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Using Net Benefit Accounts to Discipline Agencies: A Thought Experiment

Eric Posner

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John F. Kennedy School of Government
79 John F. Kennedy Street, Weil Hall
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Further information on the Regulatory Policy Program can be obtained from the program's director, Jennifer Nash, Center for Business and Government, John F. Kennedy School of Government, 79 JFK Street, Cambridge, MA 02138, telephone (617) 384-7325, telefax (617) 496-0063, Email jennifer_nash@ksg.harvard.edu.

Using Net Benefit Accounts To Discipline Agencies: A Thought Experiment

Eric A. Posner[1]

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Abstract

This paper considers the possibility of giving agencies "net benefit accounts," which are devices for keeping track of the benefits and costs of regulations. When an agency issues a regulation, the net benefits of the regulation would be added to the account (or the net costs subtracted). Agencies would start with a surplus and be forbidden to issue regulations that in the aggregate would reduce the balance of the account below zero. Net benefit accounts have two purposes: (1) to reduce the cost of monitoring agencies' regulatory activities; and (2) to provide agencies with carrots as well as sticks for issuing efficient regulation. The carrot takes the form, paradoxically, of the option to issue *inefficient* regulations that are close to the agency's sense of mission.

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[1] Professor of Law, University of Chicago. Thanks to Matthew Adler, Beth Garrett, Doug Lichtman, and Cass Sunstein for comments, and to The Sarah Scaife Foundation Fund and The Lynde and Harry Bradley Foundation Fund for financial support.

Using Net Benefit Accounts to Discipline Agencies: A Thought Experiment

Eric A. Posner

Executive orders extending back to 1981 direct regulatory agencies to perform cost-benefit analyses of major regulations, and to comply with the analyses when not barred by statute, as is the usual case. Indeed, some statutes require cost-benefit analysis, and courts have increasingly demanded it even when statutes are vague.[2] Yet there is no evidence that regulatory performance has improved since 1981.[3] Although agencies issue cost-benefit analyses with more regularity than in the past, and their analyses tend to be more sophisticated, there is not clear evidence that agencies let cost-benefit analysis prevent them from issuing cost-unjustified regulations.

One hypothesis for the lack of regulatory improvement is that the executive orders do not contain effective enforcement mechanisms. The regulatory process gives agencies the power to set the agenda, and institutional specialization gives agencies superior information about the effects of regulations. As a result, agencies can, in effect, make take-it-or-leave-it offers to the president (really, the OMB), formulating the regulation so that it is better, from OMB's perspective, than the status quo, but biased in favor of the agencies' regulatory goals rather than the requirements of cost-benefit analysis. OMB cannot punish the agency without undermining the president's own political goals. Although legislation and judicial enforcement can improve agencies' incentives, legislators and judges are also vulnerable to agencies' strategic and informational advantages.

If this is true, supporters of cost-benefit analysis need to give greater attention to enforcement issues than they have in the past.[4] In this paper, I sketch out a mechanism for increasing agencies' incentives to comply with cost-benefit principles, so that agencies issue cost-justified regulation, rather than reporting cost-benefit analyses but ignoring them, or complying with shoddy cost-benefit analyses designed to rationalize

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[2] See Cass R. Sunstein, Cost-Benefit Default Principles, 99 Mich. L. Rev. 1651 (2001).

[3] The empirical work is summarized in Robert W. Hahn and Cass R. Sunstein, A New Executive Order for Improving Federal Regulation: Deeper and Wider Cost-Benefit Analysis, U. Pa. L. Rev. (forthcoming 2002); see also the discussion of studies and data in Eric A. Posner, Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective, 68 U. Chi. L. Rev. 1137, 1179-85 (2001).

