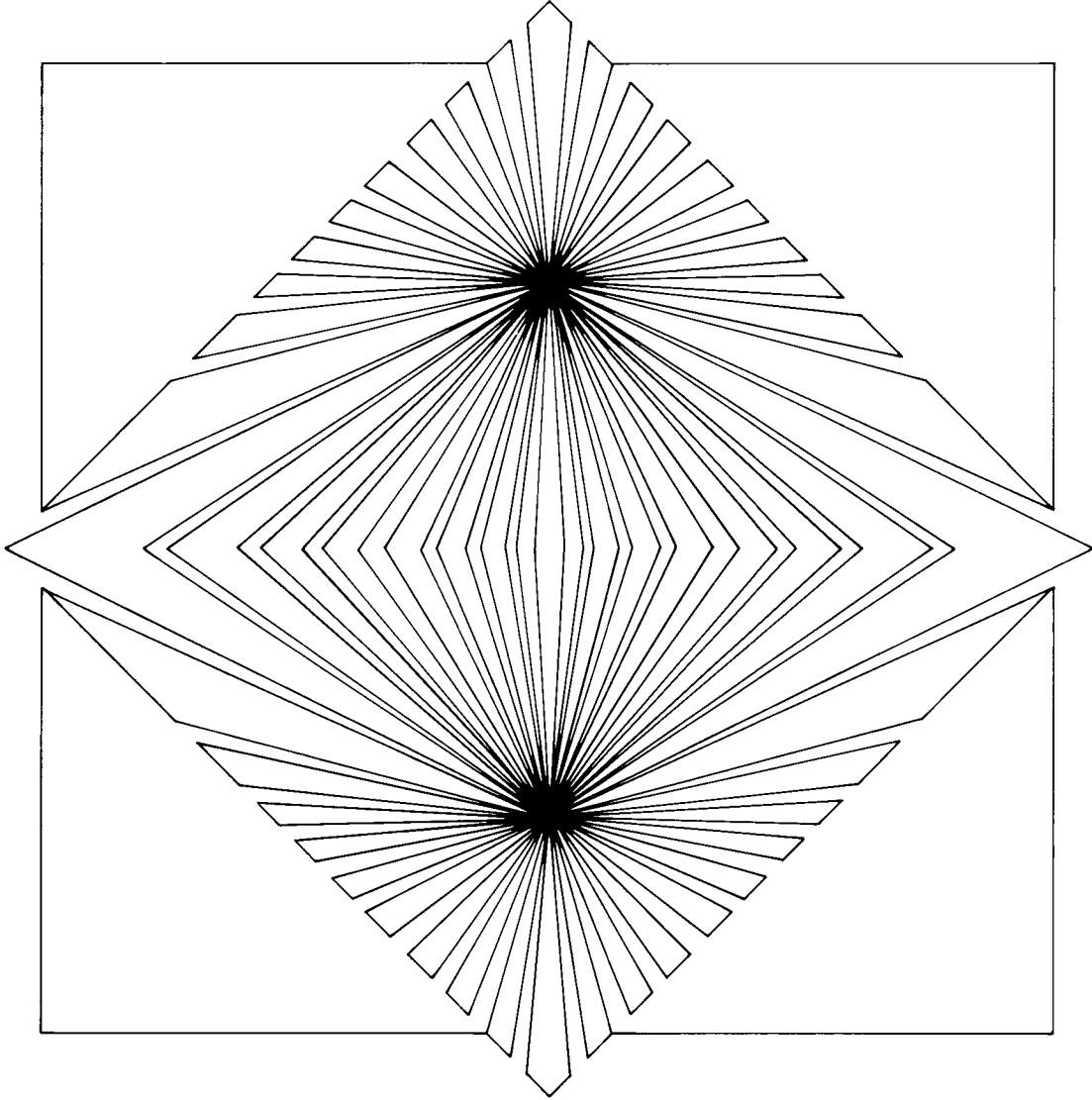


**Trends and
Perspective**

**Using the Wrong Tool:
The Pursuit of
Redistribution
Through Regulation**

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of the United States
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PREFACE

Using the Wrong Tool: The Pursuit of Redistribution Through Regulation was written in 1979 as part of a major study of regulation by the Chamber's Council on Trends and Perspective.

