RIA AND THE SEARCH FOR BETTER REGULATIONS

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The quest for better regulations is one the most debated issues of the whole history of economic thought, starting from De Mandeville and Adam Smith, until the work of today's leading economists.

Almost all OECD countries have taken action over the past few years in order to improve the quality of regulation, and institutions such as the OECD itself and the European Commission have issued guidelines or endorsed action plans that are meant to foster more effective regulations and a thorough revision of the existing burden of state intervention into the free deployment of market forces. The main focus has certainly been on reducing the so-called regulatory hypertrophy, that depends on the path-dependent character of lawmaking and leads to the histeresis of most sectorial regulations. And a crucial role has been assigned to economic analysis –Regulatory Impact Analysis, RIA, with its different methodological applications: CBA, risk-risk analysis, benefits-only analysis, benefits-only analysis constrained by technological feasibility, or some other brand. RIA's contribution in leading to improved efficiency is usually specified in three basic steps. First, by conducting economic analysis, an agency is supposed to arrive at reasonably accurate estimates of the benefits and costs of different policy options. Second, the agency is supposed to make decisions that are consistent with the results of this economic analysis, that is, by choosing the options that impose the lowest costs for a given level of benefits or that achieve the greatest net benefits. Finally, the decisions that agencies make on the basis of economic analysis should be different from-- that is, more efficient than--the ones that they would make in the absence of the analysis. (see e.g. Jessica Litman on the hysteresis of copyright law). As a result, *ex ante* RIA in most cases played the role of *ex post* analysis of existing regulations, with emphasis on identifying those areas in which the burden of regulations hindered the development of more efficient trading schemes.

Thus far, however, the results have been quite astonishing in many respects. On the one hand, some US commentators -- John F. Morrall, for example-- have traced spectacular benefits (14 billion USD over a 5-year time-span) arising from the use of RIA in the selection of the most appropriate regulations. In Italy, we have been told by the Office of the Prime Minister that the benefits of RIA in terms of cost savings glamorously exceed the corresponding administration costs for the implementation of such a procedure. These encouraging findings were mainly related to the possibility of reducing excess

regulations, whose burden was estimated to be almost equal to that of public debt in the US.

On the other hand, the use of RIA is still subject to a fierce debate, for many reasons which I will now try to highlight.
First, the use of economic tools does not fit all regulations, whose ends may well depart from that of mere economic efficiency.
Secondly, whenever regulations aim at restoring a satisficing (à la Herbert Simon) level of efficiency in a market, the tools used by administrations to estimate the costs and benefits of various scenarios are far from being scientifically tested and almost always fail to provide a trustworthy snapshot of real world dynamics.
Thirdly, in most cases RIA procedures lead to a worrying danger of capture, stemming from the government's lack of information on the peculiarities of the sector to be de-regulated or re-regulated.
Finally, the effectiveness of the RIA process heavily depends on the institutional framework in which RIA is implemented.

1. The use of economic tools does not fit all regulations

Not all regulations are created equal. Policymakers normally pursue intermediate goals that act as proxies for the maximization of social welfare. Mainstream economic theory normally helps policymakers in getting one such intermediate goals, efficiency. But what about fairness, social justice, safety etc? Since the advent of welfare economics, most scholars have discussed the criterion under which a regulation is thought to be beneficial for society. And once the limits of the Pareto criterion have been denounced[1], paradigms such as the Kaldor-Hicks test of potential Pareto superiority or a Zerbe variation, capable of considering distributional advantages, have been used or proposed[2]. Yet, in some cases, even the latter criterion does not fit the specific perspective of the policymaker. Some regulations aim at providing all citizens with a minimum level of endowment for a certain resource: these regulations normally follow a so-called lexicographical criterion, more than a Kaldor-Hicks one. Economists and philosophers (e.g., John Rawls) have shown that, given that it is almost impossible to accurately estimate individual cardinal utilities, in some cases a lexicographical order is superior to any other resourcist criterion such as the Kaldor-Hicks test.

