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THE ECONOMICS AND POLITICS OF THE
SLOWDOWN IN REGULATORY REFORM

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THE ECONOMICS AND POLITICS
OF THE SLOWDOWN IN REGULATORY REFORM

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Abstract

The late 1970s witnessed a series of major changes in regulatory policy that were based in large measure on economic policy research, including deregulation in transportation and hydrocarbon fuels and the introduction of limited forms of emissions trading in environmental regulation. In the early, 1980s, the pace of reform slowed dramatically. This essay addresses the economic and political sources of the slowdown, and argues that economists have been less successful when their advice is to undertake structural and procedural changes in regulation, as opposed to eliminate it altogether. The primary reasons for their lack of success are, first, that political leaders view structure and process as a means to advantage allies and disadvantage foes, not as instruments for improving performance, and second, that economists are less credible than in the past because they are so thoroughly involved as consultants representing an interest, which undermines their credibility as proponents of reform.

The Economics and Politics of the Slowdown in Regulatory Reform

From the mid-1970s until the mid-1980s, critics of the U.S. regulatory system won a series of heady political victories.¹ The most prominent examples were in economic regulation, where price and entry controls were virtually eliminated in transportation and hydrocarbon fuels, and made less restrictive in most other regulated industries (Joskow and Noll 1994). In environmental, health and safety regulation, important advances were made in making regulation more flexible, such as through introducing limited forms of emissions trading (Hahn 1989) and in institutionalizing economic analysis into major regulatory decisions through the regulatory review process in the Office of Management and Budget (Viscusi 1994).

Since the mid-1980s, victories have been fewer and less complete. A few examples will illustrate the general point that regulatory reform is now progressing far more slowly.

In environmental regulation, despite the success of highly constrained emissions trading programs for air pollutants and much more flexible trading systems for leaded gasoline and chlorofluorocarbons, progress has been slow in making existing emissions trading programs more flexible and extending emissions trading to other environmental problems (Foster and Hahn 1995). In some cases stringent, inflexible new regulatory requirements have been adopted, such as the standards for auto emissions and airborne toxicities in the Clean Air Act of 1990 (Portney 1990) and the uncompromising requirements of the Americans with Disabilities Act (Burke forthcoming). With respect to regulatory process, attempts to force agencies to take into account economic impact analyses of all new regulations have been unsuccessful (Hahn 1996).

In economic regulation, one of the biggest targets -- the Federal Maritime Commission --

remains largely untouched. Most states have not gone beyond minimal federal requirements in allowing competition into electricity generation, and still have little or no installed generation capacity that is accounted for by independent power producers (Utility Data Institute, 1995). The Federal Communications Commission, when it made the perfectly sensible decision to focus its regulation of long distance telephone service solely on the one firm with market power, AT&T, was required by the courts to engage in the costly and pointless regulation of AT&T's competitors. The FCC also was forced by congress to backtrack it sought to replace usage-based long distance access charges by a fixed monthly customer charge (Ferejohn and Shipan 1989).

The Telecommunications Act of 1996, which is examined in some detail in this chapter, illustrates the mixed and even dubious progress in recent regulatory policies. The new legislation deregulates cable television, gives the Federal Communications Commission the power to overturn anticompetitive state regulations and to decide not to regulate if it deems a market sufficiently competitive, and formally adopts a policy of making local telephone service competitive. But it also creates a multilayered, complex regulatory process not only for introducing competition, but also for using regulation to protect against the largely illusory myth that "universal service" -- the ubiquitous provision of telephone connections to virtually everyone -- is somehow threatened by technological progress and competition.

These examples illustrate the pervasivity and durability of extensive regulatory interventions. The purpose of this chapter is to explore the political causes of the slowdown in regulatory reform. The strategy is, first, to set forth the key elements of the theory of policy change that have emerged from rational actor models of political behavior; second, to identify some plausible causes of the loss of momentum in reform; and third, to make some observations about how the momentum for

reform might be regained.

With respect to the first question, this chapter argues that four factors have contributed to the slowdown in reform. The most obvious is that many pending regulatory reform proposals deal with issues for which the direct relevance of economic analysis is controversial among elected officials. In addition, economists have intensified this problem by dramatically changing the role of economics in the policy process. Economic policy analysis has become more adversarial and discordant, which has diverted attention from reform proposals that enjoy widespread professional agreement.

Two more general changes in the political sphere also have slowed the pace of regulatory reform: shrinking nonentitlement domestic expenditures, and increasing emphasis on giving states more independence in policy implementation. The former has increased the relative importance of regulation as a means of delivering political favors to politically influential groups, and the latter has caused a conflict between improving the economic rationality of regulation and allowing regulation to be more responsive to state politics, where the pressure to use regulation as an instrument of redistribution is frequently greater than in the federal government.

With respect to the question about how momentum for reform could be regained, the most important force that is likely to cause further reform is simply the growing unwieldiness of regulation. Organized interests are more likely to fuel reform when they perceive greater gains from making the system more flexible and effective than from using the existing structure to pursue private gains. Economic analysis can facilitate this process by documenting the inefficiencies of poorly crafted regulations and cumbersome regulatory processes and instruments.

