**Week 11: Regulation and Administrative Law**

* This week’s topic is an important one on which there is an immense economic literature, making it a sensitive thing to try to condense it to the time we have at our disposal. The topic is regulation and its oft-argued legal foundation: administrative law.
* **Regulation**, as Robert Litan puts it, “consists of requirements the government imposes on private firms and individuals to achieve government’s purposes.”
* Regulation includes—to again borrow from Litan:
* Better services (quality controls)
* Caplan’s plastic bag example after the $0.10 mandatory bag charge
* Cheaper services (price controls)
* Gas price controls in the 1970s and during crisis periods in the present
* Protection of existing firms from competition (Antitrust)
* Environmental standards
* Workplace safety standards
* Product safety standards
* Licensing laws. Public interest or rent seeking?
* Bodyguards
* Lawyers and doctors
* Taxi drivers
* Hair braiders and beauticians
* Many more!
* These are punishable by fines, seizure of property, and/or, in the extreme, criminal penalties.
* The constitutional basis on which this is performed is derived from Article I, Section 8, Clause 3, commonly known as the “commerce clause,” which permits the federal government to “regulate commerce with foreign nations, and among the several states, and with Indian tribes.”
* In some cases, these regulations are imposed on an *ex post* basis in which a firm or individual must be found to have broken an existing law pursuant to an investigation, just as any violation of a criminal law would produce.
* In other cases, regulations are imposed on an *ex ante* basis in which a firm or individual, in order to engage in a particular form of economic activity or enter a particular market, must prove *at their own expense* that they have not broken and are not about to break the law. Very often in regulatory matters, this latter method is the case and becomes, in effect, a system of pre-emptive law in which would-be market participants must effectively prove their innocence rather than the state having to prove their guilt.
* Note: this is not a normative evaluation! Some may argue that the stakes are too high in certain cases and that private actors should have to prove their innocence (e.g. pharmaceutical approval) whereas others will claim that this deviates from the due process standards we extoll in other areas of the law or that its structure is based purely on rent seeking motives in order to protect incumbents from new market entrants. The evaluation is yours to make.
* We touched on them briefly in discussing welfare economics several weeks ago, but it is worth reviewing some of the stated goals of regulation and the arguments for why it is necessary or what goods it provides.
* Mitigating negative externalities
* Promoting positive externalities
* Supplying information or mandating that private parties do so
* An important underlying assumption in these arguments is that the mechanisms of private property rights and the accompanying personal liability and potential profits and losses that attach to that property via torts do not effectively resolve problems of externalities (you will recall the article that you read which argued, to the contrary, for tort law as a substitute for regulation) and that the social benefits of a regulation exceed the social costs of its implementation as well as any unintended consequences or side effects that regulation might entail.
* These perspectives, however, began to be challenged in the 1960s, most notably improved by the work of George Stigler. In 1962, Stigler, along with co-author Claire Friedland, published a paper called “What Can Regulators Regulate? The Case of Electricity.” In it, they found that the alleged justification of regulations placed on electric companies—that is, keeping prices low—had little empirical evidence to support it, as regulation had only very small effects on electricity prices.
* In 1964, Stigler’s presidential address to the American Economic Association argued that rather than taking the effects of regulation as claimed by regulators, economists should set out to empirically test them. He argued that “[t]he economic role of the state has managed to hold the attention of scholars for over two centuries without arousing their curiosity.” He concluded that, “Economists have refused to leave the problem alone or to work on it.”
* His efforts on the subject culminated in a 1971 paper entitled “The Theory of Economic Regulation,” in which he introduced the theory of “regulatory capture” which argues that the protectionist effects of regulatory agencies—that is, defending incumbents by keeping out new entrants and promoting monopoly by stifling would-be methods of competition—is deliberate and is the result of a process by which regulated companies lobby their regulators and use regulation to their own private interests.
* Stigler’s student, Sam Peltzman, would further develop these ideas in his 1976 paper “Toward a More General Theory of Regulation.” There, Peltzman models a would-be cartel that seeks to organize in order to achieve monopoly profits. Cartels, however, as you will have learned in intermediate microeconomics, suffer from a defection problem. Their agreements are hard to enforce. Thus, they often resort to lobbying for regulation in order to use government as their enforcement mechanism. However, in the process of securing these regulations, the politicians who grant them this will always be getting something in exchange. Very often, this consists of some power over the industry in question. The regulator also exercises choice as to not only the appropriate size of the interest group he will privilege or to tax but also the structure of taxes and benefits to be applied. At all times, however, Peltzman stresses that the same supply and demand apparatus used to understand markets can be applied to regulatory behavior and the regulator’s pursuit of political profits.
