

## **Regulation and Public Interests: The Possibility of GOOD Regulatory Government**

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In theory, scientific (positive) and philosophical (normative) inquiry are quite distinct. The former involves the testing of hypotheses through the use of experiments or the estimation of statistical models using data, while the latter utilizes theological or philosophical analysis to conclude how people and institutions should behave.

Normative analysis invariably involves passionate debate because the subject matter includes the big questions: What should one do with one's life? What are one's obligations to others? For what purposes should the coercive power of government be used? Normative analysis is what excites people about going to college: learning about the big thinkers (Rawls and Nozick, for example) and then discussing them at 2 A.M.

Positive analysis, on the other hand, does not stir the emotions. It is simply the honest attempt to discern what causes what. It is about fruit flies, reagents, solvents, controls, coefficients, standard errors, autocorrelation, and heteroskedasticity.

Sometimes this passionate/passionless distinction does not hold. Scientific inquiry stirs the passions if its findings have implications for normative questions or people attempt to use science to settle normative questions. An early example, of course, is whether the earth is stationary or instead rotates as well as orbits around the sun. The answer had implications for the importance of the Catholic Church in answering normative questions. Similarly the study of biological evolution continues to have implications for the supremacy of religious authority over normative questions. In climate science we have

a modern example in which scientific inquiry has implications for policymaking. Participants debating the costs and benefits of atmospheric emissions attempt to use science to settle the dispute even though science cannot resolve normative disputes.

While public choice theory is not climate science, it is also not simply dry passionless inquiry using the methodology of microeconomics to explain the behavior of governmental actors and institutions. Just below the surface of public choice discussions about partial derivatives and utility functions is the intense debate over the proper division of labor between markets and government. In addition, there is also struggle over the role of economics in the division of labor in social science. Should economists just study the behavior of firms and consumers in markets or the behavior of people in all settings including politics? And if economists study politics what is left for political scientists to do?

My own academic experience illustrates those controversies. When I was under consideration for appointment to a policy teaching position within a political science department, I was asked by the appointments committee to supply a letter from a member of my dissertation committee certifying that I was not a “public choice zealot.” My advisor supplied the letter. I was appointed and accepted the position. But I now realize why my time there was full of turmoil. Public choice is never just the positive examination of political behavior. It is also disguised discussion of the scale and scope of government as well as the imperialistic tendencies of economics within the social sciences.

Steven Croley’s book is a critique of public choice as a positive theory of regulatory agency behavior. But it also has a normative message as well: Thank goodness economists are not that powerful because all we would have would be markets and markets sometimes fail to achieve efficient outcomes (market failure). Instead we have regulatory agencies that are in a position to perform good deeds for average people that they would not get under *laissez faire*. “The administrative process constrains agencies with poor regulatory proposals, as well as empowers agencies to do what is socially beneficial” (p. 267).

Public choice theory is characterized as having four claims (pp. 50–51). Interest groups don’t represent broad social interests. Broad social interests are unorganized. Legislators maximize electoral sup-

port. And regulatory agencies are controlled by the legislature. In Croley's view this characterization of regulatory policy is inadequate, incomplete, and misleading. Instead, interest groups represent interests other than those of their members; groups representing broad diffuse interests exist; legislators do not seek simply to enact the preferences of narrow interests; and regulatory agencies' behavior is not under the simple mechanistic control of legislators and thus is capable of serving the diffuse interests of the public.

In Croley's theory, which he describes as the Administrative Process Theory of Regulation (p. 72), agencies are more immune to narrow interests than Congress. And agencies increase social welfare under some circumstances by promoting the diffuse interests of the general public against narrow (often business) interests. He supports his theory through the study of three cases: the 1997 EPA decision to reduce exposure to ozone and particulate matter in its revision of the National Ambient Air Quality Standards, the 1996 decision of the FDA to regulate cigarettes and smokeless tobacco products, and the 2001 decision of the Forest Service to issue the so called "roadless rule" that prohibited construction of roads in about one-third of the Forest Service lands. (He also utilizes three other cases involving the FTC, SEC, and Office of the Comptroller of the Currency to supplement his three main cases.) According to Croley in each of these cases, the public interest was organized and the preferences of "public interest" organizations prevailed over the resistance of organized narrow business interests. Therefore public choice theory is inadequate and has an inappropriately elevated status in social science teaching and research.

