effort.

Command-and-control policies dominate the regulation of the environment and natural resources. By command and control, I mean policies that mandate or encourage use of particular technologies, explicitly presuming that government knows better than the private sector how to reduce environmental burdens. Command-and-control policies also include inflexible emissions standards on business that regulate stack-by-stack and pipe-by-pipe rather than view the problem as minimizing emissions from the plant or many plants at least cost. Both types of policies can lock in or, at the least, provide no stimulus to technological changes.

The logic of using economic incentives to meeting environmental and natural resource protection goals has been laid out in countless textbooks and articles. Such incentives provide flexibility to polluters and resource users to find the least-cost ways to meet the policy goal. The profit motive for business and the analogous behavior in individuals provides the motivation. In contrast to command-and-control policies, government is presumed to know less than those in the private sector about the technologies, behavioral options, and other responses that can be taken to minimize the cost of meeting the goal. Economic incentive policies also can make technological change pay in higher profits from using or selling the new technologies.

There is no doubt that we can achieve our environmental goals at lower cost than we do now. There is a very large body of academic studies and real-world evidence to show that the cost savings from use of economic incentive approaches can be substantial. The academic studies indicate savings of 50–80% of the cost of command-and-control policies. To be fair, some of these studies contrast "dumb" command-and-control policies with "smart" incentive policies. In reality, the former policies can be designed to be reasonably cost-effective in situations where the pace of economic and technological change is slow and options for compliance are few. EPA, for instance, has improved its record in targeting command-and-control policies to specific problems needing specific solutions. Also, the economic incentive policies can be difficult to implement, requiring many changes to "business as usual" in enforcement, monitoring, and even the building of new institutions.

However, actual experiences show that the promise of economic incentives is indeed being fulfilled. The SO₂ trading program is the best example. It is ironic that many

environmentalists now embrace this program while some conservatives criticize it, when a few years ago the roles were reversed. The critique is that there have been few trades, which somehow means the program is not working. I would argue that, while few trades is a possible sign of a problem, in this case, it is misleading. One should focus, instead, on the low price of the permits that have been traded (about one-third of the price expected before the program began) and the ways in which utilities have responded to reducing their SO₂ emissions. The low price and other information suggest that utilities have found cheap ways of reducing their emissions, ways that might have been barred to them if alternative types of regulatory approaches had been implemented. By simply being available as a backstop source of emissions, the permit market reduces the risks of trying something new.

The Regional Clean Air Incentives Market (RECLAIM) program, Southern California's program for trading emissions credits to aid compliance with the NAAQSs for ozone and particulate matter (PM-10), is an example of an actual market incentive program with great potential. A recent analysis by a SCAQMD researcher and others suggests that RECLAIM may result in saving \$73 million dollars annually (1993 dollars), or 42% of the command-and-control alternative.

In spite of the promise and success of economic incentive mechanisms, provisions in S.291 and S.343 dealing with incentives receive little attention in the press relative to the cost-benefit and risk assessment portions of these bills, probably because requiring cost-effectiveness is seen as a "motherhood and apple pie" issue. Who can be against the idea of meeting environmental goals at least cost?

Yet, in a very real sense, the best opportunities for reform of federal regulation may lie in mandating consideration of market mechanisms rather than in mandating cost-benefit analysis. Therefore, more attention should be paid to this issue. There are several reasons for this view.

First, the agencies are heading in the direction of market mechanisms anyway but, along with Congress, have historically resisted the idea of setting goals with benefit-cost analysis. There are many examples of increased attention to market mechanisms within the executive branch. E.O.12866 requires agencies to "...identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior..." and to "design its regulation in the most cost-effective manner to achieve the regulatory objective." Some parts of agencies dealing with environmental and natural resource issues are quite progressive in their thinking about incentives. The policy shops of the Department of the Interior, the Environmental Protection Agency (EPA), and the Department of Energy, for instance, are staffed by economists trained to design incentive-based policies and analyze their efficacy and efficiency relative to other regulatory approaches. The Air Office at EPA has embraced the SO₂ trading program and worked hard to make it a success, and considers trading and other incentive programs in a variety of contexts, such as emissions-based registration fees.

