

REGULATIONS

THE MORE IS **NOT** THE MERRIER

BY NAM D. PHAM, PH.D.,
MANAGING PARTNER, NDP | CONSULTING

Government regulation is a double-edged sword. It channels the rule of law and can protect the public from the negative externalities of private economic activities. On the other hand, excessive or poorly-designed regulation deters economic activity altogether. Productive, innovative, competitive economies require smart and well-considered regulation.

Regrettably, those adjectives do not apply to the current U.S. regulatory environment. Regulation in the United States has become excessive, burdensome, and unpredictable, retarding productivity and innovation, stifling economic growth and job creation, and undermining U.S. competitiveness.

During the past 16 years, U.S. government agencies promulgated an average of 3,566 new rules per year, or 18 new regulations every business day. The pace of regulatory expansion has been accelerating. Promulgation of “major rules”—defined under law as those likely to have an

economic impact of at least \$100 million per year—increased by 45%, from 220 rules during the Clinton Administration’s second term to 319 rules during the Obama Administration’s first term.

Indeed, regulations have been multiplying, but to what effect? Data on economic growth and employment paint an unflattering picture. U.S. GDP growth and the unemployment rate averaged 4.4% per year and 4.5%, respectively, during a period of less regulation in 1997–2000; during the tighter-regulatory environment of the last four years, GDP grew 0.9% per year with a 9.1% average unemployment rate.

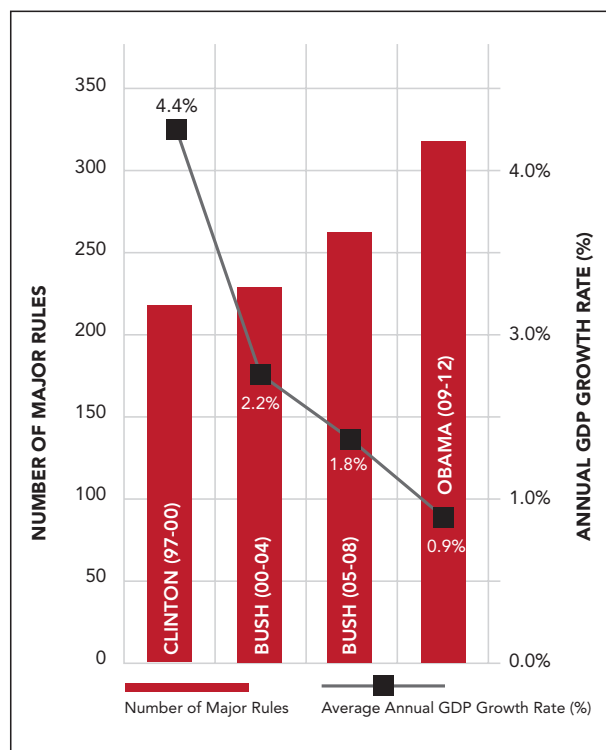


Figure 1. Number of Major Rules Published in Federal Register

Regulations that have driven up the cost of doing business have deterred current economic activity, and the specter that much more is coming down the pike is suppressing investment and hiring, which bodes ill for economic growth moving forward. In addition to the major rules that have been finalized, hundreds of other proposed rules related to implementation of the Dodd-Frank Act (DFA), the Clean Air Act (CAA), and the Affordable Care Act (ACA) are at various stages in the rulemaking pipeline, hanging like the Sword of Damocles over the economy.

The 2000-page DFA alone (which is so inscrutable as to have necessitated the commissioning of 60 independent studies and 93 congressional reports to attempt to better comprehend its reach and impact) will include 533 new



rules with which firms in numerous, disparate industries will be required to comply. By comparison, the 2002 Sarbanes-Oxley Act was a more manageable 66 pages and the 1933 Glass-Steagall Act was a mere 37 pages. So voluminous and convoluted is the DFA legislation that agency regulators have already missed more than 60% of the 237 final-rule-writing deadlines. An additional 161 deadlines have not even been scheduled yet, ensuring that investment-detering uncertainty in the business climate will persist well into the future.

In July 2012, the Consumer Financial Protection Bureau (CFPB)—a bureaucracy borne of the DFA—posted on its website 1,099 pages of details concerning two new rules governing mortgage disclosure forms. These new rules pertain to the very same disclosure documents that the Department of Housing and Urban Development revised only two years ago, at a cost to industry of \$157 million. The CFPB estimates that the

cost to industry of complying with its new rules will be an additional \$100 million, although industry estimates the cost at \$315 million. These hundreds of millions of dollars in compliance costs will no doubt be passed down the mortgage supply chain, ultimately burdening U.S. mortgage borrowers, who will also likely suffer higher service prices and other effects related to there being fewer companies to serve demand in this industry.

Meanwhile, the EPA has been burning the midnight oil, proposing, promulgating, and implementing sweeping regulations of air emissions, water use, and the disposal of combustion residuals from coal used to generate electricity. Producing electricity from fossil fuels is an activity that generates negative externalities, including higher concentrations of mercury, carbon dioxide, and other particulate matter in air and water. When negative externalities are the byproduct of economic activity, then it is reasonable for the government to attempt to reduce

them through rules that privatize their costs or, barring such alternatives, to control them through regulation. Ensuring the highest-quality air and water that is both technologically and economically feasible is a legitimate objective of public policy.