* Around the same time, Armen Alchian at UCLA was producing his own influential work on regulation. In 1962, along with Reuben Kessel, Alchian wrote “Competition, Monopoly, and the Pursuit of Money,” in which they argued for the power of profit caps to promote discriminatory behavior on the part of firms. In a market in which profits are unlimited, they argued, firm managers make business decisions—hiring and contracting—based on the profitability of their decisions. Following Gary Becker’s 1957 thesis, *The Economics of Discrimination*, they noted that discrimination on the basis of race, religion, gender, or other characteristics which do not relate to profits may indeed lead to a sacrifice of those profits. Furthering what Becker argued, though, they noted that this meant that if profits were capped by regulation, then after all achievable profits had been made, managers were free to discriminate on whatever basis they wanted and to indulge their preferences. Using evidence from Jewish and non-Jewish Harvard MBA graduates, the authors sampled across industries, categorized them as to which type of industry they entered after graduation, and found that industries which were more monopolized and subject to regulation evinced a dramatic discrepancy in the hiring of Jewish graduates, with a frequency of less than 18% relative to 41% in non-monopolized fields.
* Thus, the overall thrust of the research which emerged in this period and much of the research to follow has demonstrated the litany of unintended consequences which often beset regulatory efforts and bring us to question the role of concentrated benefits and dispersed costs which might lead special interests to lobby for regulations which are not necessarily socially beneficial. It leads us, upon hearing of a new regulation, to invoke the old Latin phrase, “*Cui bono?*”—who benefits?
* When a drug company’s efforts to secure an extract from Pacific yew trees, which it was using to treat ovarian cancer patients, was stymied by environmentalist complaints that its extraction was endangering the spotted owl, we can take it at face value and certainly there are environmentalists who would argue it on those ground. Who else might benefit from restricting the production of Taxol relative to other chemotherapy drugs?
* When a drug to ease the side effects of chemotherapy was produced several years ago but denied access to the market on the grounds that although it carried no adverse side effects, it only helped roughly half of terminally ill patients to alleviate their pain (albeit without harming the others), we could take that argument at face value. But who else might benefit from keeping that drug off the market?
* When property values in Central and Southern California skyrocket while large swaths of land are banned from being developed on the grounds that doing so would make the region less beautiful, we can take that justification at face value. But who else might benefit from rising property values and nice views?
* The point here is not to make you paranoid or to indulge conspiracy-theoretical hypotheses. It is instead to challenge the rose-goggled theories which, pursuant to our previous discussions of civil law and the potential for rent-seeking which it carries, seem difficult to maintain in such cases.

Regulation, Costs, and Growth

* Last time, we briefly surveyed what regulation is, what the traditional welfare economic arguments for it are, and a research agenda since the 1960s—advanced by such notable figures as George Stigler and Armen Alchian—which has brought those arguments into question through both theoretical and empirical counters.
* Today, we will consider more deeply some of the costs of regulation, look at how those costs can multiply to macroeconomic significance, and consider why, if regulations are so costly and their effects so contrary to the theoretical arguments which justify them, they continue to grow in number and cost.
* The costs of regulation are frequently cited in political debates, usually—in recent years, at least—by politicians on the right. Whether you see regulations as necessary and good or as pure nuisances, the empirical fact is that they have grown enormously over recent decades and continue to do so all the time. In 2016, the Federal Register, in which all federal regulations are recorded, weighed in at 95,894 pages.
* In 2010, the Office of Management and Budget reported that Americans spend 8.8 billion hours filling out government forms of one sort or another and that that number had increased 19% over the previous decade. And in 2010 the Federal Register was a mere 81,405 pages! **(Display chart)** We can infer that those compliance hours would be even greater today. In 2010, employers reportedly needed almost 70 million additional hours to claim a new credit for hiring workers. Restaurants that year spend 14.5 million hours displaying calorie counts on their menus to meet government standards. Remember: for every hour that is spent on compliance, there is an hour not spent producing output, hiring workers, and generating revenues. According to a Small Business Administration estimate at that time, the costs of this compliance to the economy was $1.75 trillion per year.
* A 2011 study by the Phoenix Center, a public policy institute, conducted an econometric study which found that for every one bureaucratic job created by regulations, 100 jobs were lost or foregone in the private economy. They found that for every $1 million increase in the federal regulatory budget, 420 private industry jobs were lost.