[4] The recent literature focuses on theoretical questions like the consistency of cost-benefit analysis with normative principles, and ways to bring it in line with these principles. See, e.g., Matthew D. Adler and Eric A. Posner, Rethinking Cost-Benefit Analysis, 109 Yale L. J. 165 (1999), and the papers collected in Cost-Benefit Analysis: Legal, Economic, and Philosophical Perspectives (Matthew D. Adler and Eric A. Posner eds. 2001).

the agency's behavior. Given constraints of space, the proposed mechanism is not fully worked out, but is intended as a thought experiment, to provoke discussion.[5]

Agencies would be given what I will call Net Benefit Accounts. These are budget-like devices for accounting for the benefits and costs that regulations produce over time: the benefit of every regulation would take the form of an addition to the agency's NBA, and the cost as a subtraction. Agencies would be required to keep positive balances in their NBA's. Agencies with large surpluses in their NBA's would be permitted to draw down a portion of the surplus for the purpose of issuing cost-unjustified regulations for which the agency has a strong preference.

The NBA idea is not entirely new. It shares some of the characteristics of the "regulatory budget," an idea that has been knocking about for more than twenty years.[6] Under the regulatory budget proposal, agencies would not be able to issue regulations that in the aggregate impose costs on regulated entities greater than a ceiling enacted periodically by Congress. The regulatory budget does not reflect the benefits generated by any particular regulation. By contrast, the NBA reflects both the benefits and the costs of a regulation.[7]

NBA's have, in the best case, two advantages over the status quo. First, they serve an auditing function: they aggregate information about agencies' regulatory activities in a way that facilitates monitoring by elected officials and commentators. The aggregation of information distinguishes the NBA's auditing function from that of ordinary cost-benefit analysis as it is used in the status quo. Second, NBA's potentially serve to improve the incentives of agencies by rewarding them when they issue socially

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[5] I also assume throughout that cost-benefit analysis is a desirable decision procedure; the proposal to follow can be attractive only on that assumption, although, as I explain below, it can be designed to give agencies needed flexibility when cost-benefit analysis falls short because of the difficulty of monetizing benefits.

[6] See, e.g., Christopher C. DeMuth, Constraining Regulatory Costs - Part I: The White House Review Programs, 4 Regulation 13, 17-18 (Jan/Feb 1980); Christopher C. DeMuth, Constraining Regulatory Costs - Part II: The Regulatory Budget, 4 Regulation 29 (March/April 1980); Lance D. Wood et al., Restraining the Regulators: Legal Perspectives on a Regulatory Budget for Federal Agencies, 18 Harv. J. Legis. 1 (1981); Robert E. Litan and William D. Nordhaus, Reforming Federal Regulation (1983). The idea apparently originated within the government. See Lester B. Lave, The Strategy of Social Regulation 21 (1981). It has not been formally adopted by the government, perhaps because of the many difficulties of implementation (on which, see __, below) or perhaps just because it is not an attractive idea (on which, see __ below). For a recent endorsement, see John D. Graham, Legislative Approaches to Achieving More Protection Against Risk at Less Cost, 1997 U. Chi. Legal Forum 13. The possibility of taking benefits into account, which would make the regulatory budget somewhat closer to the NBA system, is discussed but rejected by DeMuth, Part II, supra, at 31-32.

[7] I will discuss the differences in greater detail in Part __, below.

valuable regulations. The current enforcement system depends on ad hoc intervention by the political branches when an agency's regulation fails cost-benefit analysis.

The NBA system is not a panacea. It would involve significant implementation problems, similar to those that afflict the regulatory budget proposal.[8] But the system is different enough from regulatory budgets to deserve separate consideration.

The Problem

I will assume that agencies conceive of themselves as having a "mission" – to protect the environment, help farmers, ensure that drugs are safe and effective, and so forth.[9] In formal terms, agencies have preferences over policy outcomes that are generally more interventionist that those of the median voter or elected officials. By contrast, some commentators assume that the preferences of agencies are determined by industries or groups that "capture" them, or by the political ambitions of the officials appointed to head them; or, on the other side, by some general conception of the public interest. Although all these factors no doubt play a role – and there are agencies that do seem to be controlled by political appointees such as the early Reagan era EPA – I will stick to my simpler assumption.