Economic analysis can be influential in promoting regulatory reform. But economists will be more successful in advancing reform if their policy advice is less adversarial, more consensual,

more comprehensive, and more objective than the standard consulting report or partisan advocacy statement. Unfortunately, the latter has become the dominant method that economists use to communicate with regulatory policy makers.

Theories of Regulatory Reform

During the post-war era, the application of economic reasoning to politics and public policy formation has produced several important insights about factors that influence policy change. This section summarizes these ideas and interprets them in the context of regulatory reform.²

The underlying premise of this approach is that policy change occurs because most elected political officials find change in their interest because it either enhances their ability to maintain and extend their careers or comports with their personal policy preferences without damaging their political ambitions. In both cases the response of constituents to policy reform plays an important role. Elected leaders enhance their political careers (or, at least, do not undermine them) if their actions are perceived to be more beneficial than harmful by a majority of their constituents. Several decision-theoretic models have been developed to explore the implications of this hypothesis.³

Interest Groups and Capture

Initially, the economic theory of the politics of regulation emphasized forces that had been identified earlier by political scientists such as Bernstein (1955) and Lowi (1969): regulation is a primarily a means for delivering policy benefits to organized interests that experience a disproportionately large share of the consequences of a policy. The core ideas in the economic version of this theory are based on the economics of political organization, originating with Mancur

Olson (1965) and extensively developed by the "Chicago School" economists George Stigler (1971), Sam Peltzman (1976) and Gary Becker (1983).

The interest group theory of regulation contains two key arguments. First, because undertaking activities to influence policy are expensive, only those with a high stake in a policy are likely to derive net benefits from attempting to influence it. Second, if people with the same stake in a policy form a political organization to achieve their common ends, as their numbers grow their political organization is increasingly likely to suffer from attempts by members to free ride -- that is, not to pay their share of the costs of influencing policy. Consequently, smaller groups and groups already organized for another purpose are advantaged, holding the total stakes of all members constant.

In the simple theory of regulatory capture, a regulated industry has large per capita stakes, while customers and suppliers face small per capita stakes; hence, the regulated industry is likely to become well organized to influence its own regulation, and so to obtain regulations that advantage it relative to unorganized groups. More generally, if some but not all suppliers and customers experience concentrated effects, regulation can be expected to compromise their differences, but collectively to advantage these groups relative to unorganized suppliers and customers.

According to the interest-group theory of regulation, reform takes place because organized interests turn against it.⁴ Those who putatively benefit from regulation will advocate reform when their process costs of regulation are large compared to the benefits that these groups can extract from others. These process costs have two components. One is the direct cost of participating in the regulatory process and complying with regulatory rules. The other, and usually larger, component is the indirect effect of regulation on the efficiency with which regulated firms respond to changes

in technology, costs and demand. Because regulation makes an appropriate response slower and more costly, it causes firms to be less efficient.

An attack on regulation by the groups that are most influential in making regulatory policy may occur if unanticipated events either increase the costs or reduce the benefits of regulation to its former advocates. Three types of such changes can have one or both of these effects.

(1) So many groups that are affected by regulation may become organized that the costs of negotiating and implementing compromises among them become too cumbersome and expensive to be worth the rents that these groups can extract from others. Regulating a large number of heterogeneous firms is costly, not just because it requires collecting and analyzing a great deal of data, but also because it requires a great deal of work assessing the effects of proposed regulatory changes on participants in the industry. Good examples of areas in which large numbers of firms operating under different circumstances and with different costs caused price regulation to be cumbersome and expensive are natural gas, oil, and trucking.

If the number of regulated firms grows, the process costs of regulation can be expected to increase more than in proportion to the number of firms, and so to reduce the net benefits of regulation to its proponents. An increase in the number of regulated firms can arise through the growth in demand for a regulated service, which increases the prospective profitability of entry into the regulated market by excluded firms. As the demand for a regulated product grows, the process costs of gaining permission to enter eventually will be swamped by the prospective profits of entry. And, as more firms enter, regulation becomes more cumbersome and expensive. Examples of this process are the entry of cable television firms and nonscheduled and charter airlines in the 1970s.

(2) Technological change or entrepreneurial creativity may lead to competition that

undermines the ability of regulated interests to extract rents from unorganized groups. The source of this competition may be unregulatable competitive actions by regulated firms, or entry into unregulated activities that can substitute for regulated ones. An example of the first type of competition was the largely unregulatable service competition among airlines that shared price-regulated routes (Eads 1971). Service competition eroded the excess profits of these routes, and thereby eliminated the reason of some airlines for favoring regulation.

Because the regulatory process is costly and inflexible, when regulated firms face competition from unregulated firms, the former are competitively handicapped and so are likely to experience a diminished opportunity for extracting rents. An example arose from the convergence of telephone and computer technologies, which allowed many major business customers of telephone service to acquire internal communications systems that reduced their usage of regulated local phone service. After the Federal Communications Commission decided not to regulate private networks and computer services, regulated telephone monopolies began to experience limited competition to which they could not effectively respond while remaining regulated. As a result, local telephone companies have lost a large share of the access connections between intensive telecommunications users and long-distance carriers.

