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HANDBOOK FOR REFORM: BREYER ON REGULATION

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## ABSTRACT

In Regulation and Its Reform, Stephen Breyer sets forth an analytical structure for classifying regulatory programs and identifying candidates for reform. This review article summarizes Breyer's ideas in schematic form, and evaluates their usefulness for the purposes set forth in the book.

## HANDBOOK FOR REFORM: BREYER ON REGULATION

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Regulatory reform, like death and taxes, seems always to be with us. For decades armies of scholars in law, economics, political science and public administration have rode to tenure on treatises about regulatory policies. And, as soon as one Presidentially commissioned study of regulatory reform rolls off the presses, another is being organized.

In this milieu, it is not easy to find a truly original new general insight about regulation and its reform. Stephen Breyer has nonetheless tried, not so much by saying specific things that are new, but by constructing an overall framework for analyzing regulation in a way that is useful in structuring the debate about reform.<sup>1</sup>

In many ways, the book is impressive. It seeks to be comprehensive, covering a wide range of regulatory agencies and policies of both federal and state governments, and even some elements of tax policy, antitrust and tort law. Moreover, the discussions are usually detailed, using specific examples of regulatory decisions -- with facts, figures and citations -- to illustrate more general points. But in the end, the book is not wholly satisfying: some important issues are overlooked or dealt with in a cursory fashion, and some others are resolved in discussions that, while detailed, seem arbitrary in choice

of evidence, mode of analysis, and ultimate conclusion.

The purposes of the book are broad. First, it is a comprehensive analysis of the "topical issue of regulatory reform,"<sup>2</sup> aimed at the government official or "informed layman" who seeks better understanding of an important public policy issue. For these people, the book is a handbook for identifying specific regulatory programs that are candidates for reform. Second, it is a textbook that regards "regulation as a distinct discipline" and that is designed "to help teach it as a separate subject."<sup>3</sup> Third, it is an original scholarly work for others doing research in the field insofar as it provides a new and productive way of organizing one's thoughts about regulation and how it works.

The new ideas are twofold. One is a method of categorizing regulatory policies. It is intended to produce groupings of programs that are large enough to be subject to generalizations that can be illustrated by interpolicy comparisons, but specific enough to have significance in informing the development of specific new or reformed regulatory policies. The second new idea is the concept of "mismatch" -- a situation in which a particular regulatory approach is adopted to attack problems for which it is not suited. In addition, one quite interesting chapter contains the author's views about how successfully to undertake the process of reforming a regulatory program, based upon his experiences as a staff member for Senator Kennedy during the period of deregulation of the airlines.

The book is organized topically into four parts. In the Introduction, Breyer describes his purposes and basic approach. Following this, Part I lays out his "framework" or theoretical structure for analyzing regulatory programs. Part II uses this structure to evaluate the appropriateness of several specific regulatory policies, illustrating how the general points made in Part I can be used to illuminate the discussion of concrete policy problems. Part III discusses how one proceeds to actual regulatory reform.

The Introduction is an essential element to the book; indeed, to understand the book's motivation is probably impossible without reading it. In it Breyer reveals that he is an unabashed subscriber to the "public interest" theory of regulation -- that is, that he analyzes and evaluates regulation as if it were created to serve a general public interest. He adopts this position for normative reasons, in that he thinks that whatever the source of regulatory laws and actions, their justifications must be that the general public interest is served. Moreover, Breyer comes close to equating the general public interest in regulatory policy with an improvement in economic efficiency. Hence the primary justification of regulation is to ameliorate market failures. Several paragraphs are devoted to differentiating his approach from "general causal theories explaining the origin of regulation or its effects."<sup>4</sup> The disclaimer notwithstanding, Breyer's belief that the book is important for policy purposes, and his prescription for how to organize a governmental process that produces a valuable regulatory reform, make sense only if

policymakers are motivated in large measure by the pursuit of economic efficiency. This resurrection of the public interest theory of regulation is common among the academics who participated in airline deregulation.<sup>5</sup>