If all this is right, then it seems clear that when EPA (for example) evaluates potential regulations, its conclusions will sometimes violate the results of a cost-benefit analysis. Put most simply, EPA officials will value some environmental amenity like clean air more than citizens do, as determined by studies of health benefits and the like. As a result, EPA will want to regulate at a higher level than that which would be justified by a cost-benefit analysis. To rationalize the regulation, EPA will be tempted to appeal to nonmonetizable benefits excluded from the cost-benefit analysis by standard practice, or to argue that the cost estimates used in the cost-benefit analysis are exaggerated.

A president or Congress who has the political will could punish agencies that issue cost-unjustified regulations.[10] But these actors are hampered by strategic advantages enjoyed by agencies. Agencies have a first mover advantage. They look for problems, and are generally the first to propose a regulation. The president and/or Congress can reverse, or interfere with, a proposed regulation ex post, but the agency will generally choose the regulation so as to make elected officials just better than indifferent between implementation and non-implementation (and years more of delay). Regulations will,

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[8] See Part __, below.

[9] James Q. Wilson, Bureaucracy (1989).

[10] I assume throughout that elected officials seek "socially valuable" regulations, by which I mean regulations that pass cost-benefit analysis (and indeed maximize the surplus of benefit over cost) when there are no nonmonetizable benefits, and that produce total benefits greater than costs when there are nonmonetizable benefits. This is a simplification, but keeps the discussion manageable.

then, tend to fall short of optimal, though perhaps not as much as they would if no cost-benefit analysis were performed and the agencies were completely autonomous.[11]

A Proposed Solution: Net Benefit Accounts

As a partial solution to these problems, I propose that each agency be given a Net Benefit Account. An NBA is an account that holds fictive dollars to which a regulation's external benefits are added and from which its external costs are subtracted. The NBA system is designed to force agencies to internalize (in a political rather than financial sense) the benefits and costs imposed by their regulations on industry and other groups.

Let me start with an example. Suppose that Agency has a certain mission to do X (protect the environment, enhance food safety, etc.). Congress gives Agency two separate budgets.[12] The first budget covers its ordinary operating expenses, such as the cost of office space and salaries for employees. This budget consists of actual dollars, to be used to pay these expenses. The second budget goes into an NBA. This budget consists of fictive dollars. For simplicity, let this amount be 100.

Under current executive orders, whenever an agency issues a regulation, it must perform a cost-benefit analysis. Under the NBA system, the agency's own cost-benefit analysis is audited, either by a separate government agency like the General Accounting Office or OIRA, or by a private accounting firm.[13] The audit verifies that the agency has followed good practices, such as relying on peer-reviewed studies and using consistent assumptions when calculating the impact of regulations. The audit would rely on crude bright-line rules, and thus would permit only an approximation of the true social value of the regulation, just as audits of business firms permit only an approximation of the firms' financial health. If the regulation passes the audit, the agency's figures are used for NBA calculations. If not, the auditor will substitute its own figures, or ask the agency to revise its figures, and those figures will be used for NBA calculations.[14]

Let's suppose the first regulation produces benefits of 40 and costs of 30 over one year (at which point it expires). This means that it produces a net benefit of 10, over one year. When the agency issues the regulation, 10 is added to the NBA, and so its balance

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[11] The full story is more complex; for details see Posner, supra note __.

[12] I will note but not discuss that the NBA system could be promulgated by executive order or by legislation. Each possibility poses many legal complications, best left for future work. Some of the questions would be similar to those raised by the regulatory budget, on which see Wood et al., supra note __.

[13] The GAO already does this from time to time, but not systematically. See, e.g., United States General Accounting Office, Unfunded Mandates: Reform Has Had Little Effect on Agency's Rulemaking Actions, 3 GAO/GGD-98-30 (1998). This would address the problem of shoddy cost-benefit analyses, mentioned above.