[1] (see e.g. Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*)
[2] More recently, such criterion has been updated to take into account the cost of side payments or transfer costs (now termed Kaldor-Hicks-Zerbe criterion).

This reflection does not necessarily lead to concluding that RIA is useless. It just suggests that the so-called branch of *social regulation,* as opposed to *economic regulation,* is less promising). RIA is a very undefined label, which embraces lots of different methods and theories. I just argue that economic tools normally used for RIA, such as the cost-benefit analysis, the risk-risk analysis or the cost-effectiveness criterion should take into account that not all categories of individuals affected by the regulation should be taken as equivalent. And this has always been a very difficul task for quantitative economics.

2. What economic tools?

In the early 1970's Edward Lorenz engaged in an interesting study which led to the development of the Chaos Theory. He posed the question: Can the flap of a butterfly's wings in Brazil spawn a tornado over Texas? This "butterfly effect" also applies to the impact of a regulation on society. A quantitative estimation of the first-order and second-order effects of a regulation on directly and indirectly affected individuals is too complex a task even for the most committed and trained economists. This problem becomes even more stringent whenever we look at network industries, which are normally fraught with externalities. From this viewpoint, RIA, be it *ex ante* or *ex post*, has been termed a 'solution in search of a problem' for its inherent fallacy and lack of precision[3]. According to some commentators, RIA becomes harmful whenever economics is taken as a science, and loses meaning whenever we see it as it is – indeed, only as good as the proxies it chooses to use.

This view certainly does not lack support in economic theory. Kenneth Arrow's theory of the second best ultimately depicts economics as quite a tentative approach to an otherwise unpredictable reality. Economic theory has taken a rather agnostic direction over the past few years as far as measuring the impact of regulation on public administrations and private market players are concerned. After the Chicago School of economic thought had brought a resurgence of economics as a scientific tool, more recent developments have acknowledged that economic analysis constantly waves between Holism and Reductionism, between the need to take into account all possibile socio-economic effects of a regulation and the urge to reduce complexity, that necessarily worries policymakers in gathering information on the likely impact of a regulation. The example of ICT markets highlights the need to adapt the traditional economist's machinery to an increasingly complex reality.

[3] See C.M. Radaelli, *The Politics of RIA: What are the Lessons to Learn?*, 2001.

A second, related thought is more inherent to the traditional tools of economics. Think of the failure of the market failure approach. Economists have gradually realized that some benchmarks, mainly the perfectly competitive market, are not useful for a thorough understanding of real world dynamics. As is widely acknowledged, not all market failures call for government intervention. Yet, in 1996, the US OMB, *Office of Management and Budget,* adopted market failures as the litmus test for identifying those situations that call for government intervention, without taking into account that an accurate RIA should – as a first, inevitable step – find out whether government intervention can do more harm than good. Over the past few years, economists have identified many situations in which traces of a market failure nevertheless suggest a hands-off approach. And the role of governments is consequently seen much more as that of a facilitator than that of a regulator.

Moreover, one must not ignore the fact that the more RIA gets complex, the more imprecise and costly it becomes. CBAs normally cope with the problem of estimating all relevant benefits (which are usually harder to estimate and less tangible than costs) and calculating their net present value by choosing the appropriate 'social discount rate', which may well change from a regulation to another. The concept of actual, financial cost has gradually been replaced by more tentative calculations of opportunity costs, which entail a supplementary analysis of the foregone opportunities. As a result, in most cases the use of less ambitious tools might lead to a more satisfactory use of quantitative economics for the purpose of lawmaking. Even economic calculations must break-even, after all. And one should engage in such experiments only as far as the marginal benefit of further assessments more-than-compensate the associated cost.

Finally, RIA becomes almost impossible whenever it is performed *ex post*, possibly for the purpose of assessing the overall impact of a regulatory *corpus*. The impact of regulations is normally so intertwined that all attempts to disentagle the effects sorted out by individual rules ends up being utterly hazardous. This is why the search for a better regulation is a diabolic issue: because the devil is in the details.