The second major point in the Introduction is Breyer's emphasis on the "second best" nature of the real world. He sees his book as setting forth the analog in regulatory policy to the economic theory of market failures. The latter identifies specific sources of market failures: third-party effects, monopoly, etc. To produce a balanced, rational analysis of the wisdom of attacking a market failure in any specific way, according to Breyer, requires an equally systematic description of the sources and types of regulatory failure. This has meaning, of course, in the specific context of the Breyer assumption about the public interest -- that its objective is economic efficiency, for then regulatory failures, like market failures, become specific causes of an inability of a regulatory institution to achieve perfect efficiency. The hard, real policy choice, then, is a tolerably good mix of inefficient markets, inefficient regulatory interventions, and other inefficient policy instruments. The relative emphasis on each markets, regulation, other policies -- will turn on the relative strengths and weaknesses of the three for the specific case at hand.

Part I, A Theory of Regulation, and the first chapter of Part II, "Match and Mismatch," are the heart of the book. They contain the principal original contribution, which is the analytical framework for classifying and analyzing regulatory policies. The basic idea of

these chapters is to construct a comprehensive, all-inclusive table that depicts policies that deal with market failures for which regulation is a possible solution. Breyer's schema is shown in Figure 1, in which the columns are the justifications for regulation and the rows are the alternative public policy approaches that are available: six types of regulation and seven other policies that Breyer does not call regulation. The boxes in the table are to be filled in with the characteristics of a policy that combines the problem and approach of the corresponding column and row. A "mismatch" is when, for any given problem (column), the government picks the wrong policy approach (row).

Of course, the real world is more complicated than this, for the policy alternatives can be combined. Strictly speaking, one needs to add more rows, each one corresponding to various combinations of the "pure" policy alternatives comprising the thirteen rows in the table. But the essence of the idea remains the same: there will be some boxes that represent "matches" in that they are reasonable ways to attack the corresponding problems, while the rest will be mismatches.

The analyst identifies the matches and mismatches by a three-step process. First, some boxes can be ruled out a priori because the problem and the approach have nothing in common. Some of these are shown by Xs on the figure. Second, some boxes can be ruled out on theoretical grounds because the inherent properties of the approach will lead to a "policy failure" as serious as the "market failure" in the problem. Some of these cases that are discussed in the book are shown by Ms in the figure. Third, if more than one potential solution

FIGURE 1  
BREYER'S SCHEMA FOR CLASSIFYING REGULATORY POLICIES

Alternative Policy Approaches		Justifications for Regulation											
		Major					Minor						
		Natural Monopoly	Externalities	Economic Rents	Imperfect Information	Excess Competition	Unequal Bargaining Power	Moral Hazard	Paternalism	Rationalization	Scarcity		
Regulatory	Cost-Based Price Regulation	W	X	M	X	M							
	Historical Price Regulation		X	M	X	M							
	Public Interest Allocation					M							
	Historical Allocation					M							
	Standard Setting	X	M	X		X							
	Individualized Screening	X		X									
Nonregulatory	Antitrust	M	X	X	X	W							
	Information Disclosure	X	X	X	W	X							
	Taxation		W	W									
	Marketable Rights		W		X								
	Liability Law	X		X		X							
	Bargaining												
	Nationalization												

Key: W - winners  
M - mismatches  
X - a priori irrelevant

to a problem remains, detailed case analysis of the specific market failure in question -- not the generic type, but the specific example -- can be focused on selecting among them. Some winners according to the book are shown by Ws in the figure.

Whether all of this makes sense depends upon whether the categories are more illuminating than confusing, and whether the boxes that are serious contenders really represent distinct, valid policy alternatives. My summary opinion is that there are too many distinctions, that the number of boxes is far greater than the number of distinct policy options, and that the categorization scheme is not helpful at its most important level -- theoretical characterizations of inherent weaknesses of particular policy approaches.

The source of the excessive detail is primarily the list of independent policy approaches, which I believe are far fewer in number than Breyer presents, although there are too many different justifications as well. The five major justifications for regulation are unexceptional, especially given that one -- excessive competition -- is a straw man as a justification (but not as an excuse) that Breyer repeatedly beats throughout the book. The five minor justifications are briefly described in an especially muddy section.<sup>6</sup> Two are important, and deserve greater attention: moral hazard (for example, the adverse selection problem in insurance) and paternalism (a loaded way of saying that one person may not want another person to bear even voluntarily certain harmful risks). Three are completely opaque as independent justifications. One is unequal bargaining power, which

does not appear different from monopoly. Moreover, the point of some policies seems to be to make bargaining power less equal. A second is rationalization, which occurs when an industry has firms that are inefficiently small or insufficiently coordinated. What is this if not an externality problem, imperfect information, or excess competition, assuming it is not caused by regulation itself? Third is scarcity, a situation in which government decides "to abandon the market" because something is in scarce supply. How is this independent of either external effects or economic rents?