[14] If, as seems likely, the audit takes a great deal of time, Agency's original figures could be used for NBA purposes, and then retroactively adjusted as necessary after the audit is completed.

increases to 110. If a subsequent regulation produces a net benefit of –20, then promulgation of that regulation reduces the balance of the NBA from 110 to 90.

The agency is permitted to keep issuing regulations of any kind until the NBA reaches 0. At that point, it will be forbidden to issue any negative net benefit regulations; it can issue only positive net benefit regulations. When it does so, the balance in the NBA rises above 0.

The NBA keeps a record of the agency's net cost-benefit effect on society, excluding the agency's operating expenses (and also the nonmonetizable effects of the regulation). In this sense it is simply an *accounting mechanism*. An analogy to the business world might be helpful. Businesses, like agencies, evaluate projects. Businesses, more so than agencies, use basic cost-benefit principles when they make these valuations – the business jargon is "net present value." But shareholders, creditors, and other interested parties do not usually evaluate a particular firm on a project-by-project basis, insisting that every project have positive net present value. They understand that projects involve risk, that they usually involve costs and benefits that cannot be reliably monetized, and that often it makes sense to allow managers to rely on intuition. Rather than evaluating each project, observers look at the aggregate results: the amount of revenues produced, say, in a year or other appropriate period, minus costs, with the necessary adjustments – in other words, profits. The balance in their NBA's would be for agencies what profits are for firms: a reasonable albeit crude measure of success.

But there is an important difference between business accounting and agency accounting. A business pays for projects out of its own funds, and replenishes these funds with revenues from the projects, so that the balance sheet reflects something real – a prediction about whether the business will be able to continue to operate. An agency does not incur the (non-operating) costs of its projects, and indeed does not usually obtain revenues to pay for those costs. As a result, the agency's NBA is not a prediction about whether the agency will be able to continue to operate. The agency will cease to operate only if political actors, provoked by a negative NBA, step in and shut it down.

The NBA, then, is at base an accounting mechanism, designed to enable elected officials to monitor agencies, just as accounting statements enable investors and creditors to monitor businesses. The NBA system would make agencies' regulatory performance easier to evaluate and compare than they are under the current system, where cost-benefit analyses are prepared for each major regulation but no aggregation across regulations occurs. If elected officials do not like what they see, they can (in theory) punish agencies by reducing their budgets, curtailing their jurisdiction, and subjecting them to greater oversight.

However, the NBA system can be used more ambitiously as a device for *altering the payoffs of agencies*. To do this, it needs an enforcement mechanism. One simple enforcement mechanism is a law that forbids agencies to issue regulations that would reduce their NBA below 0. The law might create a right of action, so that parties who oppose the regulation would be able to obtain an injunction from a court. That's the stick.

The carrot is the agency's right to use the surplus in its NBA (or a portion thereof) to "fund" regulations that are not cost-justified but are close to the agency's mission, or what I will call mission-sensitive. Currently, an agency that issues a regulation with a large net benefit obtains no greater reward than it receives when it issues a regulation with a small net benefit. It simply avoids in both cases whatever sanction is attached to violation of cost-benefit analysis, if any. The NBA system's reward is an increasing function of the net benefit of a regulation. An excellent regulation increases the NBA balance more than a marginal regulation. Thus, the agency that issues an excellent regulation will have the freedom in the future to issue a mission-sensitive but cost-unjustified regulation; the agency that issues marginal or negative net benefit regulations will not.

Of course, a highly mission-centered agency will take away what it gives. If it builds up a large surplus at time 1, it will draw it down at time 2 as it pursues mission-sensitive regulations, and the net social effect will be zero. We want agencies to produce greater social benefits than this.

