

Economic Policy Vignette

Results-Based Regulation: 20th Century Lessons and 21st Century Opportunities

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“What these rules should be is the principal question in human affairs; but if we except a few of the most obvious cases, it is one of those which least progress has been made in resolving.”

John Stuart Mill
On Liberty, 1860

INTRODUCTION

Throughout the long history of the relationship between markets and government, the drafting of regulation has all too often been driven by the ideological winds of the moment. But raw ideology is a poor road map for guiding regulatory policy for two reasons. First, the nuanced “real world” rarely conforms to the purity offered by either an unquestioning loyalty to the superiority of the market or the unchallenged assumption that government can correct every market failure. Second, the ideological mood of the American people vacillates over time, creating the prospect that ideologically driven regulation will whipsaw regulated entities, effectively precluding growth enabling innovation.

So we are faced with the question: To what set of principles can we turn to drive the formation of welfare-enhancing regulatory policies? This is an easier question to ask than to answer. Indeed, as John Stuart Mill observed in the nineteenth century:

There is, in fact, no recognized principle by which the propriety or impropriety of government interference is customarily tested. People decide according to their personal preferences. . . . [M]en range themselves on one or the other side in any particular case, according to this general direction of their sentiments; or according to the degree of interest which they feel in the particular thing which it is proposed that the government should do; or according to the belief they entertain that the government would, or would not, do it in the manner they prefer; but very rarely on account of any opinion to which they consistently adhere, as to what things are fit to be done by a government.¹

Government officials even at the highest levels seek these principles. President Obama stated that a policy goal of his Administration is to “root out regulations that conflict, that are not worth the cost, or that are just plain dumb.”² But determining which regulatory constraints are “just plain dumb” is not easy.

Fortunately, elusive though they may seem, principles to guide the development of regulatory policy do exist. They emerge from an examination of the evolution of regulation over the past fifty years. For instance, a pre-1970s comparison of interstate (regulated) and intrastate (deregulated) airline traffic provided powerful testimony that a price deregulated airline industry promoted economic welfare better than a regulated industry. Similar practical comparisons gave us evidence that led to the successful bipartisan deregulatory efforts in the rail, trucking, and long-distance telecommunications

¹ JOHN STUART MILL, ON LIBERTY 12-13 (David Spitz ed., W.W. Norton & Co. 1975) (1859).

² Barack H. Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, <http://online.wsj.com/article/SB10001424052748703396604576088272112103698.html>

industries. On the other side of the regulatory coin, actual failures in the financial sector, not ideology, led policymakers to increase regulatory scrutiny in that industry.

The fact that the regulatory dial has, on occasion and in specific industries, been turned up or down provides economists and policymakers with the ability to observe directly when, and under what industry conditions, regulation—or deregulation—has resulted in welfare improvements. This suggests that the design and evolution of regulation can be driven not by ideology but by the practical results of the policy design or change. Results-based regulation (RBR), is an approach that can sidestep the problems of an ideologically driven regulatory regime and ensure that we not lose sight of the purpose of regulation.

WHAT IS RESULTS-BASED REGULATION?

Results-based regulation draws upon the most successful aspects of both regulatory and economic analysis over the past fifty years with the aim of establishing principles that can guide policymakers as they pursue regulatory and deregulatory policies in the twenty-first century. Broadly, it is captured in five principles for regulators:

1. Recognize the inevitability of imperfection. All market-governance mechanisms are, in practice, imperfect. All too often, a perfectly competitive market structure is held as a standard against which to judge the merits of regulatory intervention. Such a comparison pits the merits of an ideal regulatory construct against an imperfect market-based governance mechanism. In that case, the costs imposed by the shortcomings of market-based resource allocation are judged against an unobserved and unrealizable ideal regulatory mechanism. Alternatively, others too often pit the real-world imperfections associated with the practice of regulation against idealized market allocations that would occur in a perfect market mechanism. The reality is that in practice neither regulation nor markets will realize their ideal. Policymakers in an RBR world must examine in practical – not ideological - terms how market-oriented governance compares with more centralized regulatory structures.

