Innovative Techniques in Theory and Practice:

PROCEEDINGS OF A REGULATORY COUNCIL CONFERENCE

UNITED STATES REGULATORY COUNCIL

United States Regulatory Council

President Carter established the U.S. Regulatory Council in 1978 to improve coordination of federal regulatory activities and encourage more effective management of the regulatory process.

Presently chaired by Environmental Protection Agency Administrator Douglas M. Costle, the Council is composed of 38 departments and agencies with major regulatory responsibilities. Peter J. Petkas is the Director; Kate C. Beardsley is the Deputy Director.

The Council's semiannual *Calendar of Federal Regulations* provides a comprehensive overview of important regulations under development and a summary of the analytical basis for them. It is designed to encourage greater public participation in the regulatory process, to identify areas of multiple regulatory impact, and to assist the regulators in developing clear and cost-effective regulations.

Other Council activities include:

- organizing interagency efforts to better manage the regulatory environment of a single industry, such as the automobile industry
- improving regulatory methods such as economic analysis and evaluation, and regulatory procedures such as permitting and licensing
- encouraging innovative, market-oriented approaches to regulation
- identifying and reducing conflicting regulations or actions affecting particular sectors, such as hospitals, coal producers and small businesses
- developing national policies on major regulatory issues, such as the control of cancer-causing chemicals

INNOVATIVE TECHNIQUES PROJECT

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JULY 22, 1980

UNITED STATES REGULATORY COUNCIL

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AGENCY ACRONYMS

ACUS	- Administrative Conference of the United States
CAB	- Civil Aeronautics Board
CAC	- Consumer Affairs Council
CEA	- Council of Economic Advisors
CFTC	- Commodity Futures Trading Commission
CPSC	- Consumer Product Safety Commission
CWPS	- Council on Wage and Price Stability
DOC	- Department of Commerce
DOE	- Department of Energy
DOI	- Department of the Interior
DOJ	- Department of Justice
DOL	- Department of Labor
DOT	- Department of Transportation
ED	- Department of Education
EEOC	- Equal Employment Opportunity Commission
EPA	- Environmental Protection Agency
FCC	- Federal Communications Commission
FDIC	- Federal Deposit Insurance Corporation
FEC	- Federal Election Commission
FEMA	- Federal Emergency Management Administration
FHLBB	- Federal Home Loan Bank Board
FMC	- Federal Maritime Commission
FMSHRC	- Federal Mine Safety and Health Review Commission
FRS	- Federal Reserve System
FTC	- Federal Trade Commission
GSA	- General Services Administration
HHS	- Department of Health and Human Services
HUD	- Department of Housing and Urban Development
ICC	- Interstate Commerce Commission
NCUA	- National Credit Union Administration
NLRB	- National Labor Relations Board
NRC	- Nuclear Regulatory Commission
OCA	- Office of Consumer Affairs
OMB	- Office of Management and Budget
OSHRC	- Occupational Safety and Health Review Commission
PRC	- Postal Rate Commission
SBA	- Small Business Administration
SEC	- Securities and Exchange Commission
TREAS	- Department of the Treasury
USDA	- Department of Agriculture
USITC	- United States International Trade Commission
VA	- Veterans Administration

A BRIEF GUIDE TO INNOVATIVE TECHNIQUES

MARKETABLE RIGHTS

Distributing a limited number of rights to scarce resources that private parties can then buy, sell, or trade as market needs dictate. This can remove the government from difficult, contentious, and lengthy decisions about who can "best" use the limited resources.

ECONOMIC INCENTIVES

Using fees or subsidies (rather than government-enforced standards) to encourage private sector achievement of regulatory goals. This approach removes the government from having to eliminate or directly restrict the unwanted activity, but creates an incentive for the private sector to limit the activity itself.

PERFORMANCE STANDARDS

Replacing regulations that specify the exact means of compliance (usually detailed design standards) with general targets that the regulated firms can decide how to meet. Performance standards reduce compliance costs and provide regulated firms more flexibility and discretion to discover new and more efficient compliance technologies.

COMPLIANCE REFORM

Replacing or supplementing strict governmental monitoring and enforcement with market-oriented mechanisms including third-party compliance monitoring, penalties that reflect the degree of non-compliance, and supervised self-certification. Such measures can improve compliance incentives while curtailing costs to the taxpayer.

ENHANCED COMPETITION

Removing barriers to market entry or limits on the services that may be provided by those already in the market. This free market approach can be an important source of cost savings and can improve the quality and diversity of products and services.

INFORMATION DISCLOSURE

Providing users of a product or service with relevant information about the consequences of using it. When applicable, disclosure can replace centralized government decisions with informed freedom of choice among many users, and can stimulate competition among suppliers for improved performance (e.g., low tar in cigarettes, lower life cycle energy use).

VOLUNTARY STANDARDS

Relying on regulatory standards developed by third parties or the regulated firms themselves. Cooperating firms may reach agreement faster than government procedures will allow, and private technical knowledge can be applied directly to the problem at the outset.

TIERING

Tailoring regulatory requirements, usually recordkeeping and reporting requirements, compliance responsibilities, and the meeting of eligibility requirements for government funding programs, to fit the size or nature of the regulated entity. This can reduce the disproportionate burden that falls on small business and other entities without forfeiting regulatory goals.

INTRODUCTION

Harold Issadore Sharlin
Conference Coordinator

Conference Objectives and Schedule

On July 22, 1980, the U.S. Regulatory Council held a Conference on Innovative Regulatory Techniques. The Conference was intended to assist agencies in responding to the President's request of June 13 for all agencies with regulatory responsibility to review their programs and to find areas where alternatives that use market forces can make regulation more cost-effective (See Appendix). The long-term goal of the Conference was to begin an ongoing process of diffusing innovative techniques among the regulatory agencies.

Members of each of the 38 executive and independent regulatory agencies that belong to the Regulatory Council attended the Conference. It was an unprecedented gathering of many diverse regulatory programs. The invitees were officials with positions in their agencies that would allow them to appreciate the potential impact of innovative techniques and to advise their agencies on using the techniques as alternatives to traditional modes of regulation.

The Conference consisted of a morning Overview Session followed by workshops on specific techniques. The Overview Session was introduced by Regulatory Council Chairman Douglas Costle, who noted the importance of innovative techniques as a means for making government regulations function more efficiently. He also noted the need for a special effort to employ regulatory methods that are effective and yet extricate government from involvement in many private decisions.

Alfred Kahn, Chairman of the President's Council on Wage and Price Stability, gave the keynote address, "Regulation and the Imagination." The text of this speech begins on page 2. Regulatory Council Director Peter Petkas closed the Overview Session with a brief preview of the workshops. He described the Council's Innovative Techniques Project which is a continuing effort under the President's direction to help the agencies discover ways of employing the techniques in their own programs.

The Nature of the Workshops

Each workshop covered one of eight innovative techniques:

- Marketable Rights
- Economic Incentives
- Performance Standards
- Compliance Reform
- Enhanced Competition
- Information Disclosure
- Voluntary Standards
- Tiering

The workshops lasted one-and-a-half hours, and each was given twice.

The general approach of workshop leaders was first to define the innovative technique and then to discuss where and how it is presently being used. The Regulatory Council's Innovative Techniques Project has compiled a list of agency rules and proposals that use market-oriented techniques; each technique has been put into effect by several agencies, and every agency has used one or another of these techniques.

The intent of the workshops was to give participants enough practical knowledge about the technique for them to consider applying it in their own programs. Participants discussed possible applications of the technique and heard from colleagues in other agencies who are already using it. Actual problems of implementation were detailed by those who had experienced them. From this discussion, workshop participants could appreciate that the technique was not just a vague abstraction, but had found useful applications in actual regulatory programs. Potential users of the technique also became aware that other agencies' experience could be a valuable resource in applying the technique to their own programs.

The discussions in the workshops are summarized in these Proceedings. Individual workshops varied widely in their format and level of detail. For the purposes of clarity and conciseness, the summaries have a uniform organization that does not necessarily conform to the way in which each workshop was run. Under the heading of Description, the innovative technique is defined; General Considerations highlights issues and problems relevant to implementing the technique; Applications presents actual agency uses of the technique.

The Council's Innovative Techniques Project

Giving support to agencies under the June 13 Presidential directive is one part of a larger Regulatory Council program to promote innovative techniques. The Innovative Techniques Project represents a major component of the Council's staff and contract resources. The Project has three ongoing activities:

- active diffusion of techniques among agencies;
- case-by-case advancement of new applications;
- a Resource Center for public and agency use.