Doing away with these three, plus excessive competition which we know to be on the list for comic relief, we are down to six independent and reasonable justifications. The only one that is left out is the reduction or spread of uncertainty, as put forth by Owen and Braeutigam.<sup>7</sup> They argue that one purpose of regulation is insurance motivated by the perception that volatile markets in goods and services of great importance produce capricious, random redistributions of income.

Most of Part I is devoted to a detailed discussion of the six forms of regulation shown in the rows of Figure 1. In addition, one chapter briefly discusses the seven nonregulatory alternatives. Some of these categories are not completely clear, and require elaboration.

One is allocation, and how the types differ. By "allocation," Breyer means deciding who gets to engage in a specific activity or use a particular resource. "Allocation under a public interest standard" refers to a process in which criteria are adopted for picking the best

applicants, whereas historical allocations refers to a process that grants goodies by grandfathering.

The difficulty with these categories is that for the most part allocation is not independent of other regulatory activities. Indeed, all economic institutions are methods of allocating valuable things. The examples in the book include allocating the rights to goods made more scarce by economic regulation. In addition, it is not a stretch to regard environmental regulation as a process by which permits to use airsheds and waterways are allocated among polluters according to a public interest standard. And, of course, all economic regulation -- even of natural monopolies -- involves as its first step granting a franchise, or certificate of convenience and necessity, that enables the recipient to provide service. Allocation as an explicit primary activity is quite rare, with allocation of the use of the electromagnetic spectrum by the Federal Communications Commission the most important example, and others including concession rights in national parks, landing rights at airports, and liquor licenses in states that limit their number. In all of these cases the policy is linked to externalities, and is in reality not terribly distinct from marketable rights because regulators normally allow them to be traded relatively freely.

Less straightforward is the definition of standard setting and how it differs from several others. The book does not actually define standard setting regulation; instead it offers a detailed description of the process. Screening is defined: "highly general standards . . .

to screen out, on a case-by-case basis, those individual products or persons that are unacceptable."<sup>8</sup> The distinction between screening and standards, apparently, involves in part a degree of specificity in the standard and the emphasis on cases. Breyer also states that screening is to be distinguished from allocation under a public interest standard because the latter usually involves picking a few winners from among a larger group of qualified applicants, while the former involves weeding out unfit applicants without explicitly limiting the number of winners. Finally, standards are also distinguished from information disclosure, for the former require something specific about a product or process, while the latter provides an individual with the information regarded as necessary to write his or her own standards. By inference from these distinctions, standards are specific, minimally-acceptable design and/or performance characteristics applied to products and processes, but not to people, services, or communications. I include communications in the list not just because labeling and advertising are in the disclosure box, but also because the "seven words you can't say on radio" will, when said, deprive the radio station of its license, which is a product of allocation under a public interest standard.

Breyer recognizes that these categories are indistinct, but the problem is deeper than some loose ends in an otherwise useful classification scheme. To the extent these items do differ, they do so because basically similar regulatory statutes and responsibilities have caused agencies over time to adjust the details of regulatory policy to

the specific characteristics of the problems that they face. Thus, there is no independence of type and method; one general approach -- writing rules about products, processes and workplaces in order to protect people -- has led to different kinds of rules, with different degrees of generality, for different problems. Of course, if this is true, Breyer's approach is a make-work scheme, causing the analyst to focus on comparing several discrete boxes that are in truth the same policy under different manifestations of the same general problem.