2. Smartly design regulation to keep pace with advances in technology and evolving legal institutions. In the presence of disruptive technological innovation and the evolution of complementary—or competing—regulatory structures, regulators must be vigilant about the need to adapt and reform existing practices. While a certain regulatory approach may be superior at one point, that evaluation might not hold true at another. For example, among the most prominent institutional changes of the twentieth century has been the maturation of the consumer and competition protections now afforded by the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice. The statutes enabling these agencies provide them with wide-ranging authority to halt “unfair methods of competition,” to block “contract[s], combination[s] . . . or conspirac[ies] in restraint of trade,” and to halt “monopoliz[ation] or attempts to monopolize” in the conduct of interstate commerce. Similar intrastate consumer- and competition-protection agencies have also been created. While debates can and do exist about the level of consumer protections these agencies provide relative to sector-specific regulation, there can be little doubt that the

design of sector-specific regulation should evolve with these complementary and, arguably, substitutable institutions to promote economic welfare.

3. Benchmark market-governance mechanisms and experiment relentlessly.

Wherever possible, regulators should engage in counterfactual scrutiny of alternative market-governance mechanisms. Such scrutiny creates the prospect of observing how these mechanisms work or fail. Opportunities for these empirical exercises can be found where there are different mechanisms in different jurisdictions. Differences may exist between states' regulatory structures and federal market governance, and also across countries. The ability to examine the economic consequences of changes in policy measures over time also provides an opportunity to improve policy-making.³

4. Use empirical analysis, not abstract theory. In assessing the merits of alternative regulatory mechanisms, policymakers should heavily weight empirical evidence collected from actual markets over abstract and formulaic tests. Economic theory can be useful in framing the outlines of economic behavior and policy making, but when imposed at the highest level, the ability of theory to discriminate among different regulatory governance mechanisms becomes attenuated. The result is that reliance on high-level theory alone creates the profound risk that well-intentioned policy makers will draw incorrect inferences. A “boots on the ground” effort to scrutinize alternative governance structures will more reliably provide sound guidance to policymakers than higher-level theorizing about the consequences of potential policy changes.

5. Focus on end-state economic measures. When considering alternative governance structures for a market, policymakers should focus on tangible, end-state measures of economic value. The best instances of regulatory and deregulatory policymaking over the past half century have sprung from policymakers' emerging proclivity to focus on “retail” economic metrics such as price, output, investment, and innovation. This focus on retail economic metrics is in contrast to the historical appeals by some regulators to the vaguely—if ever—defined “public interest” standard, which creates very difficult “eye of the beholder” possibilities that have no tangible link to governance mechanisms that promote economic welfare. This focus also deviates from the historical tendency of regulators to seek to advance regulation by largely focusing on improving internal, incremental regulatory processes.⁴

³ While Principle 3 provides a promising tool for 21st-century regulatory and deregulatory policymaking, it evokes a critical corollary. Specifically, the empirical review of alternative governance structures must be constructed in the most careful and thorough manner to ensure that comparisons are valid. Indeed, the downsides from glib or inapt comparisons are well documented. See, e.g., Paul L. Joskow, *Regulation and Deregulation after 25 years: Lessons Learned for Research in Industrial Organization*, 26 REV. INDUS. ORG. 169, 169-193 (2005) (noting the propensity of World Bank and other international financial organizations to inaptly draw inferences regarding the role of institutions and institutional change in developing and developed countries). Similarly, see Scott Wallsten and Stephanie Hausladen, *Net Neutrality, Unbundling, and their Effects on International Investment in Next-Generation Networks*, 8 REV NETWORK ECON. 90, 107 (2009) (demonstrating that too-simple comparisons of broadband deployment rates across countries create the profound risk of particularly poor policy extrapolations).