(3) If a large fraction of the groups affected by a regulatory policy become organized, the opportunity for extracting rent from the remaining groups may not offset the costs of participating in the regulatory process. For example, if income growth and technological change increase the per capita stakes of the customers of firms subject to economic regulation, the demand side is increasingly likely to become organized, thereby reducing the asymmetry of representation in the policy process. Of course, if the nature of technology in the regulated industry allows it to be

reasonably competitive, eventually both sides can mutually agree that they are better off with less regulation. The evolution of surface freight transportation illustrates this pattern with respect to large shippers and railroads, although most trucking firms and the Teamsters Union fought deregulation to the end.

Interest-group theory is not exactly clear about the outcome when some organized groups want to retain regulation but others oppose it. The political science version of interest group theory emphasizes the importance of a united front among advocates of a policy. If both sides are roughly equally well organized, and one side is united while the other is divided, political actors can expect a net political gain only by siding with the united front. In the economic regulatory domain, the political science argument leads to the prediction that if the regulated industry is divided about whether regulation should be relaxed and if user groups are well organized and oppose regulation, regulatory reform should be victorious. In the environmental regulatory domain, if environmentalists are divided about the wisdom of a regulatory approach that is more efficient, and if this reform is advocated by regulated firms, then reform should take place.

The economic version of interest-group theory is more complicated in that it takes into account the magnitude of the stakes of each side. Initially, Stigler imagined that something akin to an auction for policy took place, whereby the organized group that had the largest net benefit from change would win the policy struggle. In general, as argued by Becker, this kind of process should favor a policy outcome that is reasonably efficient because, if regulation is not efficient, the gains for the beneficiaries are smaller than the losses of those who suffer from inefficiency. Hence, if all sides are reasonably equally organized politically, regulation ought to be relatively efficient.

Following Becker's argument, if two groups on the same side of a regulatory issue disagree

about regulatory policy, and both are well organized, the group proposing the more efficient alternative should be favored, since their proposal generates more surplus for distribution among organized interests and to policy makers.

Peltzman (1989) has applied the interest-group approach in attempting to explain the economic deregulation of the late 1970s and early 1980s. The model seems to work relatively well in explaining federal regulatory reforms in some cases, but less well in other areas. For example, Peltzman concludes that the interest-group theory does not adequately explain deregulation in long-distance telephone service and trucking.

Even in some cases in which interest-group analysis sheds some light, it does not appear to be a complete explanation. Two examples are local telephone service and emissions trading.

Telecommunications. In the case of local access, potential competitors and many business user groups have long advocated the end of franchised monopoly in local telephone service. In essence, these groups propose that long distance carriers, cable television companies, and specialized providers of internal networks and access to long-distance carriers be allowed to interconnect with local telcos and to sell local access service competitively. Willing providers and organized users who favor competition were certainly stronger and more numerous for local telephone service in the 1980s than for long-distance service in the 1960s.

Despite the seemingly favorable politics, the pace of regulatory reform has been much slower in the case of local telephony. Local telephone companies have been almost completely successful in preventing competition in ordinary local telephone service. Although some states have begun to allow alternative local access arrangements, no state has fully relaxed entry barriers and worked out competitively neutral policies for interconnecting competing local telephone companies.

The Telecommunications Act of 1996 attempts to speed the development of local competition by extending federal jurisdiction over interconnection regulation and mandating the FCC to issue guidelines for state regulators that specify how to construct competitively neutral rules for interconnection. Nevertheless, the act preserves for state regulators the task of developing procompetitive regulations, and creates a more elaborate regulatory system for to protect universal service.

On the plus side, the act phases out by 1999 the expensive, largely unsuccessful attempt to reregulate charges for cable television service (Section 301(b)), and reverses the court ruling that prevented the FCC from deregulating carriers that lack market power (Section 401). The act also contains provisions that facilitate competitive entry in local access, establishing a duty by local exchange carriers to provide nondiscriminatory interconnection, unbundled access elements, and collocation to competitors (Section 251(a)), and requiring that states eliminate barriers to entry against both facilities-based and resale local access providers (Section 253(a)).

Other provisions in the act are exceedingly regulatory in both process and objectives. In setting forth procompetitive policies for interconnection, the act also creates a new, exceedingly complex multilayered regulatory structure. The act asserts federal jurisdiction over the rules for interconnecting competitive telephone companies (Sections 252(e)(6) and 253(d)), and provides a long list of conditions that interconnection agreements must satisfy (Sections 251(b) and 251(c)). But the act also creates a new regulatory monster by preserving some discretion for state regulators in developing interconnection rules, subject to FCC guidelines and court supervision. In addition, the standards for interconnection requirements are vague, including even the classic "public interest, convenience, and necessity" clause as guidance to state regulators about interconnection rules

(Section 252(e)(2)(A)(ii)). Thus, the act sets up a process that invites years, if not decades, of complex legal wrangling over the details of local access competition, which in turn will raise the cost and slow the pace of competitive entry.