At the end of the day, I will concede, with Henry Richardson, that CBA is simply too stupid for teaching us something about the desirability of a political, social, economic solution. But more on that in a while.

Meta-RIA and rational ignorance at the budget office

In order not to impose an unbearable burden on society and administrative bodies, policymakers normally mandate that a careful RIA be performed only for those regulations that exert a significantly large impact on society. Nevertheless, directives that allow RIA only for laws whose impact on society is larger than "*x*"[4] defy common sense. How can we find out the impact of a regulation before we have performed an RIA? In most cases, one cannot be sure about the magnitude of the impact even after the RIA. Governments should therefore perform a RIA of the RIA (or a meta-RIA).

The truth is that in order to assess the impact of their regulations, governments need information. As for market failures, imperfect information is one of the main causes of government failure. But how can governments acquire this information? There are a number of issues that deserve being mentioned in this respect.

First, regulatory agencies normally are more informed than administrative branches or Ministers. And regulatory agencies can more efficiently survey the costs and benefits that would arise in case the sector they regulate is re- or de-regulated. But most regulations do not address economic sectors in which an *ad hoc* agency is established. The Italian experience on RIA revealed a remarkable lack of training on the side of those in charge of implementing such analysis. A good orchestra cannot be built just with instruments of outstanding quality (assuming economic tools achieve such result). Musicians also have to be trained and inspired. Complex RIA should be mostly demanded to private consultancies, which was not contemplated by the Italian legislative framework on RIA. And the five Italian regulations that were subject to experimental RIA ended up exhibiting lack of technical skills, rough calculations and very strict budgetary constraints. As an example, benefits were always computed in terms of cost savings, not as pure benefits that would arise in the future as a consequence of the new regulation. The proposed CBA turned therefore into a cost-effectiveness analysis, whose breadth and ambition – as everybody knows – is way narrower.

Secondly, government bodies, in order to acquire information on a specific economic sector, have to increasingly rely on private sources, mostly provided from industry operators. But the more governments rely on those sources, the more they become exposed to capture by private interest groups. Capture theory has paralysed the economic theory of regulation at the beginning of the 1970s, after George Stigler highlighted the inherent rent-seeking nature of regulatory processes, with specific emphasis on interventions implemented by regulatory agencies. Consequently, there is a worrying trade-off between the

[4] In the US, only those regulations whose impact is larger than 100 million USD per year.

impartiality/neutrality of state intervention and the corresponding precision/efficiency. The more complex and thorough governments want RIA to be, the higher the risk of being captured by private-party interests. The more budget offices want to reduce their rational ignorance, the higher is the risk to reduce their impartiality. This is frequently the case for regulations of sectors in which some categories of affected parties are more compact, coordinated and powerful than others – think of regulations protecting dispersed consumers. Principal-agent relationships, where market operators are agents in charge of providing the government/principal relevant information, might create disastrous consequences.

Furthermore, the theory of public choice taught us that inter-governmental relationships might be affected by diverging interests. Principal-agent issues might entail high inefficiencies whenever two separate administrative bodies are in charge of gathering the information and deciding on the favourite option.

This double principal-agent problem must be confronted with another fiduciary relationship: the one between citizens and the government that is supposed to protect their interests. And the combination in some cases is puzzling and far from promising.

RIA from a comparative law perspective

The issue of information gathering at the competent offices is important also with respect to the peculiar institutional framework in which RIA is implemented. Countries that have a long-standing tradition of *ad hoc* regulatory agencies, such as common law jurisdictions (in particular, the US and the UK) might cope with the information problem with relative ease. The US experience has shown encouraging results, starting from the Reagan administration, and today allows for a thorough review of existing regulations through a sort of *Regulatory Budget*, issued on a yearly basis by the OMB under the name of *Government Report on the Costs and Benefits of Federal Regulations*. Ongoing, decentralized information gathering is key for monitoring the impact of regulations on specific industrial sectors. But transplants into different institutional realities are likely to be rejected.