In this era of concern about high levels of taxation and government spending and the "out-of-control" federal budget, we need to be acutely aware that regulation may be used as a substitute for taxation and spending. Nearly every purpose for which government taxes and spends can alternatively be served by regulation. The question thus arises, if we manage to limit taxation and constrain government spending, will we simply get more regulation? If the political agenda in this country continues to be shaped by those bent on redistributing income and wealth, Richard Zeckhauser's paper suggests that the answer is yes. Professor Zeckhauser argues that redistribution through regulation should be resisted because it is less efficient than redistribution through the tax-and-transfer mechanism. It was not within the scope of his paper to deal with what many see as the larger question: To what degree should government be involved at all in redistributing income and wealth?

Other papers written as part of the Council on Trends and Perspective's study of regulation appear in Government Regulation of Business: It's Growth, Impact, and Future. That volume includes:

"The Impact of Regulation on the Performance of Industry," by
Paul W. MacAvoy and Dorothy M. Tella

"Competition and the Regulatory Boom," by Robert A. Leone

"Shifts in Business-Government Interaction," by Edwin T. Haefele

"On Measuring the Costs of Regulation," by Aaron J. Gellman,
Frank J. Berardino, and Fredrick G. Tiffany

"Deregulation: Accomplishments and Portents," by Allen R. Ferguson

(2)

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The traditional role of regulation in free market economies is to cope with market failures. Where there is market concentration, the government intervenes through price controls or other mechanisms to bring performance closer to the competitive ideal. When there are externalities, the government deals with them through taxes or standards. Traditional federal regulatory agencies such as the Interstate Commerce Commission (ICC) or the Civil Aeronautics Board (CAB) address market power issues, as have government's substantial efforts in the antitrust area. Regulatory agencies to deal with externalities are a more recent phenomenon. The single example in this area is the Environmental Protection Agency (EPA), which deals with the classic problem of environmental spillovers. No matter how successful or unsuccessful we may think these agencies have been in carrying out their missions, we can clearly identify the rationale for their creation: The unaided market was not thought to be able to yield a satisfactory allocation of resources.

This essay argues that, in contrast to the traditional kinds of regulatory activity, important new forms of regulation have had at their core a quite different set of concerns: They have been formulated primarily to promote redistributive goals. I shall develop my argument as follows. First, I will provide a few brief examples of what I mean by regulation that promotes redistributive goals. Second, I will explain why I believe this type of regulation is being pursued so vigorously at the present time; Third, I will assess the desirability of this form of regulation. Finally, I will speculate on likely future developments in redistribution through regulation.

The Central Hypothesis

The central hypothesis I wish to advance has two components: first, that regulation is increasingly being employed to promote distributional purposes, not economic efficiency. Second, the reasons why the tool of regulation, traditionally justified as a means of dealing with market failure, can be so adaptable to distributional purposes derive from the weakness of science as it relates to these matters.¹

Examples - The Potential for Redistribution Through Regulation

A variety of examples of ways in which regulatory activities offer potential for redistribution are offered throughout the analysis. The most significant relate to four classes of problems: allocating overhead costs in an industry where marginal cost may be below average cost; predicting experience for goods where the identity of the purchaser affects the cost of supply; predicting the adverse health consequences of exposure to various substances, and the control of rents. To give the flavor of my argument, let me suggest here a few issues surrounding these problems.

Allocating joint or overhead costs. In the highly controversial Massachusetts auto insurance decision for 1978, the allocation of company expenses -- which frequently totaled one-third of the premium dollars -- was a significant issue. A substantial portion of these expenses was not logically allocatable on either a per-policy or a per-dollar-of-claims basis. As a consequence, there was a substantial margin with which the regulator could play, and he chose to play with it rather vigorously. Expenses that could be clearly identified as on a per-dollar-of-premium basis, he ruled, should be allocated that way. All of the rest were to be divided on a per-policy basis. This had the clear effect of leveling insurance rates. Since most overhead costs cannot be clearly identified, this regulatory decision had a very significant distributional effect. That is, dividing costs on a per-dollar-of-premium basis unless they could be shown to relate per policy would have led to notably different rates.²

Prediction in cost allocation. There are some goods -- fire insurance, credit, health care, and education are outstanding examples -- whose cost of provision is affected by the individuals that consume them. The firms in a competitive market could therefore be expected to try to predict the cost of providing these goods to different members of the population. Then, in effect, there would be a different good for each individual; competition would result in providing it to him at the cheapest price.