The new telecommunications act creates another regulatory problem in its universal service provisions. The act sets up a highly regulatory process for defining and making available universal service. First, the act creates an open-ended definition of universal service -- it could easily include cable television and mobile telephones within a few years -- and an open-ended commitment to subsidize these services in high-cost, sparsely-settled regions. The universal service subsidy is not tied to either the financial needs of customers or the demand for these services in subsidized areas, and so could transfer enormous financial burdens from nationwide telephone customers to wealthy residents of sparsely settled areas or simply to pay a large fraction of the costs for capabilities that customers in these areas do not want. Second, by requiring federal rate averaging and by permitting rate averaging in the states, it invites rigid price regulation that would prevent price competition in core services for the purpose of financing universal service subsidies. These provisions invite state and federal regulators to reregulate some deregulated services and to cut back on their use of incentive regulation systems, such as price-caps, in order to implement an effective scheme of cross-subsidization for universal service.

The act reveals a more general legislative schizophrenia. For two decades economic regulatory policy has been based on the proposition that most, maybe even all, infrastructure industries could be structurally competitive. At the same time, policy makers have been unable to give up regulatory control in many of these industries. When the time comes for writing the legislation, too frequently the objective of promoting competition is put aside in a political attempt

to allocate advantages among organized interests, which requires establishing an ongoing regulatory process to protect any interest from suffering too great a financial loss from competition. Of course, this approach to reform runs a substantial risk of replacing a monopoly with a cartel, thereby forfeiting the benefits to most consumers of structural competition.

Emissions Trading. The old regulatory bargain between established industries and environmentalists included draconian "new source performance standards" (NSPS) that imposed expensive permit and compliance costs on new industrial facilities. Usually, the compliance cost to attain any given level of emissions control is much lower for a new facility than for an established one. Consequently, harsh NSPS protected established facilities against entry by more efficient competitors. This arrangement initially benefitted environmentalists as well, for imposing standards that would have bankrupted many companies and left their workers unemployed was not politically feasible. Hence, environmentalists could reasonably have believed that they would attain greater emissions reductions in the short run by protecting old facilities against entry.

As time passed, changes in demand, technology and international trade undermined the value of this arrangement for both sides. Established facilities grew increasingly obsolete, and less able to compete effectively against imports. Firms owning these facilities sought to expand or to introduce new technology, and faced the same entry barriers from NSPS because the more rigorous standards applied to any significant renovation of an established facility. Environmentalists experienced reduced opportunities for imposing additional emissions controls because of the diminished rents created by NSPS. Consequently, both industry and some environmental organizations saw increasing value in more flexible approaches to emissions controls, leading to the introduction of emissions trading; however, the pace of reform has been very slow.

The political response to the success of the early experiments with trading are disappointing. The procedures for trading air pollution permits remain highly constrained and inefficient. In nearly all cases trading can not be used to avoid compliance with NSPS, although the gap between standards for new and established facilities has virtually disappeared in areas that are severely polluted. Progress in advancing the use of trading has been glacially slow despite support from many industrial and environmental groups as well as economists.

Causes of Slow Progress. Superficially, an important element of the slow pace in reforming telecommunications and environmental regulation is that regulators, in implementing reform, reveal a preference not to introduce policies that vastly diminish their roles. For example, in the development and implementation of emissions trading in Los Angeles (Project RECLAIM), the South Coast Air Quality Management District, itself an advocate of reform, met significant resistance from both the California Air Resources Board and the Region Nine office of the Environmental Protection Agency. In general, as argued by Crandall and Winston (1994), state and federal regulators can be regarded as constituting a relevant interest group that seeks to protect its interests -- in this case, jobs and authority to control the behavior of regulated firms. This explanation is incomplete, however, because regulators are appointed and derive their power from statutes, both of which emanate from elected politicians. Whereas regulators enjoy policy discretion, they can not stray too far from the policies preferred by a majority of elected officials without risking punishment and reversal (McCubbins, Noll and Weingast 1989).

During the initial wave of reforms from the mid-1970s until 1980, congress passed statutes that reduced the formal authority of regulatory agencies, and presidents appointed regulators who were committed to reducing the influence of their agencies. For example, the Civil Aeronautics

Board (CAB) deregulated a great deal of the airline industry before congress ratified and extended these policies by passing legislation that phased out regulation and eventually abolished the agency (Levine 1981).

The case of the CAB illustrates the superficiality of the argument that regulators constitute an effective self-preserving interest. If one observes an agency persistently hamstringing reform, the explanation lies not in the interest of the agency, but in the willingness of elected political officials to allow an agency to behave in this way. In the end, elected officials must not feel threatened by persisting in these policies despite agreement among the relevant interest groups that change is warranted. In the case of RECLAIM, the resistance of state and federal regulators was rather quickly (if painfully) overcome when political leaders and EPA headquarters supported reform. Cases in which regulators persist in blocking reform require a deeper political explanation, and motivate exploring other developments in the rational actor theory of policy formation.

Rational Ignorance and the Role of Information

Although rarely applied to regulation -- or, indeed, to any specific area of policy -- the implications of imperfect information about the consequences of political actions were first explored before the development of the economics of political organization. Anthony Downs (1957) was the first to propose a theory of the interactions between voters and candidates for office that was based upon imperfectly informed voter decisions about the policies that candidates would adopt. This theory hypothesizes that voters will not base voting decisions on the positions of candidates on any particular issue unless they perceive a large difference in expected personal net benefits between the positions advocated by the candidates. The sufficient conditions for voters to perceive a difference

between candidates are, first, that the issue is important to them, and second, that the difference between the two candidates on this issue is substantial. Whether the second condition is satisfied depends on the information available to voters: do the candidates propose different policy actions, and is their difference in proposed actions likely to have a significant effect on policy outcomes?