Italy has tried such a dangerous path, with disappointing outcomes. A Decree of the Prime Minister established a *Help Desk* that acted as *deus ex machina* of the five experimental RIAs, which almost exclusively concerned regulations enacted for procedural semplification. The result was a failure of RIA in almost all respects. One of the five experiments was suspended for problems in finding reliable data. All five regulations were analyzed without relying on private

sources of information. Informal focus groups were taken as indication of the position that would be taken by the industry: government bodies just picked up thephone and called 6-7 operators that were interviewed for a bunch of minutes. As I already mentioned, a real CBA was never performed, although cost-effectiveness tests were labelled as CBA. Communication between government bodies in charge of different RIA stages was difficult, and those in charge of drafting the final regulation were not involved in earlier stages. The experimental phase should have ended with the drafting of a guide to RIA and Better Regulation, but the Government gave up after realizing that the five experiments had failed to provide an even rough idea of what a RIA would imply once extended to a wider number of regulatory processes.

Conclusion: narrowing the scope of RIA?

RIA procedures are almost always doomed to failure when: a) the policy goals are not limited to economic efficiency; b) the effects sorted out by a regulation are not confined to a single category of market operators; c) costs and benefits to be appraised are mostly indirect and hardly monetizable; d) such an appraisal is costly in and of itself, so that a meta-RIA suggests not to carry the analysis too far.

The natural consequence of such negative evaluation of RIA procedures would be, at first blush, that RIA should be banned from the process of policymaking. However, in my opinion, a better solution would be to just redefine the scope of RIA, by distinguishing those cases in which such instrument can prove useful and crucial, from those in which it can do more harm than good. And, as always, economics becomes way more helpful for lawyers once it is not taken as a science. I therefore provide some final suggestion for applying RIA:

- **Limit the scope of RIA to hardcore economic regulation**: whenever policymakers are confronted with problems of economic regulation, whose impact would likely be confined to a single economic sector, and whenever the variables involved are easily monetizable (price regulation, etc.), RIA should be taken as a central tool in the assessment of the preferred regulatory option.
- **Take RIA as a relative calculation, not as an absolute one**: as I already mentioned, RIA normally faces humongous difficulties in the search for the exact representation of the real world. But RIA is normally used to compare the impact of alternative policy options, which include the 'hands-off' or 'zero option'. Far from providing an exact view of the magnitude of benefits and costs that will be generated by the regulation,

RIAs that make use of CBA may still prove quite useful for regulators, whenever the sources of imprecision are shared by all compared options. If, for example, CBA uses the wrong social discount rate for taking into account future costs and benefits, it will certainly yield an inexact magnitude of both costs and benefits, but might still constitute a useful 'rule of thumb' for comparing the different alternatives at hand.

- **Drop holism and surrender to some degree of reductionism**: as I recalled, even RIAs must reach their break-even point. And, provided that CBA's precision decreases along with its complexity, in most cases the use of less sophisticated tools might prove more useful for regulators. After all, to be stupid, as Richardson puts it, is always better than being blind.
- **Use qualitative analysis:** I believe that quantitative techniques should be integrated with a massive use of qualitative analysis, such as that provided by EAL. EAL is of utmost importance for understanding how to regulate without replacing market dynamics with artificial equilibria, by providing the right incentives for market players to converge towards efficient outcomes.
- **Regulate lightly:** since governments should use RIA as a non-scientific – yet useful – tool, RIA should not be the basis for massive, heavy-handed regulation. To regulate lightly means to act as facilitator, not as regulator.

In conclusion, I express some concerns on both the attempt to consider RIA as a one-size-fits-all procedure for providing scientific basis to policy choices and the skepticism expressed on the use of RIA in any circumstance. Economic tools tend to become increasingly useful as economists and lawyers understand their limits and their potential. Lack of awareness means lack of results and abundance of unintended consequences. As everybody knows, the road to hell is paved by good intentions. And the road to bad economic regulation, after all, isn't that different.