In practice, of course, it is not possible to make a precise prediction of cost for each individual. Selling companies resort to statistical methods that make predictions on the basis of a number of observable variables. The essence of such methods is to minimize errors in prediction. It cannot, however, eliminate them. Some individuals will be classified in a high-cost category even though in actuality they are low-cost people.³ Naturally, there are complaints about the misclassification and the regulator, observing such errors, may require sellers to undertake corrective action. They may pay less attention to the fact that any corrective action implies other people will be overcharged elsewhere.

The whole prediction problem is severely complicated if the predicted event is one that occurs with relatively low probability, such as a fire or default. In these cases, there is rarely enough experience to demonstrate that an individual really is at high risk. This suggests that insurance companies may encounter more problems with regard to prediction than, say, a company that is trying to predict the cost of constructing buildings in different locations.

The alleged tyranny of partial prediction. Where predictions can only be made within wide confidence intervals, it is often alleged that they should not be used at all if they have noticeable distributional consequences. This argument, which is rarely stated explicitly, appears to mix arguments about equity to individuals, about the placement of groups of individuals with certain identifiable characteristics, and about the likelihood of abuse.

Consider first the use of a particular classifying variable, and let us assume that the variable in itself carries no emotional content. It could be geographic region, in the auto insurance context, or test score, if we were worrying about graduate school admissions. In assessing the use of such variables, people divide themselves into three categories. Some individuals, for reasons wholly external to the prediction process, would prefer never to use a particular variable, and are uninterested in the evidence supporting its predictive ability. I shall refer to them as principled objectors. Others wish to employ whatever variable will have predictive power.⁴ Presumably, a competitive free market would make use of every sliver of information that was available free and that had some predictive value.

The third group - let me call them the evaluators - wishes to look at the evidence before deciding which factors should be allowed to count and which should not. Among the pieces of evidence they might wish to consider would be the following:

- a. How much predictive power does the variable have?
- b. How much unexplained variability remains relative to the variance explained?
- c. Is a causal relationship readily discernible?
- d. Is the variable strongly correlated with other variables that have emotional content?
- e. Would use of this variable as a predictor tend to promote redistributive objectives?

I believe that most evaluators start with a prejudice against the use of any variable. They might ask: Unless there is a strong positive reason to do otherwise, is it not fairer, hence better, to charge all individuals the same price for a service such as auto insurance, or provide them the same access if they are applying to graduate school?

A potent reason not to allocate resources in this manner is the capacity to use classifying variables for predictive purposes. For example, if individuals living in region A have expected accident costs that are less than those of individuals living in region B, then it costs less to provide them with insurance. Thus, there are at least two reasons why they should be charged less: 1) Equity - in fairness, individuals should be charged the costs they impose; 2) Efficient allocation of resources - efficiency requires that individuals pay the expected costs that they impose on society.

However, the problem becomes more complex if predictions are poor. Consider sex as a classifying variable for auto insurance. Mileage, it is assumed, cannot be observed, hence cannot be the basis for rating individuals. Women drive many fewer miles on average than do men. This factor alone would make their competitively determined insurance rates much lower. But many men drive fewer miles than the average woman. Is it fair to have a man who drives 5,000 miles per year pay more than a woman who

drives 15,000? Note that the problem would not arise if mileage as well as sex were used as a predictive variable. However, there is no classification system that will not leave significant heterogeneity within classes.