The acquisition of an informed opinion requires undertaking a sequence of costly actions, beginning with the study of cause-effect relations and ending with the personal processing of information within the context of an individual voter's preferences and interests. The most important insight of the information-theoretic approach to politics is the observation that voters are extremely unlikely to bear all of the costs of being informed on all issues. If citizens see political participation as a means to maximize their expected policy payoff, they will decide whether to become informed by comparing the costs of information and the likely policy effect of their being better informed. Because a single vote has virtually zero probability of affecting the outcome of an election and thereby affecting policy, it also has virtually zero expected benefit to the voter. Hence, significant personal investment in information is highly unlikely to be rewarded by an increase in the personal net benefits of policy.

The preceding argument does not imply that voters always will be ignorant. Instead, it focuses attention on other mechanisms by which voters become informed, or at least vote as if they were informed.⁵

(1) Voters may consume politically relevant products from professional information providers, and thereby derive the ability to cast an informed vote as a by-product of their consumption activities. For example, voters consume information by reading newspapers, watching television news programs, or reading books, rather than explicitly investing in these activities to

improve their ability to vote according to their policy preferences. Or, they may inform themselves because they believe that having a better understanding of government will enable them to foresee policy changes more accurately and to respond more effectively when change occurs. On the other hand, if the motive for information acquisition is primarily consumption, voters may have a tendency to consume material that reinforces their prior beliefs and prejudices, in which case the acquisition of more information does not necessarily lead to political participation that is more informed.

(2) Closely related to consumption of information products is to receive propagandistic information from interested participants in the political process. If voters acquire information inadvertently and do not believe that their own political actions are consequential, the information they acquire, and the decisions that are based on it, will not reflect optimizing behavior on their part. In particular, if information is biased and incompletely processed (only enjoyable processing is undertaken), a voter can be systematically and persistently misled by it by those who are willing to pay to provide selective (and entertaining) messages. Of course, this phenomenon applies to both the standard information industry as well as to this second form; however, the former would tend to reinforce erroneous assumptions about how the world works, whereas the latter is more likely to change people's beliefs in perverse ways.

(3) A politically active group to which a voter belongs may make the individual's cost of information insignificant by spreading this cost across all members of the group and telling each member how to vote, based on the consensus preferences among members on issues pertaining to their common interests. This process fits in well with the interest-group theory of policy choice because it provides another role for organizations to play in mobilizing homogeneous groups.

A nice feature of the information-theoretic approach to politics is that it preserves a place for

the intrepid policy analyst. Truly independent, objective policy analysis can influence voters along all three pathways. The work of the policy analyst may be popularized, or political officials and interest groups may hire policy analysts to develop analyses that use information to support their positions. In either case, the importance of the information derived from policy analysis is that it causes voters to update their assessments of the policy positions of candidates and their decisions about whom to support.

Informational imperfections also play a role in the policy choices of elected officials. The idea here is that elected officials, like voters, are imperfectly informed about how their actions will influence their constituents and, hence, their electoral fortunes. Like voters, elected officials could decide to attempt to be informed about everything; however, limits of time and resources preclude doing so. Alternatively, they can delegate the duty to be informed. In some cases, they rely on information from organized constituency groups, which have an incentive to become informed on behalf of their group members and to reflect their members' preferences (McCubbins and Schwartz 1984). In other cases, they can delegate the task of collecting and evaluating information to a bureaucracy.

Recent developments in the theory of delegation to agencies have emphasized how administrative procedures influence policy outcomes by organizing the flow of information to bureaucratic decision makers (McCubbins, Noll and Weingast, 1987 and 1989, and Lupia and McCubbins 1994). According to this view, one purpose of administrative procedures is to assign weights to different types and sources of information, and even to alternative systems of values that might be used to inform policy decisions (Noll and Weingast 1991). For example, rules of standing and rights of judicial review determine whose information must be given serious consideration by

an agency in reaching a decision, and burdens and standards of proof determine the difficulty a proponent of change will face in reforming a regulatory policy.

The information-theoretic approach sheds some light on both the initial regulatory reform movement and then the subsequent slowdown. In most cases, the first wave of reform proposals was to deregulate industries that were thought to be, or to be capable of being, reasonably competitive. Economics research played a role, because, in the 1960s and 1970s, numerous studies were undertaken that demonstrated the economic inefficiencies arising from such regulation. The proposals emanating from these economic policy analyses were primarily to reduce the scope of regulation, not to change its character.