⁴ While focus on retail economic metrics provides a foundation for improved 21st-century policymaking, this focus necessitates considerable care if it is to serve as a foundation for policymaking inferences. Thus, while Principle 5 calls for focus on retail economic metrics, that focus must cautiously consider the potential for interrelationships and trade-offs among these metrics under alternative market-governance mechanisms. While price, output and innovation are sufficiently central to the foundation of economic welfare to evoke little discussion, other economic metrics are likely to prove more debatable. The principle enunciated here purposefully does not answer the question of what weights should be applied to particular economic

Both the core principles of an RBR approach to market governance and the early successes with the approach are suggestive of a fresh and effective basis for 21st century regulatory and deregulatory policy formation. An attraction of the approach is that it is neither formulaic nor ideologically driven. Rather it is fashioned to provide both structure, through the application of the RBR principles, and flexibility, as RBR policies will inevitably differ as a consequence of policymakers' scrutiny of the varying marketplace results that are the target of RBR.

RELATED CONSTRUCTS AND CAVEATS

While the framework of RBR presented here is offered in the spirit of a fresh approach, the concepts presented here do not arrive entirely *de novo*, but rather draw from and build upon the work of a number of others. As early as 1989, Alfred Kahn spoke of the importance of a "Demonstration Effect" that was at work as the airline industry moved through its deregulatory phase.⁵ More recently, Joskow has identified the growing adoption of natural experiments in industrial organization research of regulated industries as a vehicle for improved insight into the effects of regulation or deregulation.⁶

The emergence of RBR also parallels developments in administrative law. In particular, beginning with President Reagan, but continuing under President Bush and Clinton, and now Obama, a series of presidential Executive Orders have been promulgated that required federal agencies to engage in a determination of the likely benefits and costs of rules that they consider promulgating. A dispassionate reading of such a call for assessing the benefits and costs of regulatory measures would appear to be unobjectionable. Nonetheless, a number of critics have asserted that requirements for administrative agencies to engage in a benefit-cost assessment of potential regulatory requirements is meant not to be a tool for advancing sound economic policies, but rather a tool for those ideologically opposed to regulation. In this instance, the inability to separate the tool from a larger ideological push acts to undermine the credibility and effectiveness of what otherwise would be viable regulatory assessment. Hahn offers a recent discussion of the available mechanisms to improve the viability of benefit-cost analysis.⁷

Perhaps most akin to the framework presented here, Breyer offers an approach that is "built upon a simple axiom for creating and implementing any program: determine one's objectives, examine the alternative methods of obtaining those objectives, and choose the best method for doing so."⁸ Indeed, as here, Breyer observes:

metrics when trade-offs are required. Indeed, the metrics that will be worthy of focus should be resolved through public debate and are not necessarily static. Retail economic metrics that are seen to be more important in one period may take on different level and weight of importance in other times.

⁵ See, e.g., Sam Peltzman, *The Economic Theory of Regulation After a Decade of Deregulation*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS 1, 1-3 (1989) (describing the economic theory in the political market as a cause of the deregulation movement).

⁶ See Paul L. Joskow, *Regulation and Deregulation After 25 Years: Lessons Learned for Research in Industrial Organization*, 26 REV. INDUS. ORG. 169, 182 (2005).

⁷ Robert Hahn, *Designing Smarter Regulation with Improved Benefit-Cost Analysis*, 1 J. BENEFIT-COST ANALYSIS 1, 1 (2010), <http://www.bepress.com/jbca/vol1/iss1/5>. In this vein, see also CASS R. SUNSTEIN, *THE COST-BENEFIT STATE: THE FUTURE OF REGULATORY PROTECTION* (2002).

⁸ See Stephen Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92(3) HARVARD L. R., January 550 (1979).

Whether reform should take place ... depends on a detailed examination of the actual effect of the regulatory program at issue. A detailed empirically based inquiry is necessary because, regardless of the regulatory program's basic objective (and the possible inability of regulation to achieve that objective), any existing program will in fact serve a host of subsidiary objectives.⁹

Thus, Breyer's approach – and the version of RBR set for here – is rooted in an assessment of practical alternatives and their outcomes and is less driven by philosophical arguments about the merits of free markets or government regulation.