* How does this work? Let’s take a look.
* Compliance costs are a major part of the cost of regulation, as the previous statistics indicated. There can be marginal compliance costs, but generally the compliance costs of regulation are fixed costs, not varying with the size of a firm or the volume of business that it does. This means that small firms, startups, and would-be entrants can be pushed out or excluded from the market, securing larger incumbents and increasing monopoly power. It turns out, however, as great as they are and as often as they are cited, that by comparison to the inefficiencies produced through lost output, compliance costs are trivial.
* We talk about the increase in monopoly power which results from this, but what are the real social costs and inefficiencies which result from greater monopolization? There are two major forms of inefficiencies which can be generated by monopolization:
* Allocative inefficiency
* Most micro courses focus on allocative inefficiencies of monopoly or the “deadweight loss” of monopoly.
* Deadweight losses, however, are usually small.
* Productive inefficiency
* Productive inefficiencies are less discussed but can be much more costly.
* A productive inefficiency arises if and only if the average cost of producing a given quantity is above the minimum of average cost.
* They exist on all units produced, yielding, instead of a DWL triangle, a whole DWL trapezoid!
* With a contestable monopoly and unequal costs, some allocative inefficiency results but no productive inefficiency.
* However, with a government-created monopoly that has a price cap at P=MC, there is no allocative inefficiency but there will be productive inefficiency. This is the risk of policy-generated monopoly power.
* It is easy to see how, when multiplied across all regulated industries and the volume of business they conduct, these costs can take on macroeconomic significance. Indeed, in a 2013 paper entitled “Regulation and Aggregate Economic Growth,” John W. Dawson and John J. Seater find the growth in federal regulations from 1949 to 2005 to have resulted in an average reduction in economic growth of two percent per year. Remember the large magnitudes that small changes in economic growth rates can produce, though! Dawson and Seater’s conclusions mean that if the Federal Register had been frozen in 1949, GDP at the end of 2011, rather than being $15.1 trillion, would have been $53.9 trillion! This annual loss of $38.8 trillion means that in 2011, income per person in the United States, rather than $49,790, would be more like $179,000. Per household, rather than $51,926, it would have been more like $329,000 per year!
* This clarifies our question a bit as to the costs and benefits of regulation. Rather than asking simply whether there would be risks and costs involved in living in a less regulated economy (note: I didn’t say unregulated; we’re only going back to 1949), to do an honest cost-benefit analysis you have to ask whether living in a less regulated economy would cost the median household eighty-four percent of their income every year!
* The net benefits of deregulation thus appear to be huge. So why don’t we simply deregulate? What’s the holdup?!
* Milton and Rose Friedman asked this question in one of the books they wrote together, *The Tyranny of the Status Quo*. There, they described what had already at that time—in the early 1980s—come to be called the “Iron Triangle.” The Triangle consists of three parts:
* The Tyranny of the Beneficiaries
* With respect to the beneficiaries, the situation is complicated by what Gordon Tullock called the “**transitional gains trap**”: those who initially benefited from a regulation’s enactment are not the same people who would currently be harmed by its elimination.
* Take the case of a tariff. If a tariff were enacted a hundred years ago for, let us say, the steel industry, it might have generated considerable profit margins for American steel. Eventually, however, if barriers to entry are not prohibitively high, new steel producers would have entered the industry and dissipated the monopoly rents, bringing the price back down to a competitive level where price is just equal to marginal cost. Now, if such a tariff were to be repealed, it would likely very quickly increase supply and push price below marginal cost, potentially putting many firms out of business and requiring any that survived to execute judicious cost-cutting measures.
* Taxi drivers who have paid high prices for their medallions
* Thus, though they do not enjoy exorbitant profits as a result of longstanding regulations, firms may be threatened with obsolescence if they are repealed.
* The Tyranny of the Politicians
* The Friedmans draw a stark comparison to current practices by describing George Washington’s famous first election victory to the Virginia House of Burgesses in 1758 in which his supporters wooed votes by embellishing the political season festivities with twenty-eight gallons of rum, fifty of rum punch, thirty-four of wine, forty-six of beer, and two of cider at a final ratio of a quart and a half of alcohol per voter. Washington was pleased with the results but expressed concern that his friends had spent too much and stressed that even those who did not vote for him should not have been excluded from drinking.
* They note the exorbitant growth of politicians’ dependency upon doling out favors and privileges to secure votes and campaign donations.