By contrast, many of the reform proposals on the agenda in the 1990s are not based on a desire to deregulate, but instead to reform the regulatory process. For example, mandatory benefit-cost analysis in environmental, health and safety regulation is a procedural reform within a continuing regulatory system. The examples discussed above in which reform began in the earlier period but slowed abruptly in the latter period -- emissions trading, local utility services -- are also ones in which immediate reforms deal primarily with the process. Emissions trading would not cause environmental regulation to disappear, just the aspect of it that sets source-specific technical standards. Reforming the regulation of electric utilities and local telephone companies might eventually induce enough entry for deregulation to be plausible, but the immediate proposals are for procedural reforms: price caps, permission for vertical integration, competitively neutral interconnection and facilities sharing among competitors, etc.

From the perspective of elected political officials, regulatory methods and procedures are not simply a means for improving the efficiency of regulation. Elected political officials naturally want

to control policy. Because they can not make all policy decisions and must delegate some authority to civil servants, their main concern in constructing agencies is to avoid policy outcomes, conceptualized as who wins and who loses, that are not consistent with their own policy preferences. The primary purposes of regulatory structure and process are to allocate influence among groups represented in the regulatory process and to protect elected political officials from policy decisions by bureaucrats that are inconsistent with the purposes of regulatory legislation. Whereas a procedural reform plausibly could increase efficiency, it could also mean loss of political control of who wins a regulatory dispute. Likewise, if the existing structure biases regulatory policy in favor of a particular interest group, that group may still prefer deregulation to regulation, but be wary of fiddling with the process.

To illustrate this point, consider the case of mandatory benefit-cost analysis in environmental, health and safety regulation. The basis for a belief that mandatory benefit-cost analysis will improve the performance of regulatory agencies is the information-theoretic approach to understanding bureaucratic delegation. In its present incarnation, regulatory review in the Office of Management and Budget has no clear, formal means of influencing decisions, other than that it increases the amount of relevant information in the decision-making process. This rather minimal formal role can influence outcomes if either the agency leaders are interested in improving the efficiency of their policies, or a well-represented interest makes use of the information to oppose, and eventually perhaps to appeal, an inefficient proposal by the agency.

Economic analysis would have a greater role if agencies were required to base their decisions on an economic analysis that used standardized economic assumptions, methods and information (e.g., discount rate, value of life, etc.), and to bear the burden of proof if a decision overrides the

results of such an analysis. If a benefit-cost analysis were objective, in the sense of being based on the best available relevant information, this change in the formal status of economic analysis would further advantage groups favoring policies that are more efficient than the policies actually adopted.

Unfortunately, the most well-organized interests are not necessarily the ones who would benefit from efficient policies. Moreover, if citizens are poorly informed about the true nature of a regulatory problem, they may create a popular demand for an inefficient policy, in which case the failure to adopt it is seen by voters and elected officials as ideological unresponsiveness, not the result of detached analysis.

Of course, economic policy analysis frequently is biased, in which case enhancing its formal role does not necessarily enhance efficiency. Consider the case in which agencies must base decisions on information supplied by participants in the regulatory process and either information or representation is uneven among interests. In this case, increasing the weight accorded to benefit-cost analysis will increase the importance of representation bias and will add to the weight accorded to the group that possesses crucial private information.

The problem of bias in analysis tends to be insufficiently appreciated by policy analysts. If neither citizens nor elected officials have the skills, let alone the time, to evaluate the quality of economic policy analysis, a decision to give analysts greater policy influence raises some quite rational fears that the policies favored by policy analysts will reflect the values and preferences of the analyst, rather than a comprehensive, objective assessment of the issue.

This concern could hardly be expected to have been ameliorated by the growth and content of economic consulting. Active participation by consulting economists as advocates in the policy process has elevated the content and rigor of policy debates, regulatory decision making, and

litigation, which is all to the good. But consulting activity also is likely to have reduced the willingness of noneconomists to delegate formal responsibility to economists. The latter effect arises from the fact that if both parties to a dispute hire competent economists, their consulting reports are likely to be in almost complete conflict, and to make no serious attempt to reconcile opposing arguments.

The present reality of discourse among economists lies in stark contrast to the virtual unanimity among professional economists concerning the desirability of deregulation in transportation, hydrocarbon fuels, and the financial sector. From the perspective of an elected official, newspaper reporter, or interested citizen, all of whom are unlikely to be able to evaluate consulting reports, much less to integrate them into a coherent view of a proposed change in policy, the cumulative effect of discord is to foster the belief that delegation to economists may cause unreliable and unpredictable policy decisions that depend primarily on who is assigned to the job of analyzing a particular regulatory proposal.

Political unresponsiveness and politically unpopular ideological bias are potential hazards of proposals to change the way regulation is done, as opposed to eliminating regulation altogether. To succeed, reform proposals must come to grips with the multiple political purposes of regulatory structure and process, and the rational fear of antidemocratic delegation of policy influence to experts.

Mass Politics

The economic analysis of political phenomena has always been proposed as a partial theory. It is a story about sources of bias away from an outcome that would result from a hypothetical

unbiased aggregation of citizen preferences. One should bear in mind that citizens engage in political participation for a host of reasons unrelated to their association with organized interests, and have strongly held views about policy that are not related to their sources of income and their major personal consumption expenditures. Hence, another factor that may have affected the pace of regulatory reform is changes in other political issues that have a spillover effect on regulation.

Conventional wisdom holds that the most important political trend in the United States since 1980 is that the electorate has become generally more conservative. Because a tenet of conservatism is to reduce substantially the extent of regulation, the slowdown in reform since the early 1980s is perhaps surprising.