In contrast, the agencies' resistance to a fundamental role for benefit-cost analysis is plain in comments by EPA Administrator Browner and other administration officials. This resistance translates to low funding for such activities, with the analyses mandated by E.O.12866 apparently being treated as *pro forma* exercises or even being used to justify a decision made on other grounds.

Second, market mechanisms have the potential for reducing the size of the bureaucracy as responsibilities for deciding on the technologies and other approaches for meeting environmental goals are off-loaded to the private sector. BCA may put increased demands on analytic resources.

Third, market mechanisms can actually be used to reveal the costs of compliance, which then can be used to reevaluate environmental goals. For instance, Title IV of the Clean Air Act required a 50% reduction in SO₂ emissions by electric utilities and created an allowance trading market to provide them flexibility in meeting this goal. The price of SO₂ allowances represents the additional cost of reducing SO₂ emissions by one unit. The market has revealed a price much lower than expected, implying lower compliance costs than expected. Such information would be directly useful in assessing the net benefits of reducing SO₂ emissions in a future evaluation of Title IV.

These comments are not meant to suggest that the agencies are fully embracing market mechanisms. They still lack a *culture of policy efficiency*, by which I mean an automatic teeing up of economic incentive approaches to consider for a regulation in order to help minimize its costs. For instance, the Water Office at EPA, in last year's administration plan for the reauthorized Clean Water Act, put much effort into saving compliance costs through targeting its command-and-control policies better. But, other than offering to study trading approaches, this plan was devoid of incentive policies. Another example is programs to reduce solid and hazardous wastes. Much effort is going into the Resource Conservation and Recovery Act's (RCRA) command-and-control policies to reduce wastes and also into programs for voluntary recycling of wastes and source reductions. Only minor efforts are being made to create and promote economic incentive programs for waste reduction, such as unit pricing of solid wastes to provide incentives for minimizing waste generation. Local attempts to institute unit-pricing policies are being hobbled for lack of information on setting up these programs (such as guidance on rate structures) that a sustained national effort would address.

I am firmly convinced that the lack of attention to these policy tools is not a result of hostility to these ideas. Rather, the de-emphasis comes from old habits in thinking and regulating, vested interests in the current system (including that of business), unwillingness to incur the costs of retooling skills and programs, uncertainty about the performance of such policy mechanisms, and responsibilities to implement existing statutes. Change will not come quickly unless the agencies are forced to make it and unless underlying statutes let them.

Market Mechanism Sections of S.291 and S.343 Compared

The above comments lead me to favor S.291 over S.343. S.291 creates a separate title for considering market mechanisms, rather than the single line in S.343 (Sec. 622(c)(2)(D)), according this issue the significant attention it deserves. S.291 calls for an assessment and the use of market mechanisms unless infeasible or impractical, while S.343 calls only for an assessment of market mechanisms and requires that the chosen approach have the largest net benefits. The former language places a clearer burden of proof on the agency to show why market mechanisms were not used. However, S.291 should be modified to make it clear that whatever approach is chosen achieves the goal at minimum cost or maximum net benefit (again recognizing that benefits be defined very broadly).

Both bills could benefit from the following suggestions:

- (1) Make the threshold cost for performing an assessment of mechanisms lower than for performing a BCA. An assessment of market mechanisms need not place as heavy an analytical burden on agencies as a benefit-cost analysis.
- (2) The types of marketlike or other economic incentive mechanisms should be listed to give a better indication of the mechanisms being recommended.
- (3) Provisions for a peer review process could be developed for reviewing the mechanism assessment (as well as the benefit-cost assessment). In my view, this would be preferable to judicial review because of the high cost and time burden imposed by the legal system and the more direct use of expert opinion in the peer review process.

I thank the Chairman for the opportunity to present these views.