Uncovering and eradicating discrimination in credit markets are an important goal for federal and state bank regulators. Unfortunately, determining what constitutes discriminatory behavior is often more difficult than it appears. Although APR may seem a reasonable way to compare prices across different loans, it does not consider the voluntary choices that borrowers make about the terms of their loans. As a result, relying on APR can lead to inaccurate conclusions about the presence of discrimination.

Regulators and others involved in fair-lending enforcement should abandon use of APR and other similar effective-interest rate comparison tools. Instead, fair-lending compliance should be measured by statistical comparisons of the relative frequency and magnitude of overages across groups. By this means, regulators can get a clearer, more accurate picture of the true options that were available to different borrowers.

Do Environmental Regulations Increase Economic Efficiency?

By Jane S. Shaw and Richard L. Stroup

Physicist, a chemist, and an economist are stranded on an island with nothing to eat. A can of soup washes ashore. The physicist says, “Let’s smash the can open with a rock.” The chemist says, “Let’s build a fire and heat the can.” The economist says, “Let’s assume that we have a can opener.”

As this familiar joke (attributed to Paul Samuelson) attests, economists rely on assumptions. In doing so, they sometimes ignore reality. Economists have recently been ignoring an important reality: business executives are beginning to embrace economywide regulation as being good for the bottom line.

Economists know that regulation is seldom good for the economy unless the benefits outweigh the costs. Thus, they spend a lot of time weighing the costs and benefits of proposed rules.

Regulation as a Spur to Innovation?

A different idea is gaining ground in business boardrooms, however. Saving the environment is a “business opportunity,” says Tachi Kiuchi of Mitsubishi Electric. According to the Aspen Institute (in a report developed with help from businesses—from Anheuser-Busch to Weyerhaeuser), “By learning to ‘value the environment,’ companies and financial institutions are uncovering another competitive edge.”

Yes, regulation can be a good business opportunity for some, even with the higher costs it imposes. For example, producers who are the first companies to discover better ways to reduce pollution can profit by keeping costs down. In addition, they may profit by selling new technologies to other producers. (As we will note later, some companies also profit by obtaining monopoly power through regulation.)

So far, so good. But some business strategists make another leap: they argue that regulation leads to cost-reducing innovation, directly increasing profits. Lower costs and lower pollution can result. Under these conditions, who would argue against tighter regulation?

Although there are variants, the idea that regulation spurs innovation that raises profits stems largely from the work of Michael Porter and Claas van der Linde. They have presented their views in such places as the Harvard Business Journal, Scientific American, and the Journal of Economic Perspectives. Indeed, an exchange with economists in the latter journal seems to be the one serious debate over the issue—and it is not clear that the economists won. Since their competing essays appeared in 1995, economists have moved on, assuming they were victors. Or, so it would appear. Meanwhile business strategists have held conferences, written books, and persuaded journalists (in case they needed persuasion) that more environmental regulation is nearly always a good thing.

In the 1995 article, Porter and van der Linde argued that “properly designed environmental standards can trigger innovation that may partially or more than fully offset the costs of complying with them.” They offered several examples of such offsets.

- Ciba-Geigy responded to environmental standards by making process changes that saved $740,000 per year.
- 3M saved $120,000 in capital investment and $15,000 annually by replacing solvents with water-based solutions.
- The Robbins Company saved nearly $300,000 in capital
costs and more than $115,000 per year by moving to a closed-loop system in its jewelry-plating business.

These examples are undoubtedly true. The companies mentioned are making money from pollution control or material reduction. It should not surprise us. The profit motive has long led to increasingly efficient use of material resources. Every 1 percent reduction in the aluminum industry spent $102 billion in 1992 on pollution control, of which $17 billion (less than 2 percent) was offset by the regulations.) Regulation can be a competitive tool for smaller competitors more than their own. But today, they are sensitive to market pressures, and regulation is the way to make executives start looking for them.

**NOW FOR A DOSE OF REALITY**

Most environmental economists dismiss the notion that innovation depends on regulation. You could almost hear Karen Palmer, Wallace E. Oates, and Paul R. Portney sputtering with indignation as they responded in the journal of Economic Perspectives. They called the Porter-van der Linde claim, however, that environmental regulation is necessary, for the most part, to spur the innovation that will add to profits. They argue that because of poor information and management incentives in many companies today, there are “$10 bills” lying around that have not been picked up—innovations just waiting to be made. And regulation is the way to make executives start looking for them.

**MOVING BEYOND SHOCK THEORY**

But too often in the policy arena “logic is for losers.” Logic—theory, that is—is not enough. We believe that economists need to be more thorough and more carefully empirical on this question. They should be more persistent in combating the idea that stricter environmental regulation will normally pay for itself by shocking firms into innovating with better technologies, thus benefiting everyone. It is far more dangerous than the original shock-effect idea.

Large companies have always been tempted to seek tougher regulations as a means of raising the costs of their smaller competitors more than their own. But today, they can wrap themselves in the cloak of respectability by promoting regulation as a way of forcing beneficial change. One result can be to draw the most entrepreneurial companies into the process of negotiating for regulations that give their companies special advantages.

Bruce Yandle reported in Regulation (Vol. 22, no. 3) that some oil and natural gas companies have already figured out how to benefit from the proposed Kyoto Treaty negotiations—at other companies’ expense. He also noted that logging regulations to protect the northern spotted owl, which drastically reduced timber logging in public forests, increased foreign trade, wider markets in nearly every industry, and thriving merger-and-acquisition activity, surviving firms are lean, mean, and innovative without regulation.