Thus, we need one more element: we need to force the agency to "share" the surplus it generates with the public. The most direct way of doing this is to tax the agency's NBA. If an agency issues a regulation with net benefits of 100, let 40 go into the account. Even if the agency draws down the account, it still has produced 60 for society. Taxation could also take place informally, with Congress rewarding agencies periodically on the basis of their NBA performance. Congress can reward agencies by allowing them to retain a larger rather than smaller portion of their NBA balance.[15]

Let us look at an example. Compare a proposed regulation A that produces benefits of 100 and costs of 90, to a regulation B that produces benefits of 30 and costs of 10. Assuming as I have that the agency's preference causes it to focus on the magnitude of benefits and to discount costs, an agency constrained by resources will prefer A to B. Although under current executive orders, the agency is required to choose B rather than A, agency can potentially exploit its bargaining power and choose B rather than A.[16] The

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[15] This is roughly the same thing as what occurs when Congress punishes bad agencies by subjecting them to enhanced oversight, including hearings and so forth, and rewards good agencies by refraining from this harassment. Despite the fact that the agency would be permitted to retain some of the surplus, the potential gains are high, as illustrated by Tammy O. Tengs, et al, Five-Hundred Life-Saving Interventions and Their Cost-Effectiveness, 15 Risk Analysis 369 (1995).

[16] See Part __, above: again, the current problem is not that cost-benefit analysis produces wrong results (such as not being able to distinguish A and B); it is that it is hard to enforce because of the agency's superior information and bargaining power. As long as president prefers A to the status quo, he will find it difficult to interfere with the

NBA system would improve the agency's incentives. Assuming a tax rate of 50%, B would increase the NBA from, say, 0 to 10; A only from 0 to 5. With the higher NBA, the agency could subsequently issue a regulation Z that has benefits of 200 but costs of 206. The NBA generates net gains of 14 (regulations B and Z); the cost-benefit system generates net gains of 10 (regulation A alone).

As this example shows, the NBA improves on the status quo by enabling agencies to bank regulatory benefits and then use them to fund mission-sensitive regulations when the opportunity for them arises. The ability to bank is valuable because regulatory opportunities are not continuous. Just as a business maintains cash on hand or a line of credit so that it can seize business opportunities as they arise, so would a regulatory agency want to build up a surplus in its NBA so that it can seize regulatory opportunities as they arise.

It is possible that Congress would not have to tax NBA's or directly reward or punish agencies on the basis of their NBA's. Instead, an agency's NBA would become a politically salient measure of an agency's performance.[17] Agency heads who leave an agency with a high NBA would receive praise from the press and elected officials, just as the Fed chief does when the economy does well and inflation stays in control. Even if agency heads would not achieve such gains, and would prefer to deplete NBA accounts, agency staffs might resist efforts by agency heads to draw down the NBA in order to implement politically beneficial projects: staffs might become jealous guardians of the NBA as a measure of the quality of the agency. One could imagine agencies competing for the highest NBA, which would introduce an element of competition to the bureaucracy. In this way, the NBA could subtly change the agency's sense of mission, bringing the agency's regulatory preferences more closely in line with those of the public and elected officials, who place as much weight on cost as on benefit.

Some readers will make the following objection. Why should we ever permit agencies to issue a net negative benefit regulation, as might occur if an agency starts with an NBA balance greater than zero, or builds up a balance with net positive benefit regulations? Why not interfere whenever an agency proposes a socially costly regulation? To see the force of this objection, imagine that an agency starts out by issuing a highly beneficial regulation, which increases its balance from (say) $10 million to $110 million. In theory, the agency could follow up this success with a highly inefficient but ideologically or politically attractive regulation that produces net costs of $110 million. Much better, one might argue, would be to congratulate the agency for the first regulation and then prohibit the second.

The problem with this argument is that it assumes that elected officials already control agencies perfectly. The proper comparison is between the status quo – in which

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regulation, especially if the agency can make a plausible claim that A produces additional nonmonetizable benefits.