The difficulty with drawing conclusions about specific policies from general political trends is that to do so assumes that the shift in public political attitudes is more or less uniform across all issues. Poll data indicate that this is not the case; the extent to which citizens express agreement with conservative policies varies enormously across policy issues. One policy that still commands a large majority of support is environmental regulation. Whereas this support does not imply that environmental regulation can not be significantly reformed, it does mean that elected politicians take a political risk if a reform is perceived as a significant threat to environmental protection.

To my knowledge, no long-term polling data exist for most other specific areas of regulation, and in any event, regardless of public opinion, most specific areas of regulation are not particularly salient to most voters. Indeed, the general lack of significant public interest in specific areas of regulation is the basis for the economic theory of regulation, which emphasizes capture by organized interests at the expense of citizens in general. Consequently, to incorporate general political trends into the analysis, one must look for more specific issues that have some direct bearing on regulation

but that are more general than any specific area of regulation.

One such issue is the increased emphasis in recent years on greater devolution of policy responsibilities to state and local government. The federal structure of the American government is very unusual, and the consensus view among political scientists (for example, see Riker, 1987) is that a system in which different levels of government exercise significant, independent power is probably not stable. The logic of this conclusion is that if the national government possesses the legal authority to control a policy, the factions that control the national government will insist on using that authority to force lower governments to adhere to the policy that is favored at the national level. Even if the national government does not possess the legal authority, it can use its superior military power over one of its subunits to achieve its will by force.

In the history of the U.S., the role of states has ebbed and flowed in all policy areas, including regulation. Although the New Deal period is regarded as one in which considerable power was centralized in the national government, most New Deal statutes were generally deferential to the states. For example, states were given important roles in implementing nearly all New Deal social programs except for social security. In addition, New Deal regulatory statutes gave the states greater authority over intrastate activities of regulated utility industries than were contained in the earlier statutes for regulating railroads and pipelines.

In 1886, the Supreme Court held on constitutional grounds that states are precluded from regulating any business that jointly offers both interstate and intrastate service unless explicitly given the authority to do so by a federal statute. Subsequent regulatory statutes, such as the Interstate Commerce Act, delegated some regulatory responsibility to the states, but gave federal regulators the authority to override state decisions. In contrast, the New Deal regulatory statutes regulating

telecommunications, natural gas, airlines, and trucks created a confusing system of joint jurisdiction over intrastate activities, giving state regulators independent authority to regulate intrastate activities, even if these activities could not be separated, technically and economically, from interstate services. These laws have had varying and mutually inconsistent statutory interpretations by the Supreme Court concerning attempts by regulators at one level in the federal hierarchy to act contrary to decisions by regulators at another level.

In recent years, the view that more authority should be given to the states has found expression in numerous areas of policy. Most of the action has been taken by either regulators or the courts, as appointees to agencies and, especially, to the bench have expanded the scope of state regulation. Two actions have been taken through statutes. The 1992 act that reregulated cable television reinstated some regulatory authority over cable by state and local government. The 1996 Telecommunications Act gave the FCC more authority over states in regulating interconnection arrangements among local access providers, although the act is sufficiently complicated and ambiguously worded that the ultimate effect of these provisions is uncertain.

The dilemma posed by the trend toward more state authority is that devolution can work against regulatory reform. States are subject to the same kinds of representation biases as the federal government, but in the case of states one additional bias is present: the absence of an incentive to be politically responsive to organized groups in another state that sell within the state. Whereas states are generally prohibited from erecting barriers to interstate trade, they are relatively free to use regulation to discriminate against people from other states. An excellent example is a practice only recently attacked in telecommunications, which was to set higher long-distance access charges for terminating calls than for initiating them. This price structure is a means of taxing people outside

the state, since all originating calls are placed from within a state but a large proportion of terminating calls are placed by people from outside the state. Precisely the same tendency has been observed in pricing international telephone calls (Johnson 1989-90).

Regulatory reform generally has gained less political momentum in the states than in the federal government, most likely because a source of political benefits from regulation is available to states -- discrimination against out of state residents and businesses -- that is not available to federal officials. Thus, if a state essentially reflects the mixture of economic interests of the federal government, it will be, on balance, less likely to undertake reform. Of course, this conclusion does not mean that all states oppose reform, or even that all are less reform-minded than the federal government. If a state contains an unusually large concentration of well-organized user groups that advocate reform, these groups may be more successful in their home state than in Washington.

The Future of Reform

The economic and political causes of regulatory reform movement are far from completely understood, so strong conclusions about the likely future path to reinvigorated reform are hardly warranted. Nevertheless, some conclusions seem plausible enough to be worthy of consideration.

(1) Although something approaching consensus among interested parties in favor of reform is neither necessary (trucking) nor sufficient (emissions trading) to induce reform, it does appear to increase the probability that reform will be successful.

