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RECASTING THE ROLE OF GOVERNMENT TO PROMOTE ECONOMIC PROSPERITY

by Murray Weidenbaum

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In every nation, obstacles to prosperity and economic growth result from activities of government. My task is to analyze key aspects of this phenomenon and present possible improvements. I will draw on the American experience, mainly because I have more knowledge about it than of other countries' activities. Of course, it is up to the decisionmakers of Japan to decide which, if any, of these policies are appropriate for your country.

In no nation is there a government agency with a mission to depress the economy or to accelerate inflation. However, many government actions — especially taxation, government spending, and regulation — have those undesirable effects. I focus on government regulation of business because regulatory costs are especially insidious. They are a hidden tax severely reducing the competitiveness of domestic businesses at a time when they face an increasingly global marketplace.

Moreover, reducing the burden of regulation can contribute to more rapid economic growth without the adverse inflationary and currency repercussions that often accompany more stimulating monetary and fiscal policies. Reform of regulation responds specifically to policymakers' desires to reduce the structural impediments to economic growth.

The role of regulation should not be considered in isolation, but as a part of an extensive effort to reduce the burden of government involvement in the economy. This comprehensive approach is essential because of the ease of substituting regulation for other forms of government activity, such as direct Treasury outlays.

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The Many Costs of Government Regulation

The popular view of regulation is wrong. It is not a contest between "the forces of good" (meaning government) and "the forces of evil" (obviously, business). The reality is that the consumer is at the receiving end of the numerous impacts and repercussions generated by regulation. Business is the middleman (or woman).

The nature of regulation becomes apparent when we look at it from the viewpoint of the business enterprise. For each box on its organizational chart, there are government agencies that are counterparts to that box: environmental regulators and construction of new facilities; job safety regulators and the workplace; employment regulators and human resource policies; transportation and communication regulators and the movement of goods, services, and information. Those agencies — and many others — are heavily involved in the company's internal decision making.

The impact of those government rule makers and controllers is in one direction: increasing the firm's overhead and operating costs, slowing down its decisionmaking processes, and reducing the resources available to produce goods and services.

Regulation results in the higher prices that consumers pay to cover the cost of compliance. But that makes regulation attractive to government officials. The costs do not show up in the government's budget. Yet citizens do not escape paying the bill. Politicians have an old saying, "The best tax is a hidden tax." Regulation generates the most hidden taxes of all — the costs are imbedded in prices of goods and services that consumers purchase.

In the United States, the cost of meeting the rules promulgated by federal regulatory agencies add up to more than $500 billion a year. Regulation by state and local governments is in addition. If Congress had to appropriate another $500 billion a year to cover those expenses, it is unlikely they would approve so much regulation.

Going beyond the direct financial impact, we find subtle and more serious burdens resulting from the government's rules and prohibitions. By the time that the Clean Air Act is fully implemented in the year 2005 — seven years from now — its impact in the United States (combined with that of previous environmental regulations) will reduce real gross domestic product by more than 3 percent a year. That is just one regulatory program, albeit our largest.

Regulation also reduces the degree of competition, the flow of innovation, and the production of new and better products because so many government regulatory agencies have the power, which they frequently exercise, to decide whether or not a company can enter an industry or a new product go on the market. The biggest obstacles to developing a new biotechnology industry are not financial or technological. They are regulatory.

The rising paperwork requirements of government agencies inevitably produce a lengthening regulatory lag. This delay often runs into years and is a costly drain on the productivity of private managers as well as public officials. In 1980, a California land developer obtained in 90 days what was then called "zoning" for a residential development. Currently, the typical company in that state receives an "entitlement to build" for one of its developments only after two years or more of intensive work.

Opening new production facilities involves surmounting an even greater array of regulatory obstacles. A former administrator of the Environmental Protection Agency has described what is required to locate a new industrial facility:

> A company must obtain agreement from dozens of agencies at each of three levels of government, not to mention the courts. . . . A single "no" anywhere along the line at any time in the process can halt years of planning, effort and investment.

That was the experience of the Dow Chemical Company. Repeated regulatory delays forced the firm to cancel plans for building a $300 million petrochemical complex. When the project was terminated after extensive preliminary effort, Dow had obtained only 4 of the 65 permits it needed from various national, state, local, and regional regulatory agencies.

Many firms respond by shifting their activities to foreign locations. Some of the best-known American companies have deployed a majority of their assets overseas — Manpower Inc., Gillette, Mobil, IBM, Avon, McDonald's, Sun Microsystems, Exxon, Chevron, Bankers Trust, Warner Lambert, and Citicorp.

This point should not be misunderstood. My criticism is limited to those instances where companies would stay in their home territory were it not for the disincentives of government regulation. I surely do not advocate government interfering in the normal flow of goods, services, and investment across national boundaries in response to economic forces.