## Does Regulation Remedy Market Failure?

Croley's defense of regulatory agencies offers an exemplary piece of legal advocacy. That is, if the agencies were his client in a legal proceeding against public choice, this is exactly what a good lawyer would say in defense of the regulatory agencies. And like a good lawyer's brief, much of what he says is true. Groups representing environmentalists and consumers do exist and, in fact, thrive. Legislators do not respond only to narrow interests. And I agree that positive theories of policy outcomes often blur the distinction between explaining legislative and regulatory agency behavior. But in a larger context, the evidence is not consistent with the claim that diffuse interests are well served by government regulation of the economy.

The purpose of government from an economic perspective is to provide a legal framework that allows individuals to transact through markets. And in situations in which markets fail, public action, in theory, can improve welfare through the provision of public goods and the taxation or regulation of externalities (Pigou 1920). While Croley does not use the terminology of this explicitly Pigouvian perspective, his notion of regulation as a process through which diffuse interests are served by the government is certainly a close cousin.

Paul Joskow and Roger Noll (1981: 36) have described the use of Pigouvian analysis as an explanatory theory of government regulation as “normative analysis as a positive theory” (NPT). Market failure provides the normative rationale for government intervention in markets and describes variations in the existence of regulation. The existence of market failure is necessary for government intervention, and government intervention is sufficient to “fix” the market failure and create efficient outcomes. Government is a welfare maximizing social planner.

Substantial evidence contravenes NPT. Economists have examined regulated markets and discredited NPT (Joskow and Noll 1981: 36; Winston 1993: 1259). Almost all regulated markets are not actually characterized by market failure and even for those markets that are, regulation does not enhance efficiency (Van Doren 2005). I will first examine two of the cases described by Croley and then summarize the literature for some other policy areas.<sup>1</sup>

### *The Ozone Case*

Notice that the 1997 ozone struggle is over the air quality standard rather than air quality outcomes. The link between standards and outcomes is tenuous. According to the procedures of the Clean Air Act, once a standard is established, areas must be declared to be in compliance or not, plans must be drafted and approved, and emissions behavior has to respond to the plans. And finally, regions not in compliance must face sanctions.

So while it is possible that industry “loses” and environmentalists “win” in the confrontation over standard setting, the actual result of

<sup>1</sup>I do not discuss the “roadless-rule” Forest Service case because it does not really involve the regulation of a market. Instead it involves management issues in the stewardship of publicly owned land. For a critique of the Forest Service planning process see O’Toole (2008).

the remaining much less visible phases of implementation may be different. Croley notes, without comment, that even before the ozone standard change in 1997, 36 air quality regions were not in compliance with the old standard (p. 178). If you set a standard and many do not comply, how is the standard a victory? Vernon Henderson (1996), a regional economist at Brown, demonstrated that the main effect of the NAAQS ozone standard until 1997 was to reduce the peak ozone concentration but not change the average, relocate industrial plants from jurisdictions out of compliance to jurisdictions in compliance, and reduce severely the number of new firms in noncompliant areas (Becker and Henderson 2000)—exactly the raising-rivals-costs argument that plays so prominent a role in economists' discussions of the effects of regulation (Crandall 1983, Ackerman and Hassler 1981, Maloney and McCormick 1982).

Kay Jones, an emeritus air quality engineering professor, argues that the history of EPA NAAQS standard setting has much more to do with keeping the agency in power rather than protecting the public health. "I suggest that EPA's efforts to tighten the standard amount to little more than moving the goal posts at a time when the nation (outside the troublesome Los Angeles Basin and Houston) is close to being in compliance with the current standard. That is, the new standard is not about promoting health, but about maintaining EPA's command and control regulatory position in perpetuity" (Jones 2007–08: 12).

