Review of

DRAFT 2011 REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATES ON STATE, LOCAL, AND TRIBAL ENTITIES

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I have reviewed the draft report and am pleased to offer the following comments:

1) Overall, the draft report is an outstanding document that not only advocates, but itself displays, regulatory sensibility, clarity, and transparency.

2) My main substantive recommendation is the addition of reference to agency *experimentation* to examine the effects of regulation. Studies of such experimentation would usefully complement the retrospective analysis emphasized by the draft report (and, in some cases, would reduce the need for such retrospective analysis).

   a) *Experimentation*.

      The draft report's discussion of Executive Order 13563 refers to the President's directive to "consider flexible approaches to regulatory problems, including warnings and disclosure requirements" (p. 55). The idea that strategies in this category may "reduce burdens and maintain flexibility and freedom of choice for the public" (p. 55) is an extremely important one. (For a recent survey of such flexible legal strategies in place of traditional "mandates and bans" (p. 55), see "Bias and the Law," forthcoming in *American Behavioral Scientist*; copy attached with this review.) However, it is important to appreciate that different types of warnings and disclosures may have very different effects; therefore, agencies can play an immensely valuable role in *experimentally* implementing alternatives (to the extent permitted by law) and then studying their consequences.

      For example, in recent years the SEC experimentally examined the effects of loosening restrictions on short sales of stock by exempting one-third of the stocks in the Russell 3000 from short sale restrictions and then studying outcomes for those stocks compared to the non-exempt stocks. (The SEC experiment is described in detail in a report from the agency's Office of Economic Analysis, available at http://www.sec.gov/news/studies/2007/regshopilot020607.pdf.) The exempted stocks were randomly selected by sorting the Russell 3000 first by listing market and then by average daily dollar volume and then selecting every third company. The SEC's experimental study was able to provide illumination of the effects of short sale restrictions on trading volume and liquidity – effects that had previously been hotly disputed among financial economists.

The SEC's short sale rules involve bans on certain trades rather than a warning or a mandated disclosure. Because the number of decision variables (words versus pictures, size of the material, specific words and/or pictures used, etc.) is often much greater with warnings and disclosures than with other forms of regulation, the value of experimentation is typically profound. To illustrate, the FDA is presently considering 36 different proposed cigarette warning labels (http://www.regulations.gov/#!documentDetail;D=FDA-2010-N-0568-0001). A data-driven approach would allow the use of different labels in different randomly selected localities and would then examine effects of the labels on the purchase and consumption of cigarettes in these localities. Such experimental approaches compare very favorably with studies based on hypothetical surveys and other conventional methodologies.

b) *Retrospective analysis.*

The draft report gives considerable emphasis to retrospective analysis of already implemented regulations. While such analysis is undoubtedly extremely valuable, the report should incorporate reference to the possibility that, in some circumstances, altering an existing rule may be inefficient even if a retrospective analysis provides evidence that the rule should not have been adopted in the first place. Once private-sector actors have made long-term investments and adjustments in response to a rule, the disruption and uncertainty associated with a change may simply be too large.

3) The draft report's sustained discussion of empirical studies on the effects of employment, environmental, and other regulation (Part II of the report) would benefit from more discriminating treatment of the empirical studies. Studies published in leading peer-reviewed economics journals (the three leading general-interest journals – the *American Economic Review*, the *Quarterly Journal of Economics*, and the *Journal of Political Economy* – together with leading field-specific journals such as the *Rand Journal of Economics* and the *Journal of Labor Economics*) should receive more attention and weight than other studies, which will at times suffer from weaker methodology, data sources, or empirical analysis.

4) The draft report refers to recent financial regulation by entities not required to monetize regulatory benefits and costs (the Federal Reserve System and the Federal Trade Commission) (p. 30). If appropriate, the report should suggest the desirability of congressional legislation requiring the same benefit-cost procedures for independent agencies as are now operative in executive agencies.

5) The draft report's statement on p. 36 that "U.S. competition law prohibits collusion among employers but allows collective bargaining by workers" seems misplaced (at least outside the halls of the University of Chicago). In general, it seems somewhat unnatural to suggest a tension between prohibiting companies from price-fixing, on the one hand, and permitting individual workers to engage in collective action through unions, on the other.

6) Likewise, the draft report's statement on p. 40 that "economic regulation … results in higher prices in the product market" was somewhat surprising. Presumably in many cases the justification for economic regulation of utilities and other natural monopolies is that in the absence of regulation, the regulated entity would charge a highly inflated monopoly price. Ordinarily, then, economists assume that economic regulation will lower product prices below what they would be in the absence of economic regulation – though of course economic regulation may both fail to lower prices to the competitive level and introduce a range of new inefficiencies.

7) Figure 2-1 on p. 51 of the draft report would be more illuminating if it contained a second bar for each administration showing the *number* of major rules enacted during the administration. (The additional bars could be measured against the right-hand vertical axis.)

8) Table 2-5 on pp. 59-60 provides net costs per life saved for a series of rules, many of which entail "morbidity costs." A brief discussion of whether monetizing *morbidity* costs is significantly less controversial or difficult than monetizing *mortality* costs would be helpful in interpreting and motivating Table 2-5.