(2) When a regulated sector is divided, the most likely outcome is a compromised, gradual reform that appears more to divide the baby than to introduce economic efficiency. Political actors do not like to take the risk that a significant fraction of an industry will be significantly harmed by

a reform. (Their willingness to undertake a reform that drove several airlines to bankruptcy may be an exception, but more likely this outcome was not foreseen: certainly the economic studies of the 1970s did not predict this outcome.) For this reason, reform is likely to be protracted so that it can be halted or reversed before great damage has been done. Examples are the slow pace at which competition has been introduced in telecommunications for the past three decades and the gradual process of relaxing regulatory restrictions on cable television during the 1970s and early 1980s.

(3) During the past thirty years, economics has played an increasingly important role in all regulatory policies. It seems nothing short of quaint that in 1965 the Antitrust Division had no Economic Analysis Group, in 1970 the FCC had no economic policy staff, and in 1972 the Atomic Energy Commission could rule that a benefit-cost analysis of a nuclear power plant was unnecessary because the value of electricity was infinite and so would outweigh any cost. Of course, the best evidence about the increased importance of economics is the consulting issue: the conversion of so many economic experts to well-paid advocates reflects the importance of economic arguments in influencing policy.

As with interest groups, economists are more effective when they agree. If a group of economists associate themselves with their private political ideology, the impact of their advice will be limited to their ideological allies and will swing with political fortunes. Given the risk aversion of politicians, ideological victories are very likely to be tempered by compromise to avoid imposing targeted harm. In any event, the dominant political ideology of official Washington is highly unstable, so ideologically based reforms are likely to be temporary.

Unfortunately, this is probably a pointless observation. Political values are held strongly and deeply by everyone else, so why not by economists? It is most assuredly not corrupt to believe that

some market imperfections impose less costs on society than any coercive attempt to correct them, because of one's personal assessment of the value of uninhibited contract and property rights. Likewise, it is equally assuredly not corrupt to believe that regulation has produced more good than harm in ameliorating some market failures, and that if strengthened could be even more effective. Hence, economists are unlikely to see great virtue in keeping their values in check when lawyers, political officials, and interest-group advocates do not.

In addition, the market tends to reward ideology handsomely. Not only consulting but also much research philanthropy comes from sources that already know the answer and seek the least implausible economic argument to support it. Whereas this circumstance has always prevailed to some degree, it is certainly a more important phenomenon in the 1990s than it was before 1975, when the consensus emerged that structurally competitive industries should be deregulated and that economic incentives were better than technical standards for attacking environmental, health and safety problems. Economists who saw no great evil in the fact of administrative regulation nevertheless agreed with the first, and economists who saw in all administrative processes a dangerous loss of liberty could nonetheless support the latter, despite knowing that a regulator would decide how many permits would be traded. In many areas of current regulatory controversy, no similar compromised common ground has been identified.

Nevertheless, a great deal of room for professional consensus still remains. Defining an enhanced role for benefit-cost analysis in environmental, health and safety regulation is certainly one, but here the recommendation has to be policy neutral. Mandatory benefit-cost analysis will not enjoy consensus support if it is perceived as a stalking horse for vastly reducing the scope of regulation by imposing greater process costs on agencies without giving them more resources. In addition, the

procedures for formalizing mandatory benefit-cost analysis must self-consciously include provisions that address that lack of trust in economic policy analysts. Two ways that this might be accomplished are, first, to insist that all benefit-cost analyses make use of a common set of assumptions and undergo peer review, and second, that, after a few years, major benefit-cost analyses undergo a retrospective review and update. Both functions should be assigned to an office outside the regulatory agencies.⁶

Likewise, consensus probably could be achieved on how to introduce more competition into the utility sector (local telephone service, all elements of energy utilities). Procompetitive regulation has succeeded in the past, even if at a slower pace than some would have preferred. Examples are the relaxation of entry and pricing rules by the Civil Aeronautics Board in the late 1970s (Levine 1981); the gradual relaxation of administrative controls over cable television from 1972 until the industry was deregulated by legislation in 1985 (Crandall and Furchtgott-Roth 1996); the new national trading system for sulfur oxides and the local trading system for sulfur and nitrous oxides in Los Angeles that were made possible by the Clean Air Act of 1990; and, in a few states, the introduction of an independent electricity generation industry that grew out of the highly regulated and inefficient system for allowing independents to undertake cogeneration and to build facilities using renewable resources (Joskow 1989, Cameron 1996).

Both the use of benefit-cost analysis and procompetitive regulation are making headway, although progress is slow. Most likely, progress will continue, and economists will help it along. Maybe it would go a little faster if the ratio of objective research to didactic policy advocacy were a little higher.

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Notes

- 1 . The exact dating of the reform period is, of course, arbitrary. A reasonable date for the beginning of the reform period is the passage of the "4R" act for railroad regulation and the CAB's Domestic Passenger Fare Inquiry, and a reasonable ending date is the formal death of the CAB and the initiation of emissions trading programs to control lead in gasoline and chlorofluorocarbon production.
- 2 . For a more complete survey, see Noll (1989).
- 3 . For a more complete development of these ideas, see Noll (1989).
- 4 . For a more complete statement and test of this hypothesis, see Peltzman (1989).
- 5 . The discussion in this section of the acquisition of politically relevant information by voters is developed more completely in Noll (1993).
- 6 . For example, Breyer's proposed superregulatory agency could perform these functions (Breyer 1994).