Diffusion: The Council has earmarked funds to help agencies evaluate specific innovative techniques in order to apply them to new regulatory programs or to revamp existing programs. The Council is prepared to help agencies convert general ideas into specific proposals for implementing innovative techniques.

Advancement: The Council will assist agencies in establishing reforms after they have identified potential applications of innovative techniques. The Council will provide case-by-case assistance to ensure progress toward implementation consistent with the President's policy on the encouragement of innovative techniques. The Council will devote significant senior staff resources to this end and will call on other executive branch support as appropriate.

Resource Center: The Council has compiled background information on specific examples of the ways that many agencies are using or considering using regulatory alternatives in their programs. The Center has such material as proposed rules, final rules, supporting analysis and studies on why particular techniques were chosen; a "Users' List" with one-sentence descriptions of each innovative example provides ready access to the Center.

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REGULATION AND THE IMAGINATION

BY

ALFRED E. KAHN

SPEECH
TO THE
U.S. REGULATORY COUNCIL
CONFERENCE ON INNOVATIVE REGULATORY
TECHNIQUES

WASHINGTON, D.C.
July 22, 1980

More decades ago than I care to remember, I was so intrigued by the title of a book by Lancelot Hogben, Mathematics and the Imagination, that I bought the book. I now humbly admit that all I remember about it was its title: but I thought you deserved this explanation of the title I've chosen for my talk to you today.

I confess that lapse of memory also in order to take some of the arrogance out of my presumption in standing up here and preaching to you about developing innovative techniques of regulation.

Before I begin, I want also to acknowledge and laud the initiatives that the Regulatory Council has already taken in this direction. When I embarked on my present job, the Council had just been formed, and -- since regulatory reform is an important plank in the President's anti-inflation program, which it was my responsibility to run -- I was an early recipient of a series of what the posers obviously thought were rhetorical questions about the advisability of putting foxes in charge of chicken coops. Let me just say that the Council has already given the lie to that particular metaphor; and this conference is another demonstration of the leadership it has assumed in carrying out the President's pledge.

The fact is that the President's instruction really is a challenge to your imagination -- in many ways the most challenging of all the facets of regulatory reform, because what it calls for is the introduction of a radically different psychological approach to the way in which you go about devising regulations. I don't want to exaggerate. But economic deregulation, in contrast -- the restoration of the healthy forces of competition, where it can be relied on to do the job -- demands extreme persistence, and a certain amount of animal cunning in circumventing the opposition of the people who like to be protected; but not, once one decides to deregulate, much more than simply getting out of the way. Again, the demands of Executive Order 12044, with its insistence that regulators take costs into account and think about alternatives, calls for novel and often extremely difficult analytical efforts and judgments. But these instructions were initially directed primarily to the questions of how much to regulate and how stringent the requirements should be.

In contrast, our discussions today center not on questions of whether to regulate or how stringently, but on the President's challenge to us to devise, in each specific situation, innovative methods of achieving the regulatory goals.

Innovative in what ways? What is the new psychological attitude that the President is calling on us to adopt? The way to answer that question, I think, is to ask why it is we're being asked to stretch our imaginations in this way.

This audience needs no reminder that government regulation is under attack, fierce attack. That alone suggests the wisdom of reexamining our methods -- as well as each substantive policy -- if we are to preserve the values that it is our job to preserve, and that we believe in. And doing our utmost to satisfy the valid criticisms: we have no choice but to believe that if we meet the valid ones, we will be in the best possible position to repel the invalid ones.

The complaints that have some substantial measure of validity, in some situations, can be summarized under two headings -- excessive cost, and excessive coercion.

I am not going to burden what is essentially an introduction to my topic with a lengthy discussion of the cost issue. There's no question that regulation uses up scarce economic resources, a lot of them. There's no question either that in an economy characterized by chronic inflation it is especially urgent to weigh those costs carefully against the benefits they bring, in order to decide whether the latter are sufficient to justify the former. And, finally, that the assessment will produce rational policy only if it is made on an incremental basis: efficiency -- and the minimization of <u>inefficient</u> inflationary pressure -- requires that the benefits of <u>each</u> proposed regulation, and of each proposed <u>degree</u> of regulation, justify the costs it imposes -- that is, that the marginal benefits exceed the marginal costs.

Economic cost is not the whole story, however. The revolt against regulation that we are experiencing is a revolt also against government compulsion and meddling. This complaint cannot simply be dismissed as either ignorant or misdirected sloganeering, although some corporate opponents of regulation are not above wrapping their self-interest in a cloak of individual liberty. Laissez-faire does also serve real, important social and personal values. The right to make one's own decisions, on one's own responsibility, to take the risks one wants to take, to work where one chooses to work -- yes, and to operate one's own business as one chooses -- all within the framework of rules to protect the rights and interests of others <u>that are least coercive and intrusive</u> -- those are values we cherish in this country. If you listen carefully to the criticism of regulation, you will see that much of it reduces to simple resentment of the government telling people -- and business -- what to do.

These two, sometimes legitimate criticisms of regulation suggest two corresponding guidelines for our experimentation with novel regulatory techniques -- efficiency, and the minimization of coercion.

In my own suggestions for applying those guidelines, I will inevitably display the limitations of my own imagination. I am an economist. I have a great respect for the efficiency of even imperfectly competitive markets -- precisely because they leave the pertinent benefit/cost comparisons to the responsible parties, because they rely on built-in incentives of the actors to make the choices efficiently, and because they minimize the need for governmental direction and compulsion. My own suggestions for innovative regulatory techniques are therefore going to be heavily influenced by that conception.

As we go about performing our essential regulatory functions, I am going to suggest we be constantly alert to ways of preserving as much as possible of the marketplace, of the built-in incentives to produce efficient results, with a minimum of detailed governmental prescription of what those results ought to be -- and in situations in which prescription of the results is the essence of the inescapable regulatory function, then with the fewest possible detailed prescriptions of the methods and routes by which those results are to be achieved. In situations in which Adam Smith's invisible hand is insufficient, it is important for us to curb the regulator's own high marginal propensity to meddle -- and do our best to keep the hand of government as invisible as possible, too.

I proceed to offer some examples, but with just one more caveat. Every regulatory problem is in important ways unique; the technique that works in case A may be totally inapplicable in case B. Remember Jack Point's admonition in Yeoman of the Guard:

> "If you wish to succeed as a jester
>
> You'll need to consider each person's
> auricular;
>
> What is all right for B might well
> scandalize C,
>
> For C is so very particular..."

And yet, while situations differ, there are also some common threads. My hope, then, is that the following examples, which have proved all right for B, may prove illuminating to C as well.

Before I was actually confirmed as Chairman of the CAB, I had the privilege of sitting among the public and listening to a discussion by the Board on how to handle the vexing problem of bumping by airlines.

The good lawyers at the bench and facing it struggled mightily with alternative possible regulatory prescriptions, which ran almost entirely in terms of determining orders of priority among potential bumpees. One regulator suggested that the most equitable basis would be the order in which reservations were received: first come first served is certainly one principle of fairness. Another observed that this might produce very unfair results, since often the most necessitous travellers -- the ones for whom going out on the particular overbooked flight is most important -- are the ones who have to make travel plans at the very last moment -- responding, for example, to the sudden illness of a parent. As a parent myself, I found this objection appealing. A third regulator suggested that people should have priority for the scarce seats in the order of their appearance at the check-in counter; a fourth protested that people might be delayed in arriving at a check-in counter by the lateness of a connecting flight, for which it would hardly be fair to hold them responsible. Since my own connecting flights seem to have a deplorable tendency to be late, I found this objection appealing. After some additional inconclusive discussion, which included suggestions that people be selected on the basis of their sex, height, or previous condition of servitude, and ended up demonstrating only that there are competing principles of fairness and efficiency, the Board decided to think about the matter some more.

At my first meeting on the subject, I suggested that the problem is not necessarily one of overbooking, with the consequent occasional necessity for bumping, but <u>involuntary selection</u> of the passengers to be bumped. Following the analogy of the free market and free contract, I suggested that there could not possibly be an objection if the bumpees were permitted to select themselves on the basis of economic incentives. Just the application of another principle of equity: a fair, free exchange is no robbery, and if it is truly uncoerced, it leaves both parties better off -- yes, and happier.