The justifications for the government's awesome regulatory power are worthy: to promote a cleaner environment, to achieve a healthier work place, and to keep unsafe products off the market. Sadly, the reality is often different. Consider the harm that pharmaceutical regulation does to the American people.

When we examine the list of prescription drugs actually approved as safe and effective, we find that the United States is one of the last countries to permit the introduction of new and better pharmaceutical products. That means that Americans frequently are deprived of superior medicines for many years while the products are available to patients in other industrialized nations.

The adverse effects of government regulation are far more numerous than most people realize. These burdens include:

(1) the cost to taxpayers for supporting a galaxy of government regulators,

(2) the cost to consumers in the form of higher prices to cover the added expense of producing goods and services under government regulation,

(3) the cost to workers in the form of jobs eliminated by regulation,

(4) the cost to the economy resulting from the loss of enterprises which cannot afford to meet the onerous burdens of government regulations, and

(5) the cost to society, as a whole, as a result of a reduced flow of new and better products and a less rapid rise in the standard of living.

The benefits of regulation should not be overlooked. Indeed, in the reform approach that I will propose, the benefits and the costs of regulation are directly compared. To the extent that the society obtains cleaner air, purer water, safer products, and healthier workplaces, these benefits are real. However, the mere presence of a government agency does not guarantee that its worthy objectives will be achieved.

For example, a steel company was required to install special scrubbing equipment at one of its plants in order to reduce the emission of visible iron oxide dust. The scrubber succeeds in capturing 21.2 pounds an hour of the pollutant. However, the scrubber is run by a large electric motor. In producing the power for that motor, the electric utility spews out 23.0 pounds an hour of sulfur and nitrogen oxides and other gaseous pollutants. Thus, even though the company is meeting government regulations on visible emissions, the air is actually 1.8 pounds an hour dirtier because of the regulatory requirement.

The serious question is not whether regulations produce any benefits but whether they are worth the costs. That, in turn, leads us to consider opportunities for improvement.

The Benefits of Economic Deregulation

How can we reduce the burdens of regulation? We can start by questioning the traditional justification, which is the notion of *market failure*. For a variety of reasons — ranging from the inadequacy of information to the presence of major externalities — private markets are deemed not to work well enough (a typical externality occurs when a producer upstream discharges pollutants into a river harming the people who live downstream). However, economists have also developed the companion notion of *government failure*, the tendency for the public sector to do more harm than good when it intervenes in economic activity.

As a result, economists urge policymakers to rely primarily on competition in the marketplace to protect the consumer. In the last two decades, deregulation of transportation has made great progress in the United States. A little later, however, I will deal with situations where relying on competition may not suffice.

Until the late 1970s, the Civil Aeronautics Board (CAB) regulated the airline industry. It allocated routes, controlling both entry into these markets and the fares to be charged. In 1977, the CAB, led by two economists, began the process that resulted in airline deregulation. Initially, the CAB gave the companies increased freedom in pricing and easier access to routes not previously served. The results were spectacular. Fares fell sharply, planes filled, and profits soared.

A year later, Congress passed legislation that phased out the CAB, ending its authority to control entry and prices. Since then, air traffic has grown faster and airfares have fallen more rapidly than they did during regulation. The industry's employment has risen and labor productivity has increased.

The experience since 1978 has not been without problems, notably congestion in airports and in the sky. On balance, the public interest has been well served by airline deregulation. The savings to air travelers have been estimated at over $12 billion a year (in 1993 dollars).

Encouraged by the airline experience, in 1980 Congress passed a trucking law which provided more pricing freedom to individual carriers, made entry into the market easier, and eliminated many costly restrictions on the part of the Interstate Commerce Commission (ICC).

Although 300 trucking companies went out of business, the total number of trucking firms increased very substantially, from 47,000 in 1982 to 300,000 in 1997. On average, operating costs per mile are down about one-third. Estimates of annual savings from trucking deregulation — including lower inventory needs — range up to $50 billion a year.

Also in 1980, Congress gave the railroads new flexibility in setting rates and, in 1996, it terminated the ICC. The experience with railroad deregulation has been similar to trucking. A difficult adjustment occurred at the outset as the impact of competition became more pervasive. Over 27,000 miles of unprofitable rail lines were abandoned during a period of liquidations. However, the remaining firms in the industry are now in strong financial condition.

Spurred by deregulation, managerial innovations have contributed to a reduction of about one half in real railroad costs per ton mile of freight hauled. The cost cutting has enabled the railroads to pay for upgrading equipment and deferred maintenance as well as to lower rates and compete more effectively against other modes of transportation.

Less complete patterns of deregulation have occurred in telecommunications and banking. Greater freedom to innovate and to reduce costs has generally produced positive results. But the continued presence of substantial regulation has prevented the full benefits of market competition from occurring.