### *The Smoking Case*

The 1996 attempt by the FDA to regulate cigarettes and the role that attempt played in the subsequent settlement of the suit by states against the tobacco companies to recoup their health care expenditures is also narrated in a David-beat-Goliath style. The FDA championed the "public interest" against the narrow interests of tobacco companies. But once again economists' evaluation of smokers' external effects and the effects of regulation on them are not consistent with the argument that this series of events was a market failure remedied successfully by the actions of the regulatory agency.

Kip Viscusi (1999) has demonstrated that smokers do not create net costs for society. Smokers may have extra health care costs earlier in life than nonsmokers, but they die younger and thus do not collect as much Social Security, Medicare, and Medicaid (nursing

home) expenditures as nonsmokers. Thus no economic rationale exists for governmental attempts to recover money from smokers or tobacco companies.

Jeremy Bulow and Paul Klemperer (1998) have evaluated the economic effects of the tobacco settlement between the states and tobacco companies. They characterize the settlement as a very large tax on cigarette consumers, the creation of a government sanctioned tobacco cartel, and the elimination of tort liability risk for tobacco companies rather than a victory of the public over big tobacco.

How do smokers respond to the increased price of cigarettes? William Evans and Matthew Farrelly (1998) claim that the response of smokers to higher prices is a shift to higher-tar and -nicotine cigarettes to maintain their nicotine intake at as constant a price as possible. Thus smokers' health is not enhanced.

### *Public Goods Provision*

Even in a libertarian world, the government should provide public goods. But the evidence suggests that the very characteristic that makes public goods difficult for markets to provide (a producer can not easily restrict consumption to those who pay) also makes it difficult for the public sector to provide such goods. Instead, coalitions support public goods spending because of the geographically specific benefits that go to the labor and capital involved in making public goods.

Defense spending, for example, is not so much about rational defense needs as it is politically directed spending in congressional districts. Witness the great difficulty in closing defense bases within the United States (Mayer 1999) and the fierce congressional resistance to Defense Secretary Rumsfeld's attempt to cancel production of the Crusader weapon system (Loeb 2002).

Basic research and development spending also would fall under most definitions of a public good. But again, assessments by economists of actual government R & D programs are often not very positive. Linda Cohen and Roger Noll (1991: 378) write, "The overriding lesson from the case studies is that the goal of economic efficiency—to cure market failures in privately sponsored commercial innovation—is so severely constrained by political forces that an effective, coherent national commercial R & D program has never been put in place."

### *Natural Monopoly Regulation*

The regulated “natural monopolies” such as rail, trucking, airlines, telecommunications, and electricity were regulated allegedly to reduce the market power of producers and lower prices to consumers. The evidence, however, is consistent with more complicated redistributive schemes in which incumbent firms were protected against competition in return for prices above costs on some services that subsidized services to other consumers (Peltzman 1989: 21; Friedlaender and Spady 1981: chap. 1).

### *Health and Safety Regulation*

Kip Viscusi and Ted Gayer (2002) have shown that trends in accident fatalities have been steadily down over the last 100 years with no obvious evidence of effects from the creation of OSHA and the Consumer Product Safety Commission. In addition many of the health and safety regulations enacted by federal regulatory agencies cost so much per life saved that they probably increase risk to society because they lower real income relative to a less regulated society and thus reduce one of the uses of that increased income, which is the purchase of safer products and practices.

## How to Explain the Deregulation Puzzle

While I think that Croley is incorrect in characterizing regulation as serving the public interest, he is correct to argue that deregulation would seem to present difficulties for both traditional “Chicago” as well as “Bootlegger and Baptist” versions of explanations of regulation by economists (Yandle 1983, 1999). If regulation is such a good deal for the organized against the public, how do the organized ever lose?