* They cite the absurd complexity and system of exceptions in our tax code as evidence of politicians’ handouts and special favors to appease donors
* This system of favors makes the current size and scope of the regulatory code instrumental to many politicians’ continued success
* The Tyranny of the Bureaucrats
* In the case of bureaucrats, as we covered last week, the absence of a profit motive and the remoteness of a bureaucrat—especially a high-level one—from the ultimate effects of their policies, combined with an immense budget of other people’s money leads them to pursue ever-increasing power and control.
* Combine this with the interests of private parties who have developed mutually dependent relationships with those bureaucracies and will lobby for their continued existence and the question of their budgets and perpetuation become increasingly removed from their record of success.

Administrative Law

* In our last class, we discussed just a few of the complexities of regulation and bureaucracy,the nature of regulatory costs, and the effects of regulation on macroeconomic growth. Today we will look at the legal doctrine which underlies these practices: that of adminsitrative law.
* As I mentioned briefly at the end of the last class, whereas we can think of common law as judge-made (or, in many cases, really, judge-affirmed) law and civil law as the product of legislatures, we can think of administrative law as executive-made law. That is: law made either by a king, dictator, or president, *or their appointed subordinates*. The essential characteristic to appreciate with administrative law is that the traditional (in our republic) constitutional allocation of responsibilities across branches in which one branch makes laws, the other enforces them, and a third interprets them is eschewed in favor of an arrangement in which certain such responsibilities are internalized within the executive.
* The manifestation of this process is the proliferation of executive bureaucracies over the last 120-plus years. Today, there are 15 executive departments, each containing dozens of bureaus, and dozens more within the Executive Office of the President. In the last class, we discussed research which found that for every one federal bureaucrat hired, 100 jobs were lost in private industry. From 1940 to 2014, the number of civilians employed in the executive branch grew from 699,000 to 2,079,000—nearly three-fold.
* So by what constitutional authority have these departments and agencies been established? In fact, there is some debate as to their constitutionality. Traditionally, the power to bind citizens through taxes or coercive restrictions on their behavior was said to rest solely with the legislative and judicial branches. The executive could implement their wills but not pursue its own. Over time, however, its powers have been augmented and its role reconceived.
* One of the primary defenses of this consolidation of power into the executive contends that the many edicts passed down by executive bureaucracies are part and parcel of its enforcement power. Without them, it could not enforce the laws of Congress. This is the **delegation defense**.
* Another argues that despite the growth in bureaucratic size, administrative law still leaves in place the functional equivalents of limits established by the constitution.
* A third contends that administrative law is a result of the complexity of modern society and the evolution of the state to meet challenges that the Founding Fathers could never have foreseen.
* Significantly, though, none of these defenses denies that administrative law constitutes a change in the structure of the state nor that it ventures beyond the Constitution. They admit this and argue for its necessity on the grounds of either functional equivalency or unforeseen changes of a modern world.
* The notion, however, that the Founders had failed to appreciate arguments for executive prerogative or that the issue is a distinctly modern one are, upon full consideration, bizarre. The notion of royal prerogative was well established in Anglo-American law in their time and corresponds very well with legal arguments for powers which the Englich crown and its lawyers fought to defend many times in English courts. Granted: there were costs to denying the validity of laws as written; a king might need them in the future and certainly didn’t want to destroy all popular belief in the sanctity of the law. On the other hand, he needed to be able to work around Parliament at times. Thus, his supporters came to claim two kinds of prerogative: lawful and absolute. Extraordinary prerogatives were said to be extralegal or even supralegal.
* In 1539, under Henry VIII, Parliament relied upon Roman notions of civilian law when it succumbed to royal pressure and authorized prerogative lawmaking in a piece of legislation known as the Act of Proclamations, or, in its full name, An Act that Proclamations Made by the King Shall be Obeyed. Nothing comes free, however, and the language of the Act also contended that Parliament acted of necessity and urgency, thereby sharing in his expansion of power. This transformed arguments which had previously been made in times of emergency into common practice.
* Apparently many in Parliament did not take to the new arrangement, however, and when the king died, it was repealed the next year. But through the reigns of Queen Mary and Queen Elizabeth, legal battles resumed over the power of the crown relative to that of Parliament.
* At the beginning of the 17th century, the House of Commons petitioned that “no fine or forfeiture of goods or other pecuniary or corporal punishment may be inflicted upon your subjects… unless they shall offend against some law or statute of this realm in force at the time of their offense committed.” It was, in essence, a clear objection to administrative law.