[17] This was one of the rationales for the regulatory budget. See Litan and Nordhaus, supra note __.

agencies report (frequently imperfect) cost-benefit analyses but do not comply with them consistently – and the NBA system. The failure of the existing system is due, in part, to the agency's superior information and bargaining power. Principal-agent theory teaches that in these circumstances some efficiency can be lost when agents have information advantages, and mechanisms designed to enhance performance will often do so by giving some of the "surplus" to the agent.[18] In business, monetary incentives are used to extract effort from agents: wages and benefits are made a function of output. In government, monetary incentives are constrained, and the NBA system – unlike the current system established by the cost-benefit executive orders – instead holds out a political or ideological incentive for good behavior. Under the current quasi-enforced cost-benefit system, agencies continue to have incentives to bias regulation in the direction of their own preferences; under the NBA system, agencies' ability to do this would be diminished though not eliminated, and would also be made more transparent to elected officials and the public. In other words, the NBA system would formalize what is currently a surreptitious, haphazard practice, legitimating mission-sensitive regulation but also improving agencies' incentives.

A final point is that the system gives agencies needed flexibility. If Congress believes that regulation of a particular industry will produce unusually large nonmonetizable benefits,[19] then it can give the relevant agency a large initial NBA account – say, 200 rather than 100. Or if Congress or the president trusts one agency more than the other – as will occur when the agency's mission is relatively closely aligned with current political preferences[20] – they can give that agency a larger account. Of particular value is that the NBA system gives Congress a means to control the amount of flexibility given to various agencies, by contrast to a "good reason" requirement for deviating from an ordinary cost-benefit analysis, and to track how frequently agencies take advantage of the flexibility given to them.[21]

To sum up, the NBA is mainly an accounting device, useful for keeping track of the costs and benefits of an agency's regulations in the aggregate.[22] But it can also be

[18] For an introductory discussion with citations, see Eric A. Posner, Agency Models in Law and Economics, in Chicago Lectures in Law and Economics (Eric A. Posner ed. 2000).

[19] In case after case, nonmonetizable benefits are invoked by the agency against critics. See, e.g., Cass R. Sunstein, Arsenic, Georgetown L.J. (forthcoming 2002).

[20] See Posner, supra note __, at 1176.

[21] Adler and I argue that such a requirement might be sensible way for mitigating some of the perverse effects of cost-benefit analysis. See Matthew D. Adler and Eric A. Posner, Implementing Cost-Benefit Analysis When Preferences Are Distorted, 29 J. Legal Stud. 1105 (2000). The Net Benefit Account might serve the same purpose, albeit in a more formal and reviewable way, similar to a discretionary fund.

[22] For this reason, the simplest non-enforced version could be administered by third parties, not the government, who already keep track of agency performance using "regulatory scorecards" and the like. See, e.g., Robert W. Hahn, Jason K. Burnett, Yee-Ho I. Chan, Elizabeth A. Mader, and Petrea R. Moyle, Empirical Analysis: Assessing

used to directly improve agencies' incentives. If political officials or courts can enforce positive balances, then agencies will be influenced by the costs as well as benefits of their regulations. Enforcement relies heavily on the political salience of NBA's, but experience with congressional budgetary rules suggests that political salience alone can do some good.[23] Indeed, congressional budget rules and NBA's reflect the same idea: that general public reactions against bad policy is best exploited by channeling it. If the public gets upset at bad outcomes (budget deficits, bad regulation), elected officials have an incentive to enter agreements intended to avoid these outcomes (budget rules, NBA's), agreements that can be designed to give officials more refined incentives (both rewards and punishments tied to performance) than those provided by the often inchoate and largely negative public response.

Some Complications

1. Actual Versus Estimated Costs and Benefits

I have assumed that an agency's NBA will be adjusted whenever the agency issues a final regulation. In addition, the account balance could be subsequently adjusted if the estimates turn out to be false. For example, an agency's audited *estimated* net benefits for regulation X are $20, but subsequent research shows that the *actual* net benefits were only $15. A hearing could validate the subsequent research and result in the subtraction of $5 from the account. Alternatively, the NBA could be left unadjusted when the regulation is issued and adjusted only as the costs and benefits of the regulation become clear, perhaps on an annual basis. So if the regulation produces net benefits of $5 the first year, the account balance would be increased accordingly at the end of the year; if the regulation then produces net benefits of -$10 the second year, the balance would be reduced; and so forth.