Let me suggest another way of looking at the problem. If we eliminate sex as a classifying variable - assuming nothing is put in its place - we will now be charging low-mileage women the same as high-mileage men. This, too, seems unfair. In truth, there is no way to eliminate overcharges and undercharges. If we pursue instead the attainable goal of minimizing the total magnitude of overcharges, we will end up charging men and women different rates.⁵

Predicting adverse health consequences. Much of the increased regulation in recent years has been designed to protect individuals from adverse health effects. The efforts of the Occupational Safety and Health Administration (OSHA) and EPA are significant examples. There are costs, of course, associated with providing such protection. In any market situation or bargaining context such costs would be traded off against the level of protection provided, leading to such phenomenon as wage premiums for risk.

Regulatory activities certainly are not sold on a market, and although there is much bargaining associated with them, the role of the government frequently is to eliminate bargaining between contending parties. Thus, OSHA steps between the labor union and the producer; EPA avoids direct bargaining between polluters and recipients or environmental groups. There are many theories as to what happens to the welfare of the principals when a third party intervenes and establishes a regulatory standard. Depending on the circumstances, the party required to meet such a standard may bear the associated costs entirely, partially, or not at all.

However they are borne, as heated debate and extensive litigation make clear, parties feel quite differently about the level at which standards should be set. This in turn shows that they believe they receive benefits (or suffer losses) as standards are shifted. One might conclude that it was the role of the regulatory process, as directed by Congress and overseen by the regulatory agency, to strike an appropriate balance. One reasonable-sounding objective, for example, would be to attempt to minimize the sum of the costs of the damage plus the costs of avoiding the damage.⁶ Indeed, if damage could be readily assessed, this would probably be the criterion selected, though hardly without a vigorous societal debate.

OSHA has steadfastly maintained that it is not required to gauge the magnitude of a health risk in comparison to the costs of eliminating it. In formulating its benzene standard, it provided only a few pages discussing the health risks of benzene exposure and said nothing about the magnitude of the health benefits. OSHA explicitly states in its regulations that it is not required to compare benefits and costs when making a decision, and, in fact, is not even required to generate sufficient

information to make such a comparison feasible. The Fifth Circuit Court of the United States threw out OSHA's benzene standard on the basis that there was no demonstration that benefits were in any way commensurate with costs. (We cannot know what level of benefits would have satisfied the Circuit Court, since OSHA submitted no information on this issue.) OSHA appealed and the matter is before the Supreme Court of the United States.

The principle at stake here is not primarily whether the federal government can impose costs on one party to benefit another; that has already been answered in the affirmative.⁷ Rather, the question is whether, when undertaking such redistribution, the government should be guided by the magnitudes of both the benefits and costs it creates.

An Explanation of Redistribution through Regulation

Motivation

I believe there are two principal reasons for using regulation as a means to redistribute resources:

No government expenditure. In an inflationary era with significant instances of tax revolt, regulatory redistribution requires no government expenditure except to oversee the process. Rather than taxing and then spending, the government merely oversees the turnstiles as resources and benefits flow from one group of affected individuals to another. This suggests, of course, that the government's impact in this arena is far greater than the mere magnitude of government expenditures would indicate.

Emotional appeal. Redistribution through regulation accords with emotional proclivities. The feeling is widespread in society that the distribution of resources that is generated through normal market processes is not just. The principal instrument of redistribution within our society is the government. (Indeed, as the government assumes a larger role, private charities diminish. Thus, government action produces changes in conditions that make the action more justifiable.) Therefore, it would seem appropriate that the government should redistribute through all of its efforts.

I shall argue subsequently that many of these so-called redistributive efforts relate not at all, or at least not closely, to attempts to further goals of income redistribution. How, then, can redistribution be the justification? The answer is that the world is substantially more complicated than economists' simple normative models would predict. The object is not to assure our poorer brethren a greater share of resources, but rather to meet a mix of objectives in an objective function that is not only poorly defined but that shifts in shape from one decision-making arena to another. Simply put, society does not define its purposes and then set out to achieve them in the most efficient manner. Rather, it has many competing goals. Different ones are pursued with varying levels of fervor in different circumstances. While our sights are set on one goal, we rarely stop to consider what we are sacrificing in terms of our progress toward other valued goals.

Potential Meanings for Fairness, Equality and Equity

One social goal is to promote fairness, equality and equity in the consumption of particular goods. It is, of course, not clear what fairness, equality and equity mean. In different circumstances they take on different connotations. Some common interpretations are discussed below.