Finally, recall that Principle 1 of the RBR framework for 21st-century regulatory and deregulatory policy holds that in practice all market-governance mechanisms are imperfect. This is no less true for an RBR approach to market governance than it is for the prominent 20th-century mechanisms of rate-of-return regulation, price controls, or hybrids thereof. Moreover, as Smith warned over 250 years ago, it is difficult to anticipate fully the dynamic reactions of firms or regulators in the wake of adhering to the RBR principles that I have enunciated.¹⁰ That caveat notwithstanding, empirical, granular focus on the actual outcomes of economic metrics within an RBR framework create the opportunity for discriminating industries in which deregulatory policies have been successful from where they may have failed. In so doing, the realistic prospect arises for RBR as a foundation not of perfect market governance for the 21st century but of better regulatory and deregulatory policymaking.

CONCLUSION

Concurrent with issuing an Executive Order to review and ferret out unnecessary regulations that act to hamper economic welfare and growth in the United States, President Obama observed that “This is the lesson of our history: Our economy is not a zero-sum game. Regulations do have costs; often, as a country, we have to make tough decisions about whether those costs are necessary. But what is clear is that we can strike the right balance. We can make our economy stronger and more competitive, while meeting our fundamental responsibilities to one another.”¹¹

The aim of this Vignette has been to provide a new lens and fresh perspective for regulators as they seek that balance. Importantly, the RBR framework offered here relies neither on simple appeals to ideology to guide the regulatory or deregulatory policy balance nor on the ability of regulators simply to balance the strengths of opposing interest groups. Rather, the RBR framework points regulators to a set of principles that have proven themselves in practice to be useful in discerning how to move the policy lever in a way that promotes economic welfare.

⁹ *Id.* 604.

¹⁰ ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* 234 (D. D. Raphael and A. L. Macfie, eds., Oxford Univ. Press 1976) (1896).

¹¹ Obama, *supra* note 1. Note that such calls are not new. President Bill Clinton once observed that, “[w]e all want the benefits of regulation... But let's face it, we all know the regulatory system needs repair. Too often the rule writers here in Washington have such detailed lists of dos and don'ts that the dos and don'ts undermine the very objectives they seek to achieve, when clear goals and operation for cooperation would work better.” See President William J. Clinton, *Remarks at the Regulatory Reform Event* (Feb. 21, 1995) (transcript available at <http://govinfo.library.unt.edu/npr/library/speeches/265e.html>).

NOTE

The principles of results-based regulation described in this *Economic Policy Vignette*, along with a consideration of regulation in the modern telecommunications industry that serves as a proof of concept for the model of results-based regulation, are presented in full in:

John W. Mayo. 2013. "THE EVOLUTION OF REGULATION: TWENTIETH CENTURY LESSONS AND TWENTY-FIRST CENTURY OPPORTUNITIES." *Federal Communications Law Journal*, Volume 65; 2012-2013, pp 119-156.

This article identifies lessons from the past fifty years to develop a foundation for twenty-first century regulatory policy formation. It finds that while the trend toward deregulatory policies over the last half-century was nominally motivated by a push toward economic efficiency, policymakers were also attracted to deregulatory policies by deep-seated ideological desires to protect individual freedoms deemed to be infringed by regulation. Such ideological drivers are ill-suited as a basis for twenty-first century regulation. Nonetheless, when stripped of ideological drivers, it is possible to glean from the historical evolution of regulation a sound basis for twenty-first century regulatory policy. The article specifically describes a set of more subtle regulatory developments and explains how they have generated the most sound regulatory decisions over the past fifty years. Drawing on these developments, the article proposes a regulatory policy framework based upon a set of "results-based principles" that hold the potential to underlie a new, economic welfare-enhancing regulatory framework.