The problem is that Croley is not the first scholar to raise the issue. Sam Peltzman (1989), in a paper not discussed by Croley, argues that deregulation occurs after the rents created by regulation and distributed to the organized have been dissipated through competition or technological change. The main exception is trucking deregulation in which entry was allowed to occur even though incumbent firms and labor were still enjoying the economic rents from regulation.

In his commentary on Peltzman’s article, Roger Noll argues that a positive theory of collective choice on policy outcomes (i.e., a theory

of regulation and deregulation) must take into account the indeterminacy of collective choice as demonstrated by Arrow and McKelvey. That is, any theory, including the Chicago economic theories of regulation, must understand that “policies are inherently unstable and transitory” (Peltzman 1989: 50). From this perspective institutions are designed to reduce the inherent instability of majority rule. And change occurs when courts or agencies alter the regulatory status quo. “Congress lagged behind actual policy and was forced into action by the reality of the new status quo it had inherited from either the agency or the courts” (Peltzman 1989: 50). This quote from one of the advocates of the legislative dominance school would seem to support an important aspect of Croley’s argument 19 years before Croley makes it.

### How Many Cases Does It Take to Refute a Theory?

For the moment forget everything I have argued so far. Assume that I agree with Croley’s characterization of his cases and assume that some other cases could be employed in a similar fashion. How many cases would he have to invoke to refute public choice theory?

How does one test a theory? In areas of inquiry that explicitly use statistical or experimental methods, we would never use the case/counter-case approach found in the type of analysis used by Croley. Instead we would define a case or unit of analysis. Second, we would gather a random sample of cases from a population. And third, through a mixture of research design and econometrics we would estimate the marginal effect of variation in one variable holding all other variables constant. And finally we would create a confidence interval to surround that estimate of the marginal effect to reduce the likelihood of false positive causal inferences.

Thus, in those areas of social science in which data analysis and hypothesis testing are the norm, no one would ever consider examining three or six cases in the data and using such analyses to support or refute theories. For example, some smokers live long lives. If I found six of them and argued that the theory that smoking reduces life expectancy seems to be refuted, you should (and would) not give me the time of day. Instead you would estimate a regression line through the data points, each of which characterizes a person’s smoking behavior and life span, and conclude there is a relationship between smoking and life expectancy. We would never just discuss

six of the data points that were far from the trend line. And yet positive theories of policy outcomes are still discussed in this manner.<sup>2</sup>

## So What Is Positive Policy Analysis Really About?

Given the difficulties of testing theories of policy outcomes correctly, studies utilizing discussions of cases in the manner of Croley are likely to continue for some time. But my advice is that we should stop because the result is not really good science and in the end it is not clear that advancing positive theory is really what such studies are about.

Even though Croley claims to be developing a more accurate positive theory of the administrative state, his basic message is normative rather than positive—regulatory agencies can serve the public interest and economists should back off and stop criticizing them. He gives this away in his subtitle: “The Possibility of GOOD Government.”

But a close evaluation of the literature evaluating government policy toward ozone and smoking is not that supportive of view that government regulation remedies market failures effectively. And the broader literature evaluating traditional (economic) regulation (ICC, FCC, SEC, CAB) as well as the new health and safety regulation (EPA, OSHA, NHTSA, CPSC) is extremely pessimistic about regulation improving social welfare cost-effectively.

Markets do fail and, in what Demsetz (1969) called the “nirvana fallacy,” an imaginary omniscient government could use coercion to mimic what markets would achieve if they didn’t fail. But in practice, governments are not omniscient. And even though market failures exist, even though the possibility of a good government fixing them cost-effectively is not zero, and even though cases exist that would demonstrate this, flawed markets trump flawed government more often than flawed government trumps flawed markets.

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<sup>2</sup>For a discussion of the methodological issues in the positive analysis of policy outcomes see Van Doren (1991).

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