An illustration of how the boxes run together is to be found in the approach to controlling air pollution that has been taken since the 1977 amendments to the Clean Air Act. The Environmental Protection Agency begins by setting maximum allowable concentrations of the most important pollutants. This implicitly places a limit on total emissions in every region, a standard that is necessary for setting more detailed regulations for each specific source and for initializing a market in emissions rights. According to the Act, EPA is required to set performance standards for new sources of pollution. These are both specific in details and general in applicability, and so are truly standards in Breyer's lexicon. Meanwhile, states are supposed to adopt a plan for reducing emissions from old sources in areas that do not satisfy the ambient air quality standard. Sometimes these are standards for source categories, but often they are decided on a case-by-case basis because of differences among the sources in a single category -- or because there is only one major polluter of a particular type in the region. And overlaying all of this is the opportunity for

trades of emissions permits among old sources, subject to various rules and regulations, and other procedures whereby new sources offset their increment to pollution in an area by abating emissions from other sources. These are a form of marketable permits, but the trades are usually required to gain prior approval in a regulatory process. Usually an approved trade becomes a revision in the standards for trading partners that reflects the situation after the trade. In many cases, all this will be coupled with an emissions tax and noncompliance fees to add some incentive to emissions reductions. And finally, regulators are attempting to reduce emissions on a source-by-source basis for pollutants for which there is no ambient air quality standard. Thus, one generally will find a single agency, dealing with a single problem, by simultaneous application of most of the serious options for dealing with externalities. Moreover, it will be doing so not by consciously thinking of these methods as distinct approaches, but as one comprehensive policy.<sup>9</sup>

The problem this raises for policymaking is the following. Breyer's framework and method is aimed at the highest political level of decisions: the Congress and the White House. Its orientation is writing laws that establish regulatory programs. At this level, Breyer wants analysts to pick institutional approaches to regulatory problems at an intermediate level of generality, namely a kind of policy problem such as pollution, impure foods, ineffective and dangerous drugs, unsafe consumer products, etc. The alternative argument is that at the legislative level Congress should be less specific about the approach

taken by regulators, that a flaw in the Clean Air Act, for example, is that it is insufficiently eclectic in the range of tools it gives to EPA. This is not an argument for vague legislation; it is perfectly consistent to argue that Congress should be more specific about its objectives but less specific about the degree of reliance on particular regulatory approaches.

Part III of the Breyer book contains chapters on several specific regulatory issues: airlines, trucks, natural gas, pollution and telecommunications. All but the last are designed to illustrate mismatches, but two of the four -- trucks and airlines -- are hardly valid examples, because their justification is excessive competition. Natural gas, an example of rent control through cost-based regulation, and environmental pollution, an example of externalities control through standards, are argued to be better attacked by incentive-based approaches (taxes and marketable permits). The telecommunications chapter is inconclusive, presenting some of the arguments for and against reliance on either regulated monopoly or competition.

These chapters are clearly written for the textbook purpose of the treatise; they tend to be relatively thin, summarizing the main facts, issues and policy alternatives, but presenting little or no original ideas. Some have gaping holes; how, for example, could one devote an entire chapter to telecommunications regulation without even mentioning equipment markets or the implications of the differences in optimal communications systems for voice, computers and broadcasters? As case studies, these chapters are significantly less interesting than

are available in other books.<sup>10</sup> Of course, the others do not make use of the Breyer analytical framework. This matters little, for in no instance does Breyer's framework play a decisive role in his study of the cases, nor does he say anything that has not already been said by others.

The final two chapters of the book, constituting Part III, are about approaches to reforming policy. One describes the procedures followed in airline deregulation, and is very interesting. Breyer makes the point convincingly that careful empirical, case-study work is necessary to make a major change in regulatory legislation. He sets forth several key elements of successful reform: a committed, preferably bipartisan alliance of members of Congress and political leaders in the Executive; a solid backdrop of academic research documenting the problem and its causes; a visible reform process that attracts the media; and in-house objective staff that treat seriously every important claim about the effects of a policy, in the end providing convincing analysis about its merits. The chapter makes interesting reading as an insider's view of how airline deregulation came about. It is less convincing as a "how-to" guide to the intrepid reformer. Senator Kennedy did not succeed in a later attempt to reform drug regulation that was undertaken in a similar fashion, for example. It would have been interesting to see if Breyer could have successfully accomplished his objectives with respect to the use of incentives in pollution policy in the face of the interest-group politics that proved so overwhelming in the battle over the Clean Air Act Amendments of

1977.<sup>11</sup> The new source performance standards for coal-fired electric generation facilities that were built into the Clean Air Act epitomize everything Breyer dislikes about the standard-setting approach to environmental regulation. Too bad he was not in Washington working on this issue; we might have had better environmental policy, but at least we would have had a fascinating implementation chapter in his book!