Research suggests that agencies often overestimate the costs of a regulation because they underestimate the ability of industry to develop new technologies.[24] Using actual rather than estimated costs would correct a bias against regulation, at least in the aggregate over time, though certain accounting adjustments would need to be made in order to avoid a prejudice against regulations that produce costs earlier than benefits.[25] It

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Regulatory Impact Analyses: The Failure Of Agencies To Comply With Executive Order 12,866, 23 Harv. J.L. & Pub. Pol'y 859 (2000). Still, official tracking of agency NBA's by a government agency such as the GAO would likely raise the political importance of these accounts.

[23] See Elizabeth Garrett, Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process, 65 U. Chi. L. Rev. 501 (1998).

[24] See Winston Harrington, Richard D. Morgenstern, and Peter Nelson, On the Accuracy of Regulatory Cost Estimates, Resources of the Future Discussion Paper (Jan. 1999), available online at http://www.rff.org/disc_papers/1999.htm.

[25] For example, an agency with an NBA of 0 would not be able to issue a regulation that has costs of 5 this year, and benefits of 10 next year; accounting devices could be used to overcome this problem.

would also allow agencies to take advantage of their built-up expertise, enabling agency officials to rely on intuitions rather than studies, with the reward or penalty arriving as data on the actual costs and benefits finally arrive. But in general, the NBA system would present accounting challenges similar to those presented by regulatory budgets, and the literature on regulatory budgets is a fruitful source of ideas for meeting these challenges, if indeed they can be met.[26]

2. Electoral Cycles and Turnover

A low NBA account prevents agencies from implementing regulations that are marginal from a cost-benefit perspective but close to the agency's sense of mission. This is what constrains agencies. But, as we mentioned above, if you endow an agency with a surplus in its NBA – say, 100 – at its inception, it might draw it down to 0 by the time that its political appointees leave office at the next election. Indeed, even if you do not, agency leaders will be tempted to draw down in their last years the surplus they generate through good regulation in their early years. It's not clear that this is a good thing; the agency will overregulate against the interest of its successors.

This problem is important but its magnitude should not be exaggerated. Law, tradition, and the ideological commitments of those who are drawn to work for the agency constrain the freedom of temporary political chiefs. The NBA system will work best if the NBA becomes a measure of the quality of the agency to the outside world. Then employees will resist the efforts of agency heads to draw down the NBA for political reasons, just as they already resist the efforts of agency heads to turn the agency from its traditional mission.

3. Alternative Instruments Like Regulation Through Adjudication

Another danger posed by NBA accounts is that agencies will substitute to alternative forms of regulation that cannot be so easily controlled. An agency might seek to regulate, not by issuing rules, but by litigating against firms and seeking internal adjudicative rulings or consent decrees from courts. Agencies might also issue nonbinding guidelines in the hope that courts would use them to set standards of care in private litigation.

These problems apply to the cost-benefit executive orders as well; they are not more severe for NBA accounts. In addition, agencies are constrained in various ways by the relative usefulness of alternative policy instruments. Finally, it might be possible to bring these alternative instruments into the NBA system, by, for example, providing that their net benefits (or costs) – determined by private or GAO studies – be added to (subtracted from) the agency's NBA. An ambitious but possibly unworkable form of the NBA system would account for all the costs and benefits flowing from an agency's actions – whatever policy instrument it uses – so that a running tally would be kept of the agency's effect on the economy.

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[26] See, e.g., Litan and Nordhaus, supra note __, at 144-47.

4. Net Benefit Accounts Versus External Cost Accounts (or Regulatory Budgets)

An alternative to the NBA would be to give agencies External Cost Accounts, which would set a limit on how much cost the agency can impose on society through its regulations, but would not be replenished from the benefits. Just such a proposal – under the rubric of "regulatory budget" – was made more than 20 years ago by Christopher Demuth, Robert Litan, William Nordhaus, and others.[27] Despite some initial excitement, it has had little influence.