* By 1610, constitutional arguments began to prevail as a means of arguing against royal prerogatives and especially royal attempts to exercise legislative power. From the late 15th to the mid-17th century, the English crown administered the Court of the Star Chamber, an internal body the primary purpose of which was to issue economic regulations which bound subjects through extralegal legislation, including restrictions on which clothes subjects were allowed to make and wear, their trade, prices, construction, and the printing presses.
* In the noted *Case of Proclamations* (1610), James I hoped to further secure his power to exercise prerogative legislation against the challenges of antagonistic parliamentarians and took his case to the court. The specific matters at issue were whether the king could prohibit building in areas of London (a zoning restriction) and the making of starch out of wheat (an attempt to create royal monopoly).
* James I claimed the power “to apply speedy, proper, and convenient remedies… in all cases of sudden or extraordinary accidents, and in matters so variable and irregular in their nature, as are not provided for by law, nor can fitly fall under the certain rule of law.”
* The court, in response, issued an advisory opinion that “the king by his proclamation cannot create any offense which was not an offense before” and noted that the law is “divided into three parts, common law statute law, and custom; but the king’s proclamation is none of them.”
* With time, this doctrine came to hold that not even legislative consent could authorize administrative law, as such delegation was in violation of the contract which held between the people and their elected representatives. By 1641, Parliament abolished the Star Chamber, calling its decrees “an intolerable burden to the subjects and a means to introduce arbitrary power and government.”
* Fading into color, in 1984, the United States Supreme Court heard the case of *Chevron U.S.A. v. Natural Resources Defense Council*. In 1977, Congress had amended the Clean Air Act to increase restrictions on states which had not achieved national air quality standards mandated by the EPA. The amendment required such states to establish their own permit programs regulating “new or modified major stationary sources” of air pollution. Congress, however, did not specifically define what constituted a “stationary source.” In 1981, the EPA adopted new, laxer standards, which allowed a plant to acquire and have permitted new pieces of equipment which did not meet EPA standards as long as total emissions of the plant didn’t increase. The National Resources Defense Council, an environmentalist group, challenged the EPA rule, receiving a favorable ruling which was then appealed by Chevron to SCOTUS.
* SCOTUS ruled in favor of the EPA and Chevron, which one might take at face value to be a win for private industry. The legal principle which the court was addressing, however, was whether and to what extent regulatory agencies had the discretion to reinterpret rules issued by Congress. In Marbury v. Madison (1803), the court asserted its own power to review statutes issued by Congress and declare them invalid if they violate the Constitution. The question of how much discretion could be enjoyed by an executive agency, however, remained open. The Chevron case formalized that discretion by affirming executive agencies’ “administrative deference” (now known as *Chevron* deference) to interpret and apply Congress’ issuances (i.) within a “permissible construction” of their meaning and (ii.) so long as Congress had not spoken directly to the issue at hand. The majority opinion asserted that agencies can “rely upon the incumbent administration’s wise view of policy.” The ruling was thus a big win for administrative law over judicial review.

Questions

* **Quiz Question:** In “The Use of Knowledge in Society,” Hayek says that the economic calculus we have developed does not give us an answer to solving the problem of centrally allocating resources such that the marginal rates of substitution of all goods and services are made equal. Why does he say that this calculation is beyond us?
* **Bonus Quiz Question:** In “What Is Progress?,” Woodrow Wilson claims that government “falls, not under the theory of the universe, but the theory of \_\_\_\_\_\_\_\_. It is accountable to \_\_\_\_\_\_\_\_\_\_\_, not to Newton.” (Fill in the blanks).
* What, then, changed between the *Case of Proclamations* and *Chevron*?
* One common interpretation is to understand the growth of the regulatory state and the expansion of administrative law as maximizing behavior by the executive. Surely that is a necessary condition, but is it sufficient?
* If, as the ideal model of checks and balances suggests, we should see branches of government resenting encroachments by the other branch onto their turf, assuming responsibilities which are constitutionally theirs, why don’t we see more pushback?
* What does “The Use of Knowledge in Socety” have to do with administrative law and regulation?
* Does Wilson, in “What Is Progress?,” establish a clear criterion for the cases in which institutions should be uprooted and those in which they should be preserved? Is it clear when they should be respected and when abolished?
* Is the Hayekian society a more stagnant one than the Wilsonian? Will it lead to a greater transformation of society or a lesser?