Equal price for the same service. This interpretation has been played out particularly in relation to such goods as mortgages or auto insurance. The costs of providing such goods depends on the degree to which services are utilized and may differ dramatically among individuals. Some believe this is not fair. A person who happens to live in an urban neighborhood that has a high rate of vandalism and/or arson should not be charged more for these circumstances, over which he has no control.

Charging when individuals impose costs on the rest of society. The question as to whether individuals should be asked to bear the costs they impose on society is not as straightforward as it may appear. I believe our sense of the fairness of this approach will depend on the degree to which the pertinent circumstances are under an individual's control.

A health insurance example will make the point. Whether such insurance is provided publicly or privately, an individual who engages in bad habits such as smoking or drinking to excess drives up the rates for the rest of us. It has often been argued that we should charge such individuals for their imprudent behavior. Such charging will have twin advantages: First, it might seem to some to restore equity. If smokers are charged more (for their behavior that becomes antisocial once we all share in the costs of their illness), then they will not be receiving a subsidy from the rest of society. Second, charging for smoking provides appropriate incentives for individuals to stop. In effect, we do what economists call internalizing the externality. (There are other ways to accomplish this, of course. We could merely increase the tax on cigarette packages.)

Before we dash off to embrace this argument, we might wish to delve a little deeper. How would we feel if, when we began charging smokers for their externality, we discovered that virtually none of them stopped, i. e., that there was only a tiny incentive effect? Moreover, to continue in this hypothetical vein, what if many of them told us that they were so dependent upon smoking that they would not give it up at any reasonable price? This might seem surprising to many nonsmokers. Surely, they think, no one would pay \$3 a day just to be able to smoke. This seems quite clear, since they know that they would not pay anything approximating that price.

But perhaps there is another explanation. Perhaps we do not start from equal circumstances. How would our feelings about this issue change, for example, if we discovered that there was, in fact, a certain gene that gave an individual a strong predisposition towards smoking? Let us say that 30% of the population had this gene and that 98% of them chose to smoke. Might that not affect our attitude as to what is and what is not controllable behavior? I do not wish to suggest that such a gene will ever be found. My point is simply that people who would think it immoral to impose heavy charges on people who have the great disadvantage to suffer from some genetic defect may be quick to assume that some forms of behavior are under voluntary control.

Equal provision of service. Some observers feel that, for certain goods, assuring equal prices to all members of society is not enough. Equal price is likely to mean that, on average, poor people will purchase less of the good than will wealthy individuals. For these goods, then, the meaningful interpretation of "equality" may be equal provision.

In most advanced societies, and increasingly in the United States, it is argued that all individuals should have equal access to medical facilities, and that such access should not in any way be hindered through price. As a result, in many jurisdictions, more is spent on Medicaid than on welfare. There can be no doubt that many individuals, especially among the poor, would choose to cash out some (perhaps substantial) proportions of their health care benefits, if given that option. But that would defeat a major purpose of the system, which is to achieve equality of result.

This argument has also arisen in relation to proposals that we employ education vouchers to promote competition at the elementary and secondary level. Each voucher would be worth a certain amount, say \$2,000. A debate now ensues: Should we allow schools to spend more than this amount, with the difference to be made up by parents' contributions? A variety of arguments have been raised against allowing such supplementation, often by those who believe strongly that the voucher system would promote valuable competition. The core of these arguments is that the rich could buy their way into better schools and that equality of result would thus not be achieved.

Use of fair criteria in pricing. Many of our concepts of fairness are derived from consideration of unfair practices. Thus, for example, we believe it unfair for individuals to charge blacks more for a commodity simply because they are black, or to give women less than equal chances of securing a position simply because of their sex.

We extrapolate from these lessons in a number of ways, not all of them logically defensible. First, we may try to eliminate reliance on subjective criteria, for they are always subject to biased interpretation, say because of some characteristic such as race or sex. Thus, we may force loan officers to make decisions on the basis of objective criteria and observable numbers, rather than whether a businessman seems to have a well worked-out plan. This may even be done if experience proves that subjective judgment is superior to objective criteria as a predictor.

Second, we frequently eliminate criteria that appear to favor one group or another. Thus, for example, objections to many forms of testing for admission to academic programs or for jobs relate to the fact that certain groups do less well on these tests than do others. There are numerous ways to address this problem. We might merely say that unless the test can be shown to underpredict performance for these groups, it should be allowed to stand. (If it is underpredicted, then the selectors should be happy to make the appropriate corrections, once informed. No

further regulation would be needed to avoid this bias.) We could compensate for performance on the test in much the way that veteran's preference is frequently employed to give veterans an advantage. Finally, we could rule that the test was unfair, and eliminate it as a criterion for selection. This issue was discussed more fully in the earlier section entitled, "The Alleged Tyranny of Partial Prediction."

A possibly related phenomenon, which I mention only to indicate that I did not mistakenly overlook it, relates to affirmative action programs and means for assessing their performance. Here it is the achievements and/or opportunities of some group, not an individual, that must be equal by some standard.

Adequate provision of service. For some goods, while we do not insist on equal provision, we may wish to impose some sort of minimum standard; housing is a notable example. By imposing such a floor, society runs the risk of misallocating resources spent on behalf of some individuals. But it is felt that housing is a merit good, one so important for well-being that an adequate supply should be provided independent of what the consumer would purchase himself were the resources his to spend. Therefore, we may regulate an individual's expenditures and/or the society's expenditures on his behalf to achieve the appropriate minimum level. In many instances, such expenditures are made by a collectivity, say through a public housing program. However, in other instances it may be the individual's landlord who is forced to bring the housing up to some standard. Clearly, then, there may be situations in which the tenant is not willing or able to pay for the service associated with meeting the standard. Several outcomes are possible: The tenant may be replaced; if rent control is in effect, the landlord will earn less than a normal return on his asset; or, if the maximum amount the tenant will pay is less than operating costs, the housing will be abandoned.

Motivations of Regulators and Powers of Interest Groups

I shall just mention two additional interrelated explanations for the use of regulation as a redistributive device. First, regulators have their own interests and careers at stake. Some may be trying to cater to particular interest groups when undertaking regulatory actions; they may feel that their charge stretches well beyond the classic economic mandate to reproduce as closely as possible the pattern of resource allocation that would have been obtained in a competitive market.

The interest group theory of regulation views the entire regulatory process as a forum in which well-organized and concentrated interests can exert pressure to achieve outcomes that benefit them to the detriment of the diffuse general public.⁸

Although the private interests of regulators and special groups may partially explain particular regulatory phenomenon, the pervasiveness

of the trend toward redistribution through regulation owes more to the facts that 1) certain societal values appear to be served through the process, and 2) the public has no firm understanding of the likely consequences of such regulation. It is to the second subject that I now turn.

The Conceptual Argument Against Redistribution Through Regulation

There are many ways society can pursue redistributive goals. Regulation is one; government expenditure programs are another; the tax and welfare system is a third. Is there a conceptual basis for the argument that we should not redistribute through regulation, or are we limited to making the observation that it has worked out poorly in practice?

Efficiency of Regulation Compared with Taxes and Transfers

There is a fundamental conceptual argument against any form of redistribution not conducted through the tax and welfare system. However, we must realize that any mode of redistribution carries costs and, recognizing this, we might conclude that we should, therefore, seek to redistribute resources in whatever way it can be done most efficiently.

Using the regulatory system as a redistributive tool does not minimize the net cost to society. If, for example, we sell electricity to some people at lifeline rates which are below marginal cost, there is an efficiency loss because of the divergence between valuation, the price paid, and cost of production. It could be argued that the tax system suffers an inefficiency because it creates incentives for individuals to work less; however, this criticism applies equally to regulation. If we have a regulatory program that redistributes - say by charging poor people a below-market price for a service such as housing - then this, too, will create incentive effects. An individual will know that as his income rises he will either receive a reduced subsidy, or perhaps become ineligible for the housing altogether. Whatever level of redistribution is desired, assuming equal administrative costs, it is more efficiently carried out through the