The reluctance of government decisionmakers to support the wholesale substitution of competition for regulation is a serious obstacle, especially in the effort to achieve telecommunications deregulation. Eliminating the regulatory apparatus (as in the CAB and ICC examples) works far better than more timid attempts accompanied by government efforts to regulate closely the process of deregulation.

Reform of Social Regulation

Simultaneous with the reduction of economic regulation, social regulation has been on the rise. Numerous new regulatory agencies are now active in the areas of ecology and safety. Their function is not to control entry, exit, prices, or profits in the tradition of the older regulation, but to handle such market failures as information inadequacies and externalities.

Rather than dealing with the overall condition of the industries they are regulating (as was the case of the CAB and ICC), these newer regulatory agencies are concerned with achieving social benefits (safer products, healthier workplaces, etc.). Thus, the Environmental Protection Agency focuses on the impacts of all businesses on the environment.

Unlike economic regulatory commissions which, at times, were too close to the companies they regulate, EPA and its sister social regulatory agencies ignore their adverse impact on the industries they regulate. This raises the serious question of limiting the activities of the new breed of regulators.

Surely, the public does not endorse the bureaucratic approach: regulation is good, so more is always better than less. Economists look at the margin and think of diminishing returns. We ask the difficult questions that have generated the basis for reforming social regulation, especially the importance of government failure.

To an economist, the response to environmental pollution is not the negative task of punishing wrongdoers. That only occurs after the foul deed has been done. Rather, the challenge is positive: to change incentives so that people will not pollute in the first place. After all, people do not enjoy a dirty environment. They pollute when it is cheaper or easier than not polluting. Fundamentally, an appropriate regime of property rights should deal with this issue.

Until then, policymakers should make the maximum use of economic incentives. One basic approach is that the price of a product should reflect its burden on the environment. If prices of goods and services were increased to reflect those costs (perhaps as measured by cleanup outlays), consumers would buy less of those environmentally damaging products. The idea is to use the price system to make high-polluting products less attractive to consumers than low-polluting products.

A study of one estuary in the State of Delaware showed that effluent fees, set at a high enough level to achieve the desired level of water purity, would achieve the same environmental cleanup at only one-half the cost of conventional regulation.

In the U.S. regulatory process, the major use of economic incentives is the system of trading emissions permits under the Clean Air Act. This enables a company that can clean up its pollution very cheaply to sell some of its credits to a company whose compliance costs are much higher. The cost to society for achieving the desired level of air quality is lower than under the traditional approach.

What about the existing array of command-and-control regulation? Here, every president since Gerald Ford has required the regulatory agencies to do benefit/cost analysis in an effort to determine if a regulation does more good than harm.

Benefit/cost analysis has been used for decades in examining government spending programs. It is a simple way of balancing market failure (as measured by potential benefits of government action) against government failure (costs of government action). To an economist, "overregulation" is not an emotional term. It is merely shorthand for rules for which the costs to the public are greater than the benefits.

Benefit/cost tests compensate for the fact that government decision makers do not face economic constraints. If the costs to society of an agency action exceed the benefits, that situation does not have an adverse impact on the agency. The administrators may not even know about it.

Under the traditional approach they can claim credit for the benefits and ignore the costs — because, as noted, the costs are transmitted to the consumer not by the government but by business. Regulatory activists can enjoy criticizing business about price increases, even when they result from the costs of complying with the very regulations that the activists urged be adopted.

During the presidency of Ronald Reagan, federal agencies were directed to limit their new regulations to those that generate more benefits than costs. Many pending regulations failed to meet this requirement. In the case of the Department of Labor, approximately 40 percent of the proposed new rules had to be withdrawn or revised. The Clinton Administration has lowered the threshold for approval of new regulations. Currently, the agencies merely have to show a "reasonable relationship" between costs and benefits. This is a much more subjective and easier standard to meet.

Conclusion

To conclude, I offer four basic principles for guidance:

(1) *Government intervention is only warranted when markets do not work as well as regulation.* The presence of "market failure" is a necessary but not sufficient condition for government to intervene.

(2) *The legislature and the regulatory agencies should estimate costs and benefits before they enact new laws or issue new regulations.*

(3) *Whenever feasible, the power of market incentives should be enlisted in pursuit of society's goals instead of command-and-control directives.* The pressure of competition and the lure of profits should be recognized as forces vital to achieving a healthy and growing economy.

(4) *Delegations of authority by legislatures should contain specific controls to ensure that regulatory authority is not exercised capriciously.* The influence of business may be substantial, but the power of government can be overwhelming. The largest company cannot tax people or put them in jail; the smallest unit of government can.

A final thought. Government decision makers often overlook a fundamental fact in their rush to intervene in the private sector: individuals and private organizations have tremendous ability to deal on their own with the shortcomings of a modern economy. Relying on private initiative moves us closer to the ideal of a free society while simultaneously providing a powerful incentive to improved economic performance.