Title: The Impact of Federal Regulatory Costs on Small Firms

Description:

The annual cost of federal regulations in the United States increased to more than $1.75 trillion in 2008. Had every U.S. household paid an equal share of the federal regulatory burden, each would have owed $15,586 in 2008. By comparison, the federal regulatory burden exceeds by 50 percent private spending on health care, which equaled $10,500 per household in 2008. While all citizens and businesses pay some portion of these costs, the distribution of the burden of regulations is quite uneven. The portion of regulatory costs that falls initially on businesses was $8,086 per employee in 2008. Small businesses, defined as firms employing fewer than 20 employees, bear the largest burden of federal regulations. As of 2008, small businesses face an annual regulatory cost of $10,585 per employee, which is 36 percent higher than the regulatory cost facing large firms (defined as firms with 500 or more employees).

The regulatory landscape highlighted above and detailed in this report emerges from an updated analysis of the regulatory record explored in three previous studies for the Office of the Chief Counsel for Advocacy of the U.S. Small Business Administration (Hopkins, 1995; Crain and Hopkins, 2001; and Crain, 2005). Direct comparisons to the results in these prior studies should be made with caution, however. The present study introduces some new methodological techniques, which may account for some of the differences in the cost estimates for 2008 versus those for prior years.

Purpose/Objective:

Government regulations pervade modern life in America and other nations with few exceptions. Regulations are needed to provide the rules and structure for societies to properly function. This research, while mindful of this fact, does not consider the benefits of federal regulations, but looks at the overall costs imposed by them. Little stock is taken of the cumulative effects.

OMB Category: Influential

SBA Point of Contact: Dr. Radwan N. Saade (Radwan.Saade@sba.gov)
Program Office: Office of Advocacy

External Reviewers:

Richard Williams, Regulatory Studies and Government Accountability Mercatus Center at George Mason University
Bob Litan, Kauffman Foundation

Review Year: FY2010

Comments:

==

Richard Williams:

This is a great project, and I hope the following comments will help make it stronger.

The study uses the World Bank's Regulatory Quality Index to estimate the effects of economic regulation on GDP. It measures the cost of environmental regulations by using agencies' ex ante estimates compiled by OMB and Hahn and Hird (1988)'s estimates or the costs of pre-1988 environmental regulations. It measures the costs of workplace safety and homeland security regulations by using agencies' ex ante estimates compiled by OMB and Johnson (2005) for pre-2001 regulations. Finally, it measures the cost of tax code regulations by estimating the paperwork costs associated with tax compliance.

1. Regulatory Quality Index

The use of the Regulatory Quality Index is an innovative idea. However, I am concerned that the index may not measure what the authors say it measures, and even if it does, it may overstate the costs of regulation when used in conjunction with the other measures.

The index needs a more careful explanation in the text, not just refer to other studies. It is not clear from the description in the study precisely what the Regulatory Quality Index measures. At some points the authors present it as a measure of the amount of regulation, other times as a measure of the costs of regulation, other times as a measure of the "quality" of regulations, and still other times as a measure of regulatory institution quality. At a minimum, this needs to be explained carefully, and the meaning of the index needs to be described consistently.

The authors should also consider whether the meaning of the index affects their results. The index might indicate the amount, cost, "smartness," net benefits, or some other aspect of regulation, or it might measure satisfaction with administration of the regulatory system, or some combination of these things. Is the index only a useful measure if the authors can show that it really does measure the amount of regulation? Or, suppose the index measures something more vague like stakeholder confidence in the regulatory system. Are the authors willing to make the case that the GDP differential associated with different levels of the index still counts as a rough measure of the costs of regulation?

Is this really an index of "perception" of regulatory burdens? If so, how can perceptions be measured across cultures, how can it be consistent? Even if the Regulatory Quality Index is intended to measure stakeholders' perceptions of economic regulation, it might actually measure their perceptions of all regulation. There are two reasons. First, the survey respondents may interpret the questions as an inquiry about the quality of more than just economic regulation. Second, even if they correctly understand that the questions solely concern economic regulation, their attitudes toward other regulation might influence their responses. For example, a public utility executive who deals extensively with environmental regulation might provide a more negative response than a plumber, even if we assume that both are equally affected by the barriers to entry created by the *economic* regulation of their industries. Thus, the Regulatory Quality Index might actually measure the amount, cost (etc.) of more than just economic regulation.
Even if the Regulatory Quality Index only measures economic regulation, the econometrically estimated effect on GDP might reflect more than just the effect of economic regulation on GDP. If the amount, cost, quality (etc.) of non-economic regulation is correlated with the Regulatory Quality Index, then regressing GDP on the Regulatory Quality Index without controlling for the effects of other forms of regulation will yield a coefficient that measures the effects of economic regulation plus the other regulation that is correlated with economic regulation.

To assess whether this is plausible, one only need ask if it is plausible that governments that impose a lot of economic regulation also impose a lot of safety or environmental regulation or tax compliance burdens. The main implication of all this is that the study might over-estimate the total costs of regulation because the effect of the Regulatory Quality Index on GDP may also capture some or all of the effects of environmental, workplace, security, and tax regulations. Thus, it is possible that the total cost of federal regulation is "only" $1.236 trillion annually. (This critique may also apply to the 2005 study.)

On the other hand, there are reasons to believe that it may underestimate costs. The following paragraph should take into account that I have not read the original justification which may explain this. You can start with the fundamental idea of opportunity costs. Resources that are devoted to complying with regulations are not used to produce GDP that responds to normal market forces (demand). Both activities, complying with regulations and normal market activities add to GDP. What has been estimated here is the difference between the two, GDP with resources that would have been devoted to normal market forces minus GDP with resources devoted to complying with regulation. That difference is, I think, one component of the cost of regulation. However, that may leave, (if I am thinking about this correctly) the cost of complying with regulation that is picked up by GDP. That is, a person can produce 10 widgets that comply with regulation and 15 widgets if employed normally by the market, and this model would estimate the costs of the regulation at 5 widgets (the difference in GDP). But that doesn't count the original 10 widgets of expenditure that adds to GDP and is also a cost and must be weighed against the benefits. In the OMB model, all of these costs are counted.

Some of the problems mentioned above could perhaps be solved simply with a better and more careful explanation of what the Regulatory Quality Index really measures. To guard against over-estimating costs, however, the authors would either need to control for the effects of other types of regulation on GDP, or refrain from adding some or all of the costs that are estimated via other methods.

2. Cost increase

The study indicates that the total cost of regulation has increased significantly since 2005. This may be an overstatement. Since this conclusion is largely driven by economic regulation, and the authors use a different index to measure the effects of economic regulation, the difference may be driven by the estimation method. The authors could check for this by updating the 2005 analysis to 2008 using the same index used in the 2005 study, and also replicating the 2005 analysis using the Regulatory Quality Index. Results of these two exercises should show whether economic regulatory costs actually increased, or the measured increase resulted simply from the different indices used for estimation.

The reference to Sarbanes-Oxley as the explanatory factor on page 24 does not sound plausible as written, but maybe the authors can make a stronger case. The $1.4 trillion figure from the event study would be the present discounted value of all the future effects of SOX on corporate profits, not an annual figure comparable to the annual figures estimated in this study. Some of the other cost figures for firms would be more helpful if the authors could multiply them by the number of firms to provide a total.

3. Other costs

There are three other costs that I think are probably left out of most cost estimates. Firms do not understand them and most RIA's do not account for them. The first is administrative costs. These are management costs related to following regulations (to see which ones apply) and decision making costs of deciding how to comply and then leading compliance. As this is generally the highest paid category of labor, these costs may be quite high. The second cost is not a resource cost but is real nevertheless. It is the additional cost of loss of liberty that comes from restraining our choices. There are both constitutional and non-constitutional losses of liberty. Finally, most RIA's do a bad job of estimating risk/risk trade-offs. Where risks are increased as a result of a regulatory action, that may or may not have been accounted for in the estimation of opportunity cost. For example, there may be a consumer surplus loss from a food ban of switching from a banned food to a substitute. The benefit will be the reduction in risk from the banned food. Whether an added cost or a decreased benefit, there may also be an increased risk from a substitute food. In general, this holds for all costs, every increased activity carries with it some risk but it is rarely accounted for in RIA's. One last addition, I wasn't sure if transfer regulations were counted, the costs are rarely estimated but they do have the potential to distort resources.

4. Allocation of costs

If the authors continue to use cost figures from OMB that ultimately come from RIAs produced by agencies, it should be possible to examine the RIAs to see what they say about the incidence of the costs between consumers and producers. Some address this, some don't.

When describing the cost allocation across sectors, it would be helpful if the authors could explain why we should expect sectors' share of regulatory costs to vary based on the factors that are used to calculate the allocations. Why should we expect the sector's share of the regulatory burden to vary based on its percentage of GDP or employment? Also, regulations with Regulatory Flexibility Act analyses usually indicate which industries are affected; this may provide a more accurate assessment of the incidence across sectors.

Specific Page Comments

Page 9 – I was unsure how the lack of small businesses in some utilities affected the number of employees per firm?
Page 20 – is this really a complete specification for country wealth. How about well defined property rights?
Page 25 – The assertion that OMB's coverage of environmental regulations being complete should be noted as an assumption.

Bob Litan:

I looked it over and it's terrific, nothing to add. Congrats

==