Indeed, since the creation of the EPA in 1970, air and water quality in the United States has improved dramatically. Since 1980, there have been significant reductions in all six National Ambient Air Quality pollutants (carbon monoxide, ozone, lead, nitrogen dioxide, fine particulates, and sulfur dioxide) targeted under the Clean Air Act. While some of that improvement can be credited to the EPA's regulatory mandates, significant gains in air and water quality are the result of market forces that have led to innovation, changes in production techniques, and shifting consumer demand. Regulators should be mindful of that fact and heed medicine's Hippocratic Oath by not harming what they regulate.

Economics is about making the best use of scarce resources, and public policy formulation must heed its implications: policy decisions may yield measurable benefits, but they also impose costs. In 1970, when the EPA began to regulate activities that were presumed to have adverse impacts on environmental quality, there was plenty of scope for air and water quality improvement.


For every dollar of abatement effort, relatively large public health benefits were realized. Low-hanging fruit was plentiful in the early days of pollution abatement. Today, however, after the most obvious and affordable abatement measures have already been adopted and the associated benefits have been reaped, after working down the continuum of abatement efforts toward the limits of

technological feasibility, the marginal cost of the next increment of abatement becomes even higher and the marginal benefit even lower.

Through an executive order, President Obama decreed that regulating agencies “must, among other things...select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits [emphasis added].”

Net benefits are maximized where the marginal benefit equals the marginal cost. In other

words, the optimal amount of regulation is the amount that maximizes net benefits, and that happens at the point of regulation where the marginal benefit of an additional unit of regulation equals its marginal cost. As put in a recent report from the President's Council of Economic Advisers: “A regulation that is expected to eliminate 90% of certain harmful emissions at a cost of \$100 million per year may well generate higher net benefits than one that eliminates 98% of those emissions at a cost of \$1 billion per year.” Maximizing total benefits and maximizing net benefits imply very different amounts of regulation.



Regulations that have driven up the cost of doing business have deterred current economic activity, and the specter that much more is coming down the pike is suppressing investment and hiring, which bodes ill for economic growth moving forward.

In a 2005 study, the Office of Management and Budget concluded that regulators “tend to overestimate both benefits and costs [of proposed regulations], but they have a significantly greater tendency to overestimate benefits than costs.” Projected benefits in agency “regulatory impact analyses” were overestimated 40% of the time and costs were underestimated 26% of the time. The lack of precision in prospective regulatory assessments is a serious cause for concern. According to a recent study from the Small Business Administration, total U.S. regulatory costs amount to about \$1.75 trillion per year—a figure that exceeds the total value added from the entire U.S. manufacturing sector in 2011.

Acknowledging that regulations can be costly, counterproductive, and superfluous, President Obama—in another executive order—decreed that regulators “must identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends.” Yet the EPA appears to have not received the memo. In describing its Utility MACT rule in the Federal Register, the EPA wrote:

“We may determine it is necessary to regulate ... even if we are uncertain whether [the rule] will address the identified hazards. We believe it is reasonable to err on the side of regulation of such highly toxic pollutants in the face of uncertainty.”

Agency cost analyses fail to consider the inevitable spillover effects onto other industries and entities along the supply chain.

The EPA has demonstrated nothing short of contempt for concerns about the high costs of excessive regulations expressed by power producers and the industries, businesses, and households that consume electricity and purchase products and services that will be impacted by higher electricity prices. The EPA estimates that the

total capital expenditures needed to comply with six (of many) new rules will be between \$175 billion and \$539 billion. Industry estimates range from \$405 billion to \$885 billion. Divergences between estimates from industry and from regulators are to be expected, but the EPA’s analyses fail to even consider whether banks or other financial institutions would be willing to finance those massive compliance expenditures or whether the technology needed to achieve marginally better

air quality or to measure air quality at the infinitesimally small increments needed to demonstrate compliance are even technologically feasible. In the case of several EPA mandates, the prevailing view is that financiers will be unwilling to lend resources to utilities for the purpose of complying with EPA regulations, when the technology necessary to comply and to demonstrate compliance does not even exist.

Furthermore, agency cost analyses fail to consider the inevitable spillover effects onto other industries and entities along the supply chain. EPA regulations, for



example, do not only affect power plants that burn coal. They also have significantly negative impacts on millions of industrial, commercial, and residential consumers of electricity, many of whom have downstream customers who are forced to bear some of the increased costs. And higher prices of manufactured goods and services tend to reduce sales at home and abroad. When reporting the results of their cost and benefit analyses, however, regulating agencies generally fail to consider these costs.

As confirmed by the reticence of businesses to invest and hire during this sluggish economic recovery, excessive regulation and the uncertainty created by an ascendant regulatory inclination impedes economic growth and hinders innovation. Regulation is a necessary evil in a competitive, dynamic economy rooted in the rule of law. Yet, regulation must be smart, balanced, and implemented with an eye toward insuring that the health of the productive economy is

given at least as much consideration as the inclination to curb it excesses. In light of the precarious state of the U.S. economy, further burdening American wealth and jobs creators with costly regulations would be ill-considered, if not a dereliction of duty. ■



Nam D. Pham, Ph.D. is the Founder and Managing Partner of ndp | consulting. Prior to founding the firm in 2000, Dr. Pham was Vice President at Scudder Kemper Investments in Boston, where he was responsible for research, asset allocations and currency hedges for Scudder's global and international bond funds. Before that, he was Chief Economist of the Asia Region for Standard & Poor's DRI in Boston. Dr. Pham has more than twenty years of experience in multinational organizations and government agencies. Pham is an adjunct professor at The George Washington University. Dr. Pham earned a Ph.D. in economics from The George Washington University with concentrations in international trade and finance, economic development and applied microeconomics, a M.A. from Georgetown University, and a B.A. from the University of Maryland.