The airlines engage in overbooking for economic motives -- needless to say, I do not use the word "economic" as synonymous in any way with "reprehensible." They do it because it pays, despite the ill will bumping generates. In the circumstances, it makes abundant sense simply to require them to compensate people who have to be bumped -- and, since the evil is involuntary bumping, to make the necessary relinquishing of the scarce seats voluntary by requiring them to solicit volunteers on the basis of their willingness to accept whatever reward is necessary to induce the requisite number to offer up their places.

Ordinary market incentives could be counted on in this way to subject both overbooking and bumping to efficient limits: the airlines could be expected to engage in the practice only up to the point at which the economic benefit to them of the fuller planes that overbooking assures is equalled or exceeded by the cost to them of securing the requisite number of voluntary bumpees.

A similar example of the use of market principles in regulation is the white market. It is now almost unanimously accepted that if we ever do have to have gasoline rationing, we should permit free purchase and sale of the ration coupons. Such a system has the critical virtue that under it every single gallon of gasoline purchased would have to be worth its marginal opportunity cost to the buyer, because he or she could choose instead to sell the coupons for that amount of cash. In other words, the white market would assure that every gallon of gasoline would go to the use for which it has the greatest value, while rationing the salable coupons would serve the putative social purpose of distributing the entitlements to the limited supplies on the basis of need rather than ability to pay. Of course, there would still have to be a regulatory determination of how many ration coupons each person should receive at the outset; but that is unavoidable once the decision is made to ration. The white market sees to it that every use of gasoline meets the proper economic test, and no one goes without who is willing to pay the marginal social cost -- which is what the gasoline is worth to somebody else.

I wonder, however, whether we will ever be willing to face up to the realization that we could achieve the identical result without using ration tickets at all, simply by putting a tax on gasoline sufficient to bring consumption down to the level of the available supplies, and then distributing the revenues in any way we deem socially desirable -- which is just what we do when we hand out valuable ration tickets that can be sold for cash.

Once you think about it, you will see a whole raft of regulatory problems that are basically the same as the cases of bumping and allocating scarce supplies of gasoline: they involve regulators in choosing -- deciding who gets to do something or gets something that is scarce -- choosing who gets a certificate to carry goods by truck between cities A and B, choosing who gets the right to land at a crowded airport, choosing who gets to use a specified portion of the radio spectrum that has itself been set aside for a particular service, choosing who will be allowed to commit a specified amount of environmental contamination.

In many of these situations -- perhaps most -- the regulators are spending time, effort and money to make those choices when in fact the marketplace could do it as well or better. In some, like deciding how many truckers a particular market can profitably employ and which ones can do it best, the market can do the entire job of choosing; in others, such as deciding on the distribution of gasoline ration coupons, or setting standards of safe operation of trucks, the regulators have to make the requisite social judgments: but they still don't have to make the ultimate allocations.

Some of these examples illustrate yet another principle of regulatory reform that similarly serves the ends of efficiency and minimizing coercion. The principle is: make the rules or prescriptions as general as possible while still achieving the ultimate purpose. It tends to run against the regulatory grain. Complete regulators tend to be compulsively neat: there is a Freudian characterization of that trait. They want things to be done the right way; they want to spell out all the steps, all the procedures.

In treating the case of airline bumping, we steeled ourselves to restraint. We didn't tell the companies how to handle the problem. All we did was prohibit involuntary bumping, and then merely suggest a number of ways in which the airlines might conceivably obtain volunteers. But we left it to them to decide how to do so at the lowest possible cost to themselves, considering both the monetary costs and the desirability of minimizing passenger ill will.

According to a recent article in the Wall Street Journal, this system has worked very well. The only problem seems to be that sometimes there is a surplus of volunteers. A complete regulator would be tempted to prescribe methods of solving this problem as well; but it seems to me that the better part of wisdom is to leave that selection process to the companies themselves: after all, it is not in their interest to precipitate fist fights among passengers vying for an excessively generous reward for getting off planes.

Let me give you another example from my current regulatory responsibilities at the Council on Wage and Price Stability. Whatever flaws there may be in the wage/price guidelines we administer, some consideration was given in their design to minimizing regulatory intrusion -- that is, to achieve the broad goal of restraining increases in the general price level in a less intrusive and consequently less distorting manner than had been true under previous price control programs. Accordingly, we designed the standard in terms of the average of the prices charged by a company, rather than product by product. By permitting prices within a company to vary in relation to one another, we avoided some of the shortages and gluts that the more rigid limits in the past had precipitated.

This prescription of only average results follows the same principle as EPA has followed in developing the bubble concept, for which it has so justly been praised. The prohibition of prescription need not and often should not apply to the most disaggregated regulated unit possible -- since doing that destroys the ability of the regulatees to make rational choices about how best to comply, is an inefficient way of producing the intended result, and violates the principle of meddling and coercing as little as possible.

A corollary of this principle of making regulatory prescriptions as general as possible is the preferability of performance standards over methodological ones -- prescribing ends rather than means. Let no one miss the import of OSHA now telling industry that fire extinguishers should be "accessible," rather than stipulating their precise height from the floor.

Another corollary is the desirability of seeking out alternatives to flat prohibition, except in extreme cases. Let's look one last time -- I promise -- at the bumping case. Many airline travellers insisted the proper answer was to forbid overbooking, period. The practice, they asserted, was simply immoral: wasn't it fraudulent to confirm more reservations on a flight than the available number of seats? But a flat prohibition would have precluded an economic assessment of the costs of such a prohibition against the costs imposed upon consumers by being bumped.

The issue was not moral but economic. So long as it is either infeasible or undesirable for airline companies to charge people for making reservations and then not showing up, they have strong economic incentives to overbook; and every once in a while, following the inexorable dictates of the laws of probability, that produces a larger number of people showing up than there are seats on the flight. What we did was provide a mechanism for automatically comparing the economic benefits of the practice to the carriers with the costs it imposed on travellers, by forcing the beneficiaries -- the carrier -- to pay the costs -- which are whatever proves necessary to induce passengers voluntarily to give up the requisite number of seats. We did not compare the benefits and costs ourselves, because we were not competent to do so. We never told the airlines that they could or could not overbook. Instead we put the costs where they belonged -- on the beneficiaries; and we left the price tag on those costs to be determined by the market. Airlines are now free to overbook practically as they please, and will presumably do so as long as the benefits to them exceed the costs -- which they now have to bear. And that is as it should be.

After all, the generic case for regulation is that the market is not always organized to weigh all the social costs of this or that activity against all the benefits -- the familiar problem of externalities, leading to market failures. Regulation becomes that instrument for internalizing the pertinent costs -- this is by now familiar.

What is almost certainly less obvious to regulators is that they are now being accused of exactly the same kind of failure: of imposing on this or that economic activity costs that do not get adequately assessed in the marketplace, and get passed off on innocent third parties -- labor, in reduced real wages; capital, in reduced returns; the consumer, in higher prices; all of us, in inflation.

One interesting regulatory innovation to remedy this kind of failure that is surely worth exploring is to look for situations in which the decision-making process can be modified so that all the costs as well as benefits get weighed by the same actors. Take the case of regulation aimed at assuring safety on the job. One justification for this kind of intervention is that firms driven by competitive pressures may try to cut costs in ways that impose serious costs on their workers; and the labor market may not work well enough to put those costs back on the employers in the form of correspondingly higher wages. But regulation itself may not achieve full internalization: labor may press for improved safety requirements with inadequate attention to costs, if they feel those costs can simply be passed on in increased prices without serious threat to their jobs.

In the auto industry, this situation has at least momentarily changed. Workers have some reason to feel in the industry's current competitive situation that the costs of regulation cannot always be passed along in higher prices without further jeopardizing sales and their jobs. Accordingly, GM, the UAW and OSHA recently worked successfully together to find a less costly but at the same time somewhat less convenient means of protecting the workers from dangerous exposure to lead and arsenic than had originally been proposed. The safety of the workers has not been compromised, but the circumstances made this type of more economical regulatory solution possible because the cost-bearers and beneficiaries had obviously come to be the same people, who therefore had a much clearer interest than before in weighing the respective costs and benefits of alternative methods of achieving the same goals -- the basic prerequisite for market-type transactions producing socially efficient results.

There are other alternatives to flat prohibitions and prescriptions that I know many of you have been exploring in various contexts. Prominent among these is the provision of the information necessary for informed judgments. The use of disclosure and labelling as an alternative to stricter regulation has, as you know, a long history, particularly in financial and capital markets. The concept is terribly attractive, of course, because it leaves the marketplace free to respond instead of having regulators specify what interest rates must be paid, who shall get capital and who not, what level of energy efficiency appliances must have, how crashworthy cars must be, and so on. In this case perhaps above all others, however, it seems desirable to underline the caveats: disclosure as a substitute for prescription is in some ways the most market-like of all these innovative techniques. It makes sense, therefore, only in those situations in which our general confidence in markets is justified.

These are trying times for us regulators. But they are also exciting times. I have every confidence that if we make an intense and imaginative effort to follow the principles we ourselves would espouse -- to regulate only when and where and to the extent the market itself produces seriously defective results; to avoid and reverse regulations whose principal purpose is to protect private parties from the socially beneficent pressures of competition; to recognize that we have no right to impose costs on society except where they are justified by the benefits; and to use the minimum of prescription and compulsion to achieve legitimate regulatory ends -- I am confident that if we do these things, we can count on the support of the overwhelming majority of the American people. To the extent we fail to do so, we don't deserve it.

WORKSHOP SUMMARIES

1. MARKETABLE RIGHTS

Chairman: William Drayton, Jr.
Assistant Administrator for
Planning and Management, EPA

DESCRIPTION

Marketing rights (or permits) is a regulatory reform technique applicable to a wide array of federal programs where the use of resources is controlled or limited or where a scarce resource must be allocated among competing uses. The government customarily establishes procedures granting access to the use of these resources and allowing exchanges among users of resource use permits. Total use is governed by the number of permits the regulating body issues or the limits of the resource. A resource that is a prime candidate for allocation by marketable permits is one for which there are externalities of cost -- costs imposed on society by private activities -- if the market is unregulated.

A value becomes associated with the permit regardless of whether the permit was originally free or purchased. Trading among parties who wish to use the resource can take place after the initial purchase or allocation of rights. Advantages of marketable rights are that they encourage economically efficient resource allocation, reduce compliance costs and administrative burdens associated with regulation, and remove the government from unnecessary centralized involvement in complex allocation decisions.

GENERAL CONSIDERATIONS

The following factors must enter into the decision to institute a marketable rights system. These include:

- Legal and constitutional issues. The legality of government selling rights to private users on a basis other than cost to the government has to be determined.

- Designing equivalencies for permits. In protecting the public welfare, it may be important to ensure that trades of rights are between equivalent uses. For instance:

  - Location. The value of permission to emit air pollutants in California is not the same as in Maine; air traffic slots at National Airport may be more valuable than slots at Dulles Airport.

- Time. The detrimental effects of emissions may not be at a constant level throughout the year. The value of airport slots may vary according to the time of day.

- Equity. In an open market, the rights currently enjoyed by small businesses could be effectively eliminated, given the potential for large businesses to monopolize trading in permits.

- Administrative issues. The market system that is managed by the government should avoid imposing administrative barriers to potential participants. General Motors and DuPont can deal with almost any scheme; however, a complex scheme may not be administratively feasible for small businesses.

APPLICATIONS

(1) Federal Aviation Administration - Airport Landing Rights (Clark Onstad)

Airports are local monopolies that have many limitations imposed on their operations, among them, limits on the rate of landings and takeoffs. The policy question then becomes how to allocate takeoff/landing slots among airlines.

Four airports in the U.S. are currently slot-limited: Chicago (O'Hare), New York (JFK and LaGuardia), and Washington (National). Los Angeles may soon become the fifth. The FAA has studied an auction plan to allocate slots at these airports. One current idea is to accept bids for slots at each hour of the day. These would be ranked from highest to lowest bid and the top 40 bids, for example, would qualify for the 40 slots available during a given hour. The lowest bid would become the price for all bidders. A carrier that bids successfully would then have to pair this slot with a compatible slot at another airport in order to move its plane between cities. If it cannot get both slots for a flight, then the carrier would have to trade. This trading establishes a secondary market for landing rights.

A significant problem with this system is that the federal government may not be allowed to charge industry a fee for landing rights that is not based on the government's costs. One suggested plan is to pay surplus funds generated from bidding directly into the federal treasury. Another way is to let the market set the price instead of the FAA. This legal question has not yet been resolved.

Another problem with auctioning landing and takeoff slots is that large air carriers could outbid smaller carriers, thereby excluding small carriers from major airports. This issue might be resolved by allocating the available slots between large carriers and small carriers and by permit auctions and secondary trades <u>within</u> these categories.

(2) Environmental Protection Agency - Chlorofluorocarbon Emissions (Jim Titus)

Chlorofluorocarbons (CFC) are a serious long-term problem currently being studied by EPA. CFC uses are growing, and over the next few decades, the National Academy of Sciences predicts, enough CFC will be emitted to cause a serious depletion of ozone in the upper atmosphere. This ozone loss would allow harmful ultraviolet radiation to pass through to the earth, resulting in an increased number of skin cancer cases, as well as crop losses and marine life damage. All CFC used is eventually emitted into the atmosphere and remains there for decades. The problem is one of controlling the total amount of CFC used.

EPA has been studying a plan to allocate permits for the production or sale of CFC. These permits could be bought and sold among producers or users to bring about the highest economic efficiency. Since it is not environmentally important where or when CFC is emitted into the atmosphere, only one market would be necessary.

The Rand Corporation has extensively studied the use of marketable permits for CFC, under EPA contract. According to Rand's work, the use of traditional mandatory controls to hold emissions to 1979 levels for CFC would cost about 185 million dollars to implement, and the marketable permits system would cost about 108 million dollars. The marketable permits system would be 42 percent less costly to society to implement. However, the initial industry cost to acquire permits is large. If permits are sold, the total cost to producers would be approximately 1.5 billion dollars. The wealth transfer is potentially enormous if the permit buyers are not subsidized in some way. An initial free allocation system would avoid this problem but would require arbitrary government decisions about who gets the permits.

One attractive feature of this system is that there is a continuing incentive to all CFC users to find innovative ways to decrease their use of CFC. If EPA later wants to continue to reduce CFC use, permits could be retired in series as they expired (permits might have a designated lifespan, such as five years), providing incentives to develop better control technology.

(3) Federal Communications Commission - Spectrum Allocation (Ken Young)

The FCC faces the problem of how to most efficiently and equitably allocate the use of the electromagnetic spectrum among competing uses. Recently, a specific issue in spectrum management -- how to assign the use of multipoint distribution service channels to users in cities across the country -- has become a problem. Only two channels can be used in any municipal area. Typically, the FCC has held hearings to determine the relative merits of competing applications. The process is expensive, time consuming, and fails to make meaningful distinctions between applicants.

As an alternative, the FCC has asked for comments on allocation through either an auction or a lottery. With a lottery, the winner could use the right or sell it to another applicant who may value the right more. An auction may be an even better solution because the highest bidder represents the highest valued use of the channel. With either type of system, considerable costs would be saved. An additional benefit is that the FCC would have an indication of the economic value of allocations within the electromagnetic spectrum. Such information will be valuable in future FCC decision-making.

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Jim Curtiss	NRC	Bob Siegel	DOC
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2. ECONOMIC INCENTIVES

Chairman: Robert Miki
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DESCRIPTION

Economic incentives can be built into regulations, putting the price system to work toward making business costs more consistent with social goals. Incentives may take many forms, including taxes, subsidies, rebates, or point systems that determine a firm's right to market its product.

GENERAL CONSIDERATIONS

In general, economic incentives can improve resource allocation as well as encourage research and development on techniques that will exceed current performance. The general reaction to economic incentives will be different depending on whether an agency regulates economic or social behavior. Several general observations associated with these incentives were made in the course of the discussion.

- Economic incentives allow industry greater flexibility in responding to regulations. However, their results may be difficult to predict, and industry may oppose them as a change in the status quo.

- Incentives are usually used in combination with other regulatory approaches.

- Proposals for the use of economic incentives are not likely to arise from the kinds of compromises between interest groups that generally determine regulatory policy.

APPLICATIONS

- The Department of Interior (DOI) wants lessees of federal coal lands to stay in continuous operation once they get started. DOI's current regulations allow the use of economic incentives in lieu of a requirement for continuous operation. The lessee can be given the option of paying advanced royalties, rather than continuing to produce, for a period of ten years. This allows the lessee greater flexibility to respond to the changing economic environment, but still provides an incentive to resume operations.

- The Department of Energy (DOE) is considering using economic incentives to meet the national security goal of increasing the amount of petroleum that U.S. companies hold in stock. Some of the questions that DOE must analyze are: Why does a firm hold stocks? Are economic incentives reliable enough to assure the level of stock retention the government wants? What are the verification problems when incentives are used? Will subsidies at the beginning of the process help or is it better to concentrate on performance? One possibility is to couple a subsidy with direct regulation. Loans, storage finance fees, or a public corporation are possible approaches.

- Some have suggested that the Occupational Safety and Health Administration (OSHA) could use economic incentives to encourage firms to meet and exceed standards.

- Workmen's compensation insurance rates could be used as an economic incentive in conjunction with other techniques if the premium rates were structured to reflect a firm's health and safety performance. [However, it was noted that in one industry, companies have been forced to self-insure and even this has not changed their behavior.]

- The National Credit Union Administration (NCUA) used an economic incentive to implement its Central Loan Fund (CLF). The CLF was set up as the equivalent of the Federal Reserve Bank for credit unions, but the NCUA found that credit unions were not interested in joining until the reserve requirements were redefined as a non-risk investment. This changed the credit unions' economic equations, freeing other funds for more lucrative investments, and made membership in the CLF attractive.

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Mervyn Schwedt	DOL	Mary Ellen Weber	DOL
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3. PERFORMANCE STANDARDS

Chairman: Terry Dowd
Deputy General Counsel for
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DESCRIPTION

Performance standards, as distinguished from design or process standards that specify the means of compliance, constitute an innovative approach to regulation that can be used in a wide variety of federal regulatory programs. Performance standards establish levels of performance or ultimate goals that regulated parties must meet; but unlike traditional regulatory techniques, they do not specify the technology or means of compliance that must be used. Under performance standards, the regulated parties are free to meet the specified level of performance in whatever way they choose.

GENERAL CONSIDERATIONS

There are a number of issues to consider before adopting performance standards as a regulatory strategy:

- Monitoring compliance may be more difficult for the regulating agency under performance standards. These standards may require more judgment calls by compliance officers; or they may involve new technology for measuring performance. Compliance officers may need new training under this new regulatory approach.

- Performance standards may not be popular with regulated entities. Some may prefer step-by-step regulations, particularly if they lack expertise necessary to meet performance standards without guidance. One approach used by the Occupational Safety and Health Administration (OSHA) to address this problem is to provide an appendix with its performance standards that suggests specific methods of compliance. Small businesses, in particular, may benefit from such suggested methods.

- Performance standards sometimes pose problems for constituent groups that monitor compliance with regulations. Under performance standards, since the regulated entity can choose a variety of different methods of compliance, it becomes difficult for these outside groups to pinpoint violations. To address this problem, an agency might try to assist the constituent groups in understanding the performance standards. OSHA, for example, adopted this approach with organized labor.

- In some program areas, it is difficult to define an appropriate level of performance. For example, in programs that aim to provide human services it may be difficult to express goals in measurable performance standards. However, even in many areas where it is not possible to set broad performance levels or goals, component parts of a program can be amended to include performance standards.

Some of the advantages and disadvantages of performance standard regulations were also discussed at the workshop.

- Advantages of Performance Standards:

  - regulated entities may be able to reduce compliance costs by finding the most cost-effective means of meeting regulatory goals;

  - innovation in compliance methods and technologies is encouraged;

  - the need to amend regulations or grant exemptions to regulations when new technologies are developed can be reduced;

  - statutory goals may be more efficiently achieved because the focus is on outcomes rather than compliance techniques that, in fact, may not be yielding desired outcomes.

- Disadvantages of Performance Standards:

  - compliance monitoring may be more difficult;

  - industry and constituent groups may not support performance standards because optional methods of compliance create uncertainty;

  - drafting a performance standard may be difficult because it requires a high level of abstraction and foresight about risks that may be created by the various methods of compliance;

  - in some areas, it may be impossible to define appropriate, measurable performance standards.

APPLICATIONS

The workshop discussions examined the experience of five agencies using or planning to use performance standards as a regulatory technique.

(1) Environmental Protection Agency's "Bubble"

The Environmental Protection Agency's (EPA) "bubble" policy sets overall emission limits for particular pollutants for a plant or a region (consisting of many plants) and allows firms to implement any type of control that will achieve the overall standard. This policy allows a plant manager to use the most cost-effective strategy for meeting the pollution limits for his or her plant. EPA's former policy specified emission limits for each source of pollution and level of technology that must be used. It is estimated that the "bubble" policy will save between 15 and 20 percent of the total compliance costs for air pollution.

(2) Department of Labor's Safety Standards

The Labor Department's Occupational Safety and Health Administration (OSHA) has used performance standards in its health regulations and is now expanding their use in its safety regulations. For example, OSHA's design standards for fire safety formerly specified that fire extinguishers must be a certain height off the floor. Now the performance standard simply states that fire extinguishers must be "accessible." OSHA has developed training materials on performance standards for its compliance officers and video tapes and other educational materials to assist union officials in understanding these new approaches to regulation.

(3) Federal Trade Commission

The Federal Trade Commission (FTC) is responsible for controlling deceptive advertising. Some of its cease and desist orders and consent orders require advertisers to run "corrective ads" that have been designed by the FTC to correct past deceptions. The FTC hopes to use performance standards that will require an advertiser to run effective corrective ads, without defining exactly how the advertiser should do it. For example, a performance standard might require that a certain percentage of a targeted population group receive and understand the information contained in the corrective advertisement.

Difficulties with this type of performance standard are:

- Setting the appropriate level of consumer knowledge;
- Defining the target group;
- Monitoring compliance and performance levels.

(4) Department of Transportation

The Department of Transportation's National Highway Traffic Safety Administration (NHTSA) is required to set motor vehicle safety standards that are based on performance levels and are objective and reasonable. In the 1980s NHTSA hopes to develop an overall safety performance standard for the automobile.

Currently, however, it sets performance standards for components of the auto, such as the head restraint and steering wheel. For example, the performance standard for head restraints requires that they be constructed in a manner that prevents whiplash, but the regulation does not mandate the design features to be used. Similarly, the rule for passive restraints does not mandate the method to be used to achieve the required level of occupant safety. In regulating fuel economy levels, NHTSA has set a corporate-average performance standard that allows manufacturers to make some car models that fall below the average miles per gallon, if improving their fuel economy would be excessively costly, as long as their fleet average meets the required overall performance standard.

(5) Department of Health and Human Services

The Department of Health and Human Services (HHS) has been successful in implementing a financial "bubble" policy in some areas. For example, it sets a ceiling on the level of reimbursement to hospitals for general in-patient routine costs, but does not prescribe, except within general limits, how much a hospital can spend on individual items such as food, laundry, nursing care, etc. In health planning, HHS sets performance goals (such as 4 hospital beds for every 1,000 people), but it leaves it up to the local agency to decide how to achieve that goal. In regulating nursing homes, HHS has proposed performance standards to measure the quality of patient care, and in the future it hopes to develop and use performance standards to ensure that states and localities are providing welfare services fairly and in a timely manner.

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4. COMPLIANCE REFORM

Chairman: Judy Sorum
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Chairman: Neil Eisner
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DESCRIPTION

Most regulatory reform efforts are directed to regulation development; this workshop focused on the often neglected areas of enforcement and compliance. Compliance reform is any approach that meets the dual goals of using federal resources more effectively and achieving compliance, without unnecessarily burdening the regulated public.

Compliance reform may also eliminate instances of unnecessary federal presence, thereby shifting responsibility more to the private sector. Use of closer-to-home expertise can have the additional advantage of stimulating a deeper commitment in the regulated public to the goals of regulation. Generally, these techniques try to relieve the regulatory burden by helping, inducing or reminding the regulated to comply with federal regulations. Compliance reform usually does not involve rewriting regulations, passing new laws, or expanding staff.

Workshop participants mentioned many compliance reform techniques currently being used in the regulatory process in various agencies. These examples fall into three broad subcategories of compliance reform. Specific examples from federal agencies are listed below for each of those subcategories.

(1) <u>SELF-CERTIFICATION AND THIRD-PARTY CERTIFICATION</u>

DESCRIPTION

Regulatory agencies on occasion use non-government personnel to perform inspections or monitor activities needed to ensure compliance with regulations. These personnel may be independent third parties certified or approved by the agency, the regulated party itself, or a consumer group or trade association knowledgeable about the regulated industry or product. Independent third-party inspection services may or may not be paid for by the regulating agency.

In many cases, this technique is used because the agency lacks the staff to adequately inspect and monitor all potential violators. Also, when agencies lack the expertise necessary to certify certain groups, they often rely on outside experts, such as medical doctors. The technique makes the government appear to be less meddlesome.

GENERAL CONSIDERATIONS

Workshop leaders presented issues that must be addressed before implementing this technique:

- The agency must have statutory authority to certify outsiders.

- If the inspection or monitoring information is to be used in legal enforcement proceedings, a professional, well-qualified independent examiner is needed.

- The qualification of third-party inspectors could be assured by federal or state certification, but the establishment of clear qualifications, procedures and limitations could require more regulations.

- The duties and responsibilities of the certified party must be clearly outlined to define liability.

- The agency must retain the authority to check on the validity and quality of data generated by the independent or self-monitoring agent.

- Self-compliance reports from industry or producers may be biased or invalid. There is a potential for conflict of interest or criticism of the agency when an industry, or independent party paid by industry, is certifying the quality or safety of the industry's own products.

Self-certification and third-party certification are useful when many products, firms or organizations must be monitored to ensure compliance. This technique appears to be particularly useful in product safety regulation because often the regulated party has a shared interest in making the product acceptable to the public. It is also possible in product safety regulation to devise inspection criteria that an outside investigator can evaluate objectively.

APPLICATIONS

- The Department of Transportation requires automobile manufacturers to certify that their automobiles and equipment comply with federal regulations. It also uses independent medical doctors, authorized by its Federal Aviation Administration, to certify the health of airline pilots.

- The Department of Health and Human Services uses the Joint Commission on Accreditation of Hospitals, an independent association, to certify or accredit hospitals that meet agency standards.

- The Department of Agriculture regularly uses independent veterinarians to examine livestock for certain types of diseases.

- The Internal Revenue Service makes extensive use of self-monitoring and voluntary compliance on tax returns.

- The Consumer Product Safety Commission allows producers to certify that their products meet appropriate standards. It also uses independent inspections and analyses (e.g., Underwriters Laboratories) to certify product quality and "Consumer Deputies" from trade associations and consumer organizations to ensure that products are in compliance.

- The Labor Department's Occupational Safety and Health Administration (OSHA) is encouraging systems by which labor-management groups monitor safety within their own organizations, thereby supplementing the efforts of OSHA compliance teams. Changes in compliance procedures may be necessary to encourage this self-policing.

(2) NEGOTIATED SETTLEMENTS

DESCRIPTION

Negotiated settlements are a way of dealing with complaints by consumers or employees against firms or industries that have not complied with certain regulations. Using this technique, the regulatory agency encourages the parties involved to attempt settlement themselves of disputes or conflicts over regulatory compliance. The agency may act as an intermediary. If the problem is not resolved to the satisfaction of the complaining parties, the agency steps in and enforces the appropriate regulations.

This technique reduces the agency's burden by reducing the number of cases requiring direct attention. The burden on industry is also reduced because federal intervention is required less often. Industries are thereby encouraged to develop their own internal review procedures.

This technique seems to be most useful in situations where the regulations affect two distinct groups (e.g., employers/employees, producers/consumers). It also applies to cases where the federal government has the responsibility to negotiate settlements or ensure fair practices.

GENERAL CONSIDERATIONS

- Settlements are easier when affected parties are easy to identify, more difficult when parties are obscure or diffuse.

- Employers might feel coerced into settling "nuisance" cases because the threat of federal involvement is present.

- Complaining parties may be afraid to confront the offending party directly.

APPLICATIONS

- The Labor Department's Office of Federal Contract Compliance Programs (OFCCP) receives complaints about hiring practices and discrimination. These complaints are not acted upon by OFCCP for 60 days in order to permit the parties to conduct an internal review. In 25 percent of the cases, the complaint is resolved with no further cost to or effort by the agency. This serves as an automatic screening process. Only the most serious and difficult cases require federal intervention.

- OSHA uses negotiated settlement with employers who have been charged with firing an employee for filing an OSHA complaint.

  An investigation of an employee's complaint formerly took a government investigator six months or more to gather evidence and affadavits. Under the new system, OSHA notifies the employer immediately of an employee complaint and asks if a negotiated settlement can be reached before the long investigation begins and fault is assigned. Employer response has been positive.

<u>(3) ADVISORY INSPECTIONS</u>

DESCRIPTION

Advisory inspections are compliance checks to offset strict "command and control" strategies. They provide an opportunity to communicate compliance requirements to an organization without a concomitant citation and fine.

GENERAL CONSIDERATIONS

A violation citation is a heavy burden on the violator, especially if he/she was not aware of the regulation or what constitutes a violation. Advisory inspections, as an alternative to the command compliance system, would be useful in many of the same situations as self-certification. In addition, it is a good way to instruct firms and industries about violations and increase understanding and competence in the regulated group. In implementing advisory inspections, the following must be taken into consideration:

- The agency must have statutory flexibility to inspect without citing.
- The agency should use this approach only where a non-life-threatening violation occurs.
- If an outside consultant with no authority to cite is given the inspection role, the industry may be more inclined to participate.

APPLICATIONS

- OSHA provides private consultants to business to help companies solve health and safety problems before inspections occur. The goal is to eliminate the need for a citation wherever possible. Only if a very serious hazard resulting in imminent danger is observed and not corrected would the OSHA area office be alerted to inspect.
- The Labor Department's Mine Safety and Health Administration uses "Compliance Assisted Visits," which are inspections without citations. Firms are given time to correct any hazards found during the visit. A citation is issued only after a reasonable grace period.

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5. ENHANCED COMPETITION

Chairman: Mary McInnis
General Counsel, CAB

DESCRIPTION

Reduction of regulatory and other barriers to competition can be an important source of cost savings, can improve the quality and diversity of services, and can relieve an agency's regulatory burden since decisions are made by market activities.

GENERAL CONSIDERATIONS AND APPLICATIONS

Enchanced competition may be expected to benefit the public particularly in the domestic airline industry, which became the workshop's focus. One factor determining the amount of competition present is the ease of entry into a particular market. Prior to 1978 (as required by a 1938 statute), if an airline wanted to enter a new market, it had to prove to the Civil Aeronautics Board (CAB) that (1) it was "fit, willing and able" to serve the market (that it was safe, in compliance with minimum insurance requirements, etc.) and (2) the transportation to be supplied was "required by the public convenience and necessity" (interpreted to mean that a need for service existed and the market was large enough to accommodate another carrier). The second requirement was particularly burdensome because if more than one carrier sought entry into a single market, an oral evidentiary hearing was required to form the basis for a comparative carrier selection. Such a proceeding would often take years to complete. If an applicant requested an expedited hearing (a usual step for a serious applicant), a negative judgment on the expedited hearing issue would not be subject to court review, thus providing another barrier to market entry.

In 1978, before the passage of the Airline Deregulation Act, the CAB took a step toward the removal of these barriers by adopting a "nonoral evidentiary hearing, show cause" procedure in the Piedmont Boston-entry case. In that case, the airline was fit, willing, and able to serve the particular route, and the CAB issued an order requiring that others show cause why the application should not be granted. Without shifting the burden of proof away from the applicant, this use of paper pleadings alone as the basis for the decision significantly reduced the amount of time needed to process an application.

Another example of how a change in CAB's procedures and policies resulted in public benefits is the Oakland service case. Due to its proximity to San Francisco's airport, the Oakland Airport was under-utilized. The Board established a new Multiple Permissive Entry Policy. Under this program, the CAB determines whether or not some new service is needed in a market. If the Board so determines, using non-hearing show cause procedures, it then grants authority to every applicant who is fit, willing, and able.

Grantees are not required to actually use their authority or to notify the CAB before using it. The program's effect is that many airlines will apply for this authority so that it will be in hand should they ever decide to serve a particular market. Even if only one carrier exercises its authority, it is encouraged to provide good service by the threat of competition from other carriers who may enter the market without notice. This procedure not only fosters competition, but also relieves the CAB of some of its regulatory burden since the decision of who will serve a particular market is made in the marketplace, rather than in a comparative selection hearing proceeding.

In October 1978, Congress enacted the Airline Deregulation Act, which ratified several of these policies and procedures. It changed the public convenience and necessity standard for domestic certification, from "required by" to "consistent with" the public convenience and necessity, thus permitting the Board's multiple permissive entry policy. It also shifted the burden of proof from the applicant to those opposing certification.

Small markets with light passenger loads present an additional problem. The Airline Deregulation Act made it much easier for airlines to stop serving unprofitable points. In order to maintain a minimum level of service to small communities, the Airline Deregulation Act provides subsidies for essential air service. Determining what is a reasonable price, the amount of the subsidy, and who should provide the service could be difficult questions for the CAB to answer. The CAB now allows the marketplace to resolve these issues by requesting proposals to provide service to such markets. The CAB, of course, still decides what constitutes essential air service.

The question of protecting new competition arose again in 1979 when World Airways, a chartered carrier, proposed to begin scheduled service in the transcontinental market offering low normal fares to attract passengers. Having decided to grant the certificate authority, should the CAB allow other carriers to match World's low fares? Should it make any difference that World was a newcomer to scheduled service, rather than an established competitor in other markets? The concern was that entrenched carriers would "dump" additional capacity in the market at the lower fares to keep World out, later increasing fares once World's threat was removed. The CAB decided to let the other carriers match World's fares, placing full reliance on actual and potential competition to discipline domestic markets over both the short and the long run. The Board's concern did not in fact materialize, but the situation was not clear-cut because World's operations were delayed by a strike for nearly eight months. Since the World decision, other carriers have entered the transcontinental market and low fare competition has become well-established. World survived, and has become an aggressive competitor in this and other markets. Another, more recent, situation occurred in June 1980, when Eastern Airlines began transcontinental service and instituted new low fares. The CAB again decided to let everyone match the new entrant's fares. The situation was complicated, however, when American Airlines came up with an even more attractive fare package and obtained CAB approval just before a weekend; and Eastern allegedly matched these lower fares over the weekend without obtaining prior CAB authorization. From a broad policy standpoint, should Eastern be punished if the public actually benefitted? Other carriers, who followed the rules, were not able to match American's low fares. Should the CAB first protect the integrity of the statute and its rules that require fares to be filed with the CAB before they become effective? If Eastern were to be punished, how and to what degree should this be accomplished, considering that it had begun the latest round of competition for the low fare market? The situation is still under preliminary investigation.

The Eastern situation points out a limitation on the extent to which an agency may act to increase competition, namely, the statutes that provide the agency's regulatory authority. In the case of the CAB, the statute provides that no airline can change its fares without filing a tariff with the CAB at least 30 days in advance. The CAB, however, has a general exemption authority and may permit the charging of new fares on less than 30 day's notice if it finds that it is in the public interest to do so. Pursuant to this authority, the CAB can and generally does approve fare reductions on short notice, but in a fiercely competitive pricing situation, even the Board's short notice procedure may prove restrictive. More broadly, the CAB believes that in some situations there is no sound economic reason for requiring the filing of tariffs at all. In fact, following the 1977 amendments to the statute, which removed most of the Board's regulatory authority over domestic all-cargo service, and in light of the general mandate to deregulate embodied in the Airline Deregulation Act of 1978, the Board exercised its broad exemption authority to eliminate the filing of all domestic cargo tariffs.

Charter service tariffs have also been eliminated because the Board found no continuing regulatory need for them. The Airline Deregulation Act, however, provides for domestic passenger fare deregulation by January 1, 1983. This provision, and its legislative history, is generally interpreted to mean that the CAB must regulate domestic passenger tariffs, at least to some extent, until that date. If the CAB, through its administrative procedures, deregulates too quickly, Congress might be tempted to re-regulate the area. Thus, the CAB's present course is to promote a smooth transition to total deregulation.

In general, the removal of regulatory barriers to competition has a positive effect on the industry regulated, on the public, and on the regulatory agency. In the airline industry, companies are able to pull out of unprofitable markets more easily, charge lower fares, increase passenger loads, and make more effective use of their equipment. Airline passengers benefit from the competitive fares. Small town passengers often receive more frequent and convenient service when commuter airlines fill the void left when a large carrier leaves a market. The CAB benefits by allowing some of its decisions to be made in the marketplace.

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6. INFORMATION DISCLOSURE

Chairman: Robert Reich
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DESCRIPTION

Information disclosure starts with the assumption that marketplace information is valuable to consumers, if properly presented. If consumers are provided with relevant information, it is assumed that they will then use it to protect themselves. Information disclosure can thus be a powerful regulatory technique, used either alone or to complement traditional techniques.

GENERAL CONSIDERATIONS

Discussion focused on two questions: (1) how can information disclosure induce sellers to respond to further regulatory goals, and (2) how can the information be presented in the most complete and comprehensible manner?

The first question addresses marketplace incentives. Informed consumers will not purchase products that do not satisfy their preferences, thereby raising the incentive of sellers to produce and advertise products that score well based on the information disclosed. This intensified competition and advertising reinforces the information disclosure program. At the same time, even those consumers who do not use the disclosed information benefit by having a better average set of products among which to choose. For example, although few consumers appear to read nutrition information on cereal boxes, cereal manufacturers now fortify cereals to increase the disclosed nutrition content. Similarly, builders competing for energy conscious consumers would have an incentive to satisfy even voluntary energy standards, if energy use ratings were disclosed.

The second question concerns measurement and format. Disclosure is most effective when complete information is presented in a way that is easy to comprehend. The energy cost information required on new appliances is one example: labels disclose the appliance's yearly energy cost relative to the maximum and minimum energy cost of appliances in its class. This label provides both cost information and a handy frame of reference to evaluate it. Combining a number of attributes into a single index number is another method of achieving both completeness and comprehensibility. For example, a recent USDA experiment demonstrated that comparative supermarket price indexes can induce price competition to benefit all consumers, even those who do not use the information.

Information disclosure is most appropriate when a variety of consumer preferences and product possibilities exist and markets are competitive. It is most powerful for goods that are purchased. It is used by EPA (mileage rating information), ICC (information about moving companies), the CAB (information about limitations on cheap airfares and bumping penalties), and several other programs. It has potential applications in many other federal agencies, including CPSC, USDA, DOE, OSHA, and HHS. It is less appropriate where:

- externalities occur (for example, a motorcycle noise standard benefits third parties, not the purchaser);
- vulnerable consumers such as children or the elderly predominate;
- product competition is weak and consumer choice is limited.

APPLICATIONS

One of the most well-known applications of information disclosure of those presented in the workshop is the health warning and tar and nicotine level information required by law on cigarette packages and in cigarette advertising. The Federal Trade Commission (FTC) and the U.S. Congress followed parallel paths in making this information publicly available. The FTC originally proposed a health warning in 1964 after the Surgeon General's report on smoking was released; the next year, Congress passed a law requiring all cigarette packs to display such warnings. In 1969, the FTC proposed rules banning cigarette advertising on all broadcast media and requiring disclosure of tar and nicotine levels. Cigarette manufacturers agreed to voluntary disclosure of this information in 1971. In 1972, the FTC and cigarette companies reached a consent decree.

The results of this labeling and other disclosure programs were analyzed for workshop participants in terms of the following criteria:

1. Sellers' Positive Competitive Response

The tar and nicotine level disclosure induced a positive competitive response on the part of cigarette manufacturers: they began to push their current low-tar cigarettes; they developed new lower tar cigarettes; and they even used the government's testing results in dramatic advertisements to support their claims. The following figures illustrate a dramatic increase in the marketing and marketability of low tar and nicotine cigarettes. In 1967, low tar cigarettes comprised only 2 percent of the market and 5.5 percent of the manufacturers' advertising budgets. By 1978 low tar cigarettes comprised 28 percent of the market and 48.5 percent of advertising budgets. In this instance, disclosure of tar and nicotine content gave manufacturers an increased incentive to develop and advertise brands with lower tar and nicotine content. A similar example is the auto companies' EPA mileage disclosures, which have become a prominent feature in media advertising.

2. Sellers' Negative Strategic Response

In decreasing the levels of tar and nicotine, however, the level of harmful carbon monoxide may in fact have been increased. The lack of a similar disclosure requirement for carbon monoxide gave cigarette manufacturers little incentive to reduce it or even try to reduce it. Thus, a disclosure in one area may trigger a negative strategic response in another area in that the content of harmful, but undisclosed, ingredients may increase in the course of decreasing the content of the disclosed substances.

3. Comprehensibility vs. Completeness

Theoretically, the potential for a negative strategic response could be eliminated by the disclosure of complete information. However, increasing the information disclosed raises potential consumer comprehension problems. Too much information may create confusion or "information overload." This trade-off between completeness and comprehensibility always exists in an information disclosure program. It can often be solved by combining a number of attributes into a single index number or by periodically redefining the attributes disclosed or the index number weights.

4. Measurement and Format Issues

Questions of effectiveness and method of presentation are raised by the fact that despite the general health warning, people continue to smoke. Part of this is due to the "wear-out" effect: people have seen the same statement for so many years that they now ignore it. Sweden gets around this "wear-out" problem by requiring cigarette manufacturers to rotate 20 different warnings. The health warning's continued effectiveness may also be limited because it simply does not supply specific enough information in a persuasive manner. In addition, a negative strategic response by sellers is to downplay any impact of the warning by placing it in the lower left-hand corner of the advertisement where people normally do not look.

5. Other Sources/Users

Other information users besides consumers and manufacturers may also be targeted in an information disclosure program. For example, insurance companies have an incentive to offer discounts for more crashworthy automobiles.

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7. VOLUNTARY STANDARDS

Chairman: Robert Knisely
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DESCRIPTION

Voluntary standards can be viewed as "getting someone else to do your work," akin to Tom Sawyer's technique of fence painting. Voluntary standards simply refer to standards (of behavior, performance, or design) that may be developed by someone other than the government. Voluntarily developed standards may later be incorporated into the official regulations of the agency.

GENERAL CONSIDERATIONS

Discussion in the workshop centered on when and how the government can use voluntary standards. Before an agency can begin to use these standards, several relevant questions must be considered:

- Who outside of government is involved with the problem?
- What are their incentives to cooperate?
- Who knows best the details of the problem, solution, and necessary standards?
- Can the government achieve its objectives through voluntary standards developed by the non-government sector?
- Can the public be involved in the standard-setting?
- Can the standards be structured to minimize cost?

Voluntary standards are applicable in many situations. They have several advantages over mandatory government-developed standards: they may present fewer court challenges; they are cheaper, easier, and quicker to implement; the burden of proof on government is reduced; and they may be more realistic. However, voluntary standards suffer from several disadvantages: they may leave the government with less control over outcome and less compliance (although even government standards never achieve 100 percent compliance); the agency also may seem to the public to be in less control.

APPLICATIONS

An agency may take advantage of voluntary standards activity by way of endorsement: an agency endorses an existing standard, and products that meet this standard can then be labeled as approved products. This endorsement, however, raises a number of questions. Is due process followed when endorsement circumvents public notice and comment? Is endorsement merely de facto regulation by the government?

Participants provided the following examples of voluntary standards use:

- The National Bureau of Standards has an ongoing program in which its staff cooperates with societies and other agencies to develop voluntary standards.

- The Consumer Product Safety Commission encourages voluntary standards: television fire-safety problems and burn-safe furniture were cited as specific examples.

- The Federal Communications Commission uses the Electronics Industry Association, the Land Mobile Communications Council, and the American Standards Institute for Electrical and Electronic Engineers to form joint technical committees to help develop many of its regulations. The voluntarily developed accounting code for broadcasters was also noted.

- The Department of Agriculture has used voluntary standards for inspection standards, acreage limitations, and in other areas. The Department normally sets up a group of involved parties to develop these standards.

- The Federal Railroad Administration has developed voluntary standards for the quality of equipment exchanged between railroads.

- The Food and Drug Administration encourages voluntary standards for medical devices.

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8. TIERING

Chairman: Steven Levy
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DESCRIPTION

Tiering is the tailoring of regulatory requirements to fit the size and other characteristics of specified classes of regulated entities. Although the tiering technique is most often viewed as providing regulatory relief to smaller businesses, tiering has broader implications. In general, tiering is perceived to be a good innovative technique, some aspects of which are congruent with the current deregulatory mood of the country.

GENERAL CONSIDERATIONS

The following issues must be considered in evaluating tiering as a regulatory technique:

- No common agreement exists among regulatory agencies on the definition of appropriate tiers. Because different agencies use different distinctions, tiering raises the possibility of increased overall regulatory complexity and conflict. Although some forms of tiering already appear to be commonly used in the government, problems of definition mean that agency decisionmakers may need training in this area so that wider applications can be developed.

- If tiering is applied on the basis of company size, differential impacts must be considered. Larger companies typically incur specific compliance costs as a necessary part of doing business. Although the exemption of smaller firms from disclosure statements may provide some relief, the overall impact as a regulatory cost-cutting measure is likely to be small. Thus, tiering as a regulatory tool need not be considered as an all or nothing approach.

- Tiering may result in a restructuring of economic incentives so that some companies may prefer to stay within a given tier or opt to remain small. It is essential that the possible adverse structural changes that may be caused by tiering are given serious thought before implementation.

- Tiering may not be appropriate for all situations since the cost/benefit considerations may be obscure. In addition, the public benefit from tiering may be difficult to discern. Unlike the airline bumping example, which was provided as an application of an economic incentive, the public benefit from tiering is not so straightforward.

APPLICATIONS

Tiering has been implemented by various government agencies under different programs. Workshop participants mentioned the following examples:

- The Food and Drug Administration has tiered according to potential risk, not company size. Greater requirements have been placed on critical industries, such as medical devices, where the potential risk to the user population is high.

- As a deregulatory technique, the Commodity Futures Trading Commission (CFTC) has moved slowly with the tiering concept because of an apparent absence of public benefit. CFTC has had difficulty in setting different standards for large and small firms. Currently, reporting is required mostly for large traders because of their impact on the commodities market; smaller firms are not covered by some requirements.

- Under a program sponsored by the Office of Surface Mining, state surface mining regulatory authorities assist small operators in meeting regulatory requirements. Two reports, one hydrological and one geological, must be submitted to a state before surface mining can begin. If an operator qualifies as a small operator, the state will pay for the expensive laboratory studies so that the operator can submit the reports and receive a mining permit.

- The Department of Housing and Urban Development uses statutory tiering on grant programs based on population size. Reporting standards imposed on public housing agencies vary depending on the extent of previous compliance.

- In the case of hazardous cargo, the Coast Guard is placing regulatory emphasis on smaller businesses because large shippers tend to use better containers and apply more efficient transport methods.

- The Occupational Safety and Health Administration (OSHA) applies worker safety and health standards uniformly, regardless of size. However, businesses with ten or fewer employees are exempt from reporting.

OSHA also exempts from reporting requirements small businesses with seven or fewer injuries per year and/or businesses in certain standard industry categories.

- For the Environmental Protection Agency, tiering is sometimes superseded by the urgency of a given situation. For instance, court-ordered mandates to implement hazardous waste regulations have priority over tiering schemes.

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APPENDIX: PRESIDENTIAL MEMORANDUM

THE WHITE HOUSE

WASHINGTON

JUN 13 1980

MEMORANDUM FOR THE HEADS OF EXECUTIVE DEPARTMENTS
AND AGENCIES

Two years ago, I issued Executive Order 12044, "Improving Government Regulations". This Order directed regulatory agencies to find ways to achieve their goals with reduced burden on the private sector. The agencies have developed several new regulatory alternatives that provide flexibility and decentralized decisionmaking. Last year, I asked the Regulatory Council to study these ideas and develop a blueprint for applying them more widely.

The Council's survey of agency experience found eight techniques that show real promise:

- marketable rights;
- economic incentives;
- performance-based standards;
- market-oriented compliance measures;
- reduction of barriers to competition;
- information disclosure;
- voluntary standard setting; and
- adjustment of standards to distinguish among categories of regulated entities ("tiering").

These techniques are not always appropriate. In some cases, only the traditional approach of rigid, detailed "command-and-control" regulation adequately protects public health and safety. Often, however, alternatives that allow flexibility or use market forces can make regulation more cost-effective. Such approaches can cut cost and red tape without sacrificing legitimate regulatory goals. They can also promote innovation, putting private ingenuity to work finding better long-term solutions to regulatory problems.

Each of these alternatives is being used by several agencies and is producing substantial benefits. They are described in greater detail, with specific examples, in the attached summary report by the Council.

I am directing all agencies with regulatory responsibility to review their programs and find areas where these alternatives can be applied. In addition, each agency should expedite the development and implementation of flexible alternatives now under consideration.

The Regulatory Council will report to me on your progress on October 1, 1980. Council Chairman Douglas Costle and his staff will work with you to apply successful alternatives to new regulatory areas. Please designate a contact person for this program and tell the Council who it is.

I know I can count on your personal involvement and support to expand the use of these alternative approaches to regulation.

Jimmy Carter

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