The last chapter discusses "generic" approaches to regulatory reform -- that is, solutions that take the form of across-the-board changes in the way regulation is undertaken. Examples are a regulatory budget, mandatory benefit/cost analysis, a science court for reviewing technical decisions, and Congressional reviews of regulatory decisions. Breyer views many of these proposals favorably, but does not regard them as addressed to the salient issue: that the wrong approach is often used to attack a regulatory problem. Obviously, if his central thesis is correct, it cannot be seriously ameliorated by smarter commissions, one-house vetos, or improved administrative procedures. This chapter provides an interesting summary and review of a long list of generic reform proposals. It is useful in this regard; however, it is more an appendix than a concluding chapter, for it bears little relation to the central thesis and stream of analysis.

The numerous examples and analytical investigations of different regulatory methods in Breyer's book provide several important lessons, and in fact illustrate a central point that Breyer seeks to make: that regulation has inherent weaknesses that manifest themselves

in different ways in different forms. One is that regulation as a process for gathering information and writing decisions to constrain business behavior "in the public interest" is a very difficult task that can be expected to produce inexact results. Hence, the erstwhile regulator should be reluctant to tackle a problem by regulating it unless the situation is quite bad and there are no reasonable alternatives. Second, administrative law makes regulators very dependent on the information that is available to them, and usually the information is biased and poor. This is an important source of the inexactness of regulation, and creates the additional property that the more uncertain are the facts about the problem to be solved, the more likely it is that regulation will become hopelessly mired down -- or used by a special interest in control of information. Third, policymakers have probably been too reluctant to use more decentralized methods to attack the problems that give rise to regulation. Promising alternatives are incentives, information disclosure, and face-to-face bargaining.

These are all good points. Breyer is a good scholar with an enormous amount of relevant knowledge and experience in regulation, so it is not surprising that his evaluations of regulatory policies and reform proposals are generally very sound. The trouble is, of course, that the merits of these points can be obscured more than illuminated by a cross-tabulation of problems and approaches that contains 130 separate categories of public policies without yet getting to specifics. One does not need all this detail nor the concept of

mismatch to understand that regulated competition is pointless, that the use of price controls to extract economic rent causes shortages, or that the procedures of the FCC for awarding broadcast licenses lack meaningful content. Hence, in the end, the overriding purpose of the book is not successfully served. The richness of detail is often penetrating and at times very interesting, and we would be better off if all the small analytical points about regulation were better understood by policymakers. But it does not add up to an insightful new way to look at regulation.

## FOOTNOTES

1. Stephen Breyer, Regulation and its Reform, Harvard University Press, Cambridge, Mass. (1982), 472 pages.
2. Ibid., p. vii.
3. Ibid.
4. Ibid., p. 9.
5. See the Winter 1981 issue of the Journal of Law and Contemporary Problems, and especially the paper by Michael E. Levine, "Revisionism Revisited? Airline Deregulation and the Public Interest."
6. Ibid., "Other Justifications," pp. 32-34.
7. Bruce M. Owen and Ronald Braeutigam, The Regulation Game: Strategic Use of the Administrative Process, Ballinger, Cambridge, Mass. (1978).
8. Breyer, supra, note 1, p. 131.
9. For a detailed description of how numerous regulatory approaches interact in controlling sulfur emissions in Los Angeles, see Robert W. Hahn and Roger G. Noll, "Designing a Market for Tradable Emissions Permits," in Wesley Magat (editor), Reform of Environmental Regulation, Ballinger, Cambridge, Mass. (1982).
10. Owen and Braeutigam, The Regulation Game, supra, note 7; Almarin Phillips, Promoting Competition in Regulation Industries, Brookings Institution, Washington, D.C. (1975).
11. Bruce Ackerman and W. T. Hassler, Clean Coal/Dirty Air, Yale University Press, New Haven (1981).