One reason for its lack of influence is the difficulty of implementing the proper accounting procedures. If these difficulties are indeed insurmountable, then the NBA would be a bad idea as well. NBA's require all the information about costs that regulatory budgets require, plus information about benefits, which if anything is even harder to acquire than information about costs. Nonetheless, if cost-benefit analysis is a viable decision procedure – which is the premise of this paper – these problems are in principle surmountable.

NBA's are superior to regulatory budgets for two reasons. First, because regulatory budgets do not, as an accounting matter, incorporate the benefits of the regulation, they do not measure the social value of the regulation. The normative basis for imposing a regulatory budget is therefore obscure, as critics point out.[28] A regulatory budget prevents an agency from issuing a regulation whenever the regulation's costs would deplete the budget, regardless of whether the regulation's benefits exceed its costs.[29]

Second, regulatory budgets come with crude sanctioning mechanisms: a stick but no carrot, or not the right kind of carrot. Agencies would be prevented from regulating when a new regulation would break the regulatory budget.[30] That's the stick. But they are not benefited when they produce highly valuable regulations. Instead, the agency can benefit only by issuing a low-cost regulation. Consider the choice between regulation R, which produces benefits of 100 and costs of 80, and regulation S, which produces benefits of 60 and costs of 50. Although R is better than S, the regulatory budget encourages the agency to choose S over R, because S produces lower costs; the NBA encourages the agency to choose R over S, because R produces greater net benefits. The

[27] See supra note __.
[28] See Shapiro, supra note __, at 34.
[29] DeMuth says that benefits are taken into account ex ante when the regulatory budget is calculated, but he does not explain how this would work, or why it would be superior to accounting for benefits directly. DeMuth, Part II, supra note __, at 32-34. Indeed, his claim is puzzling because the reason he gives for rejecting the latter strategy – namely, the difficulty of calculating benefits – applies as well to the regulatory budget proposal.
[30] Litan and Nordhaus do not clearly explain how sanctioning would work, and do not in fact endorse such an extreme approach; see Litan and Nordhaus, supra note __, at 155-56.

problem with regulatory budgets is that they reward agencies only for minimizing regulatory costs when we want to reward agencies both for minimizing costs and for maximizing benefits.

Conclusion

NBA's will not appeal to critics of quantification,[31] but for those people who think that cost-benefit principles provide adequate guidance for agencies and are frustrated by agencies' resistance to this decision procedure, NBA's are worth consideration. They would generate better information about regulations than the current cost-benefit executive orders do; and they might make agency performance a more politically salient issue, providing elected officials with new mechanisms for disciplining agencies. Most important, if NBA's tie an agency's incentives to its performance – by rewarding agencies either with prestige or flexibility when they issue socially valuable regulations – they mitigate the moral hazard problem characteristic of principal-agent relationships..

NBA's do pose problems but they should not be exaggerated. The NBA system would require agencies to generate a great deal of information, but the cost-benefit executive orders already do that. What is new is how this information is used. Difficulties in choosing the appropriate accounting procedures, including those that would prevent gaming by agencies, would need to be addressed, and the literature on regulatory budgets suggests that this would not be an easy task. But accountants know that business accounting is also a very crude process, one that is vulnerable to gaming, as the Enron bankruptcy illustrates, but still quite useful for shedding light on the financial health of firms. Finally, it is not clear whether the NBA system's sanctioning devices would work. At the least, Congress would need to avoid meddling with NBA's except when there is a good reason. One might doubt whether Congress can be expected to do this, but there might be grounds for optimism in Congress' experience with its own budgetary procedures.

In the end, all I am arguing is that the accounting methods used to evaluate agency performance should be brought up to date, and put on par with the accounting methods used for businesses, with the hope that as better information becomes available, the political process will kick in and supply the needed discipline. The NBA system could be a first step in this complex process.

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[31] See Lisa Heinzerling, [this issue].