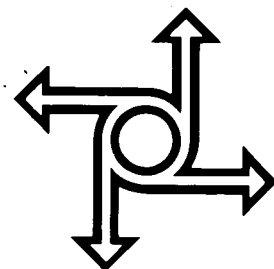


Alternative Regulatory Approaches: AN OVERVIEW

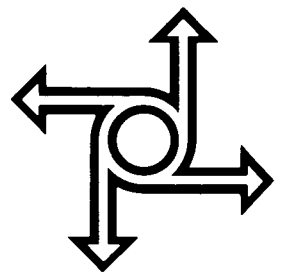
September 1981



Project on Alternative Regulatory Approaches

Alternative Regulatory Approaches: AN OVERVIEW

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Project on Alternative Regulatory Approaches

Guidebook Series on
Alternative Regulatory Approaches

This series is intended to provide a practical introduction -- featuring both the theoretical merits and the proven limitations -- to a special set of alternative regulatory tools: approaches that are generally more compatible with the market forces that govern business decisions.

The series includes six books:

- 1) Overview
- 2) Marketable Rights
- 3) Performance Standards
- 4) Monetary Incentives
- 5) Information Disclosure
- 6) Tiering

The series was produced by the staff of the Project on Alternative Regulatory Approaches and its support contractor, SRI International of Menlo Park, California, Richard A. Ferguson, Project Manager.

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ALTERNATIVE REGULATORY APPROACHES

"Alternative Regulatory Approaches: An Overview" is the first in a series of six guidebooks on Alternative Regulatory Approaches. Each guidebook summarizes the advantages and limitations of specific alternatives and provides examples of how agencies use them. These alternatives include marketable rights, performance standards, monetary incentives, information disclosure, and tiering.

Why Are Alternative Regulatory Approaches Important?

One of the significant (although not the best-noted) products of the recent campaigns for regulatory reform has been the growth of a sense of self-consciousness about regulatory decisionmaking.

By and large, regulators now agree that their decisions can and should be a deliberate choice among competing alternatives, and should result from a systematic comparison of the relative costs and benefits among the array of choices. A more thorough analysis of such alternatives will be increasingly important during the reviews by the Office of Management and Budget of major new rules under E.O. 12291 and in light of pending legislation advocating agency use of alternative approaches. Policymaking is becoming a conscious matter of choosing the "right" tool for the job at hand.

One class of regulatory tools that is of particular interest includes those that bring the least disruption to private decisionmaking in the regulated firms and use market forces to reduce the overall direct and indirect costs of regulation. These market-oriented techniques -- alternative regulatory approaches -- stand in contrast to the traditional "command-and-control" form of regulation, which involves a detailed specification of private compliance requirements and formal sanctions against those who violate them. In general, alternative regulatory approaches can have these relative advantages over command-and-control regulation:

- They provide more flexibility and more incentive for regulated firms to devise least-cost ways to comply.
- They impose fewer indirect costs (e.g., red tape, inspections).
- They are results-oriented, rather than means-oriented.

- They reward private innovation.
- They impinge less on private choice and encourage market competition.
- They avoid the pitfalls of centralized, discretionary decisionmaking.

These alternative techniques are not new inventions -- some regulators have been using them for years. However, as a class they are not yet well understood, and they are still more often a subject of rhetorical debate than serious policy discussions. This tendency has caused some agency skepticism about their practicality. These guidebooks attempt to show that market-compatible techniques are more than interesting ideas -- they are interesting ideas that work to solve real governmental problems.

We do not presume that market-oriented solutions will fit every regulatory problem. Only those who know particular programs in detail can determine how appropriate an alternative regulatory approach is in a specific case. Thus, these guidebooks are intended as introductions to the techniques rather than as "how-to-do-it" manuals. We have relied extensively on actual examples of past and present agency use. We hope that a realistic summary of both the merits and drawbacks of these approaches will encourage regulators to begin to count them among the alternative tools at their disposal.

Who Are the Guidebooks For?

This guidebook series is designed to help those who are responsible for developing new regulations and reviewing old ones and those who monitor regulations inside and outside of government to improve their practical appreciation of alternative regulatory approaches.

How Are the Guidebooks Organized?

Each guidebook contains three parts:

Part I answers basic questions about the alternatives that agencies frequently raise. The answers reflect actual experience of Federal, State, and local agencies.

Part II gives detailed descriptions of applications that are currently in place or under consideration, or that have been considered in the past. The examples are for illustrative purposes only; no attempt has been made to evaluate the merit of each action.

Part III contains an annotated bibliography that refers the reader to additional sources of information.

Where Is More Information Available?

The Project on Alternative Regulatory Approaches, begun under the U.S. Regulatory Council, completed its work in September 1981. The Administrative Conference of the United States now maintains the Project's resource files and publications.

Additional copies of the guidebooks and other project publications (see page 24) may be requested from:

Administrative Conference of the United States
2120 L Street, N.W.
Suite 500
Washington, D.C. 20037
(202) 254-7020

For answers to specific or technical questions about alternative regulatory approaches, the Project's contractor may be able to provide assistance. The contractor provided general support to the Project and implemented measures to train agency personnel in the use of alternative approaches. Contact Trudy Speciner:

Regulatory Analysis and Management Program
SRI International
1611 North Kent St.
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(703) 524-2053

**ALTERNATIVE REGULATORY APPROACHES:
GUIDEBOOK SUMMARIES**

MARKETABLE RIGHTS

Marketable rights are government-issued permits that can be bought and sold. Making permits tradeable creates an important new incentive, in contrast to "command-and-control" regulations. Distributing a limited number of rights to scarce resources that private parties can then buy, sell, or trade as market needs dictate can remove the government from difficult, contentious, and lengthy decisions about who can "best" use the limited resources.

Advantages

The main advantage of a marketable rights approach is that it reduces overall costs to the economy. It also can encourage innovation and competition, reduce agency burdens, and provide greater policy flexibility.

Example

A Rand study estimates that the compliance costs of a system of marketable rights for non-aerosol freon (chlorofluorocarbons) would be 42 percent less costly to society to implement than a command-and-control system of discretionary curtailments.

Applications

Applications described in this guidebook show that marketable rights apply to a wide range of regulatory programs at the Federal, State, and local level:

- Federal Communications Commission considers marketable permits system for allocating spectrum.
- Federal Aviation Administration considers market system to allocate landing slots at major airports.
- Environmental Protection Agency explores marketable permit strategy to control chlorofluorocarbons and to reduce air pollution.
- New York City and Puerto Rico control growth through transferable development rights.
- Lake Tahoe implements transferable building permits system via random selection to control development.
- Western States use system of marketable permits for trading water rights.

How A Marketable Rights System Works

Preconditions

To be a candidate for marketable rights, a regulatory program must be:

- suited to a permit system;
- relatively indifferent to the identity of the user of the controlled rights; and
- free of major structural defects, including monopoly and thinness of the permit market.

Elements of a Permits Market

Major design features of a permit market include:

- the permit, which may be either permanent or temporary, either unitary or stratified by priority or class of ownership;
- the initial allocation scheme, which may be auction, lottery, "grandfathered" distribution, or a hybrid scheme; and
- facilitating features, such as public education, brokers, and agency gatekeeping functions.

Practical Issues in Permits Markets

Factors that can complicate the design of an acceptable marketable permit scheme include:

- 1) Market defects, including uncertainty perceived by participants, concentration of permit ownership, and market thinness.
- 2) Institutional barriers, including dispute over initial allocations, investment in the status quo, and controversy over the "correct" number of permits.
- 3) Legal constraints, including statutory constraints, rules on the use and disposition of permit revenues, and tax treatment of property rights.

Practical ways have been found to solve these problems in many cases.

PERFORMANCE STANDARDS

Performance standards replace 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 can reduce compliance costs and provide regulated firms more flexibility and discretion to discover new and more efficient methods of compliance.

Example

The Occupational Safety and Health Administration performance standards for "fall hazards and walkways" allow employers to devise various methods to prevent injuries from falls at work sites. This allows employers to develop effective alternative fall-prevention techniques rather than having to adhere to a specific guardrail design that may not be practical in certain work environments.

Applications

A particularly interesting form of performance standard is "averaging," as illustrated in EPA's "bubble policy" for air pollution.

Example

In place of mandated point-by-point air pollution controls, the Environmental Protection Agency (EPA) instituted a "bubble policy," which allows plant managers to control whatever emission points they care to, as long as they can show that overall pollutants generated under an imaginary plant-wide "bubble" will not increase. This "bubble policy" has resulted in dramatic cost savings for industry; Dupont expects to save more than \$12 million (60 percent of capital expenditures) at a New Jersey chemical complex.

There is, in most cases, a spectrum of regulatory options available to regulators, ranging from pure design standards to pure performance standard. A central idea -- and problem -- in moving toward the performance end of this spectrum is that of determining if the alternative strategy will yield equivalent results.

Advantages of Performance Standards

Performance standards leave firms free to choose - or invent - least-cost solutions to given regulatory objectives. They foster innovation, impede competition less, and can produce more flexible, results-oriented policy than design standards.

Example

The Department of Health and Human Services' new performance approach to hospital fire safety may save one-half of the costs of compliance. In one case a Boston hospital saved over \$5 million -- about 70 percent of previous compliance costs -- to meet equivalent levels of fire safety.

Applications described in this guidebook show that performance standards apply to a broad range of regulatory programs.

- Department of Transportation uses time averaging for fuel economy standards.
- Consumer Products Safety Commission adopts performance tests for children's toys and product packaging.
- Civil Aeronautics Board employs performance standards in its "bumping procedures" for airlines.
- Center for Disease Control considers establishing performance standards for the evaluation of clinical laboratories.

Practical Issues

In some cases, performance standards pose special difficulties for agencies.

- They may, in some cases, be harder to write when performance is difficult to capture in an objective measure.
- They may, in some cases, be harder to administer, particularly with respect to ease of inspection and enforcement.
- They may be perceived to give competitive advantages to larger or more sophisticated firms.

The guidebook describes these issues and ways to mitigate them.

MONETARY INCENTIVES

Monetary incentive systems comprise five market-oriented approaches for achieving regulatory goals that present promising alternatives to direct command-and-control regulation. These monetary inducements may come directly from the regulatory agencies in a variety of forms, including: direct payments, fees, penalties, various forms of tax incentives, and various schemes to internalize costs -- e.g., required insurance or warranties. Monetary incentives can be used directly to further regulatory goals or can be used as part of a system of enforcing regulatory requirements. Thus, a system of monetary incentives can be used both in conjunction with command-and-control regulation, and as an alternative.

Using fees or subsidies (rather than government-enforced standards) encourages 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.

Example

Monetary incentive schemes have been used or proposed in many regulatory sectors; emissions fees for pollution, grants for the construction of sewage treatment facilities, subsidies to air carriers for providing service on otherwise unprofitable routes, tax incentives for hiring disadvantaged workers, nonconformance penalties for vehicle pollution standards, and assignment of liability for offshore oil spills.

Advantages

The main advantage of a monetary incentive approach to regulation is that it has the potential to greatly reduce the overall costs to the economy of achieving a particular regulatory goal. A monetary incentive scheme can lower costs to businesses and consumers and can be less costly to administer for both the regulatory agency and the regulatory entity. It also can encourage innovation and competition, reduce agency burdens, and provide greater policy flexibility.

Example

The Postal Rate Commission (PRC) provides monetary incentives for bulk mailers to presort their mail by offering lower postage rates for mailers that presort. The alternative of requiring that all mailers presort would impose large costs on firms that do not have the capability to presort. Savings of \$2.2 billion per year can be realized.

Applications

There are five major types of monetary incentive schemes represented in this guidebook. Applications come from a wide variety of regulatory programs.

- 1) Fees - Some sewage treatment facilities charge users according to the volume of effluents discharged. This provides an incentive for firms to reduce their effluent discharges through alternative production techniques when such reductions cost less than the direct sewage treatment fee.
- 2) Monetary Penalties - The Mine Safety and Health Administration (MSHA) uses monetary penalties to enforce health and safety standards in mines. The penalty amount depends on the gravity of the violation, and thus provides a more efficient incentive for operators to maintain safe mines.
- 3) Tax Incentives - The IRS has established an excise tax on the sale of "gas guzzler" passenger cars, pursuant to the requirements of the Energy Tax Act of 1978 that is intended to discourage the manufacture and purchase of such cars.
- 4) Warranties, Bonds, and Insurance - EPA requires vehicle manufacturers to provide an Emissions Performance Warranty which requires the manufacturer to repair free of charge any emission control device that fails an EPA-approved test; MSHA requires firms engaged in strip mining to post performance bonds to guarantee that they will have the financial resources to pay for reclaiming the land after the mining is completed; States may require mandatory automobile liability insurance to ensure that drivers will be able to provide monetary compensation when they cause damages.
- 5) Grants, Subsidies and Payments - EPA sewage treatment grants reimburse qualifying communities 75% of the costs for regular construction and 85% for the use of alternative technologies; the CAB has developed a subsidy scheme ensuring "essential" air transportation to small communities that may lose service as a result of airline deregulation.

Practical Issues

Monetary incentive systems may require more precise monitoring than traditional, detailed regulation. It is often difficult to determine the appropriate magnitude of the incentive that is necessary to ensure that the regulatory goals are met. An incentive scheme may be impeded by political and institutional barriers and legal constraints.

INFORMATION DISCLOSURE

Information disclosure is a regulatory alternative which provides 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. Ideally, normal market forces govern how producers disclose information about their products. But "market failures" can result in poor information flow. These failures can occur when:

- the effects of poor product choices are ambiguous or hidden; and/or
- no firm has a sufficient incentive to disclose information.

Under such conditions, government regulators can intervene to strengthen the flow of information from producer to consumer. A disclosure scheme can either substitute for or supplement, a mandatory regulation.

Example

People encounter information disclosure almost daily when they see the EPA estimated gas mileage ratings in automobile advertising, the Surgeon's General's health warning on cigarette packages and advertising and in motion picture advisory ratings on the suitability of films for young people.

There are two basic types of information disclosure:

- 1) private, in which the producer discloses the information; and
- 2) governmental, in which the government regulator takes the initiative. The degree of government intrusion into the information disclosure process varies with the method used.

Advantages

Information disclosure can be 1) less paternalistic, 2) less costly, and 3) less coercive to manufacturers than mandatory rules. Also, it can enhance competition and encourage innovation and high quality goods, services, and practices.

Example

The FTC has established standard test procedures for tar and nicotine ratings in cigarettes. Tobacco companies now use these ratings extensively in

their marketing, which reinforces buyer awareness of tobacco health issues and has led to the introduction of newer, ultra-low tar cigarettes.

Applications

The guidebook describes applications in a wide range of regulatory programs.

- The National Highway Traffic Safety Administration requires grading and labeling of all new tires.
- The Federal Trade Commission requires appliance energy efficiency labels.
- The Commodity Futures Trading Commission uses a consumer information system to inform consumers and receive complaints.
- The Department of Agriculture uses food grading to categorize agricultural products into different levels of quality.
- The Food and Drug Administration has considered requiring patient package inserts for prescription drugs to provide consumers with important information about the drugs.

Practical Issues

Practical issues in designing a disclosure strategy include the adequacy of the content of the disclosed information, the form of the disclosure, and implementation issues. It is the choice among options, not the attributes of a particular product or service, that is the real focus of a disclosure effort. There are a number of problems that can make disclosed information inadequate for this purpose, including incomplete or imbalanced comparative information, overly technical information or information that contains too much jargon, and test measures that produce unintended incentives. Experience shows that the form of the disclosure is also of crucial importance in informing consumer choice. A key implementation issue is predicated on whether seller incentives are to make the disclosure a part of their meeting strategy or not.

TIERING

Tiering is the tailoring of regulatory requirements to fit the particular circumstances surrounding regulated entities. These diverse circumstances make an across-the-board requirement inappropriate. Treating all regulated entities -- businesses, organizations, and governmental jurisdictions -- in an equal manner places unnecessary burdens on entities that do not contribute significantly to the problem a regulation is designed to address.

Example

Taxpayers comply with the requirements of the Internal Revenue Service each year by filling out Form 1040 or the shorter Form 1040A depending primarily on their level of income.

Advantages

Through tiering an agency can: 1) ensure that its regulatory solutions are apportioned according to the nature of the problem; 2) alleviate disproportionate impacts and unnecessary or inequitable demands that across-the-board regulations may place on certain classes of entities and; 3) make more efficient use of its own resources.

Example

To make better use of its limited enforcement resources to where significant problems occur, the Occupational Safety and Health Administration targets its scheduled inspections toward those industries or firms that pose higher risks to worker health and safety or for which OSHA has received specific worker complaints.

Applications

Tiering can be used in each of the three major components of a regulatory program.

- 1) The substantive requirements imposed by the regulation.

Example

The Department of the Treasury's Bureau of Alcohol, Tobacco, and Firearms believes its current method of setting bond requirements (for tax collection) for users of denatured alcohol has an anticompetitive

effect because it requires small users to buy a proportionately higher bond than large users. ATF, therefore, is proposing to amend its bonding requirements to make it easier for new businesses to begin operations and for small businesses to obtain bonds.

2) Reporting and recordkeeping requirements.

Example

The Civil Aeronautics Board tiers the frequency and scope of reporting and recordkeeping requirements for airlines by both the amount of gross revenues and the size of aircraft. For certificated aircraft, the CAB has established three classes based on revenue; and air taxi operators, who are uncertified and use only small aircraft, and who have even fewer reporting and virtually no recordkeeping requirements.

3) Enforcement and compliance-monitoring efforts.

Example

In assessing civil penalties under the Federal Insecticide, Fungicide, and Rodenticide Act, the Environmental Protection Agency tiers the fines according to gross sales volume. These entities also are tiered according to the relative gravity of the violation, with as many as five levels used for some types of violations.

Tiering Variables

Traditionally, tiering according to various size measures has been the most prominent use of tiering. However, differentiating by other indicators is also possible.

<u>Size</u>	<u>Non-size</u>
- Number of employees	- Degree of risk
- Operating revenues	- Ability to comply
- Assets	- Geographic location
- Market share	- Level of Federal funding

Practical Issues

Possible drawbacks to be avoided in tiering include increased complexity for agency programs; potential adverse impact on competition; delay in the rulemaking process; reduced incentives for more fundamental reform; and legal constraints such as statutory conflict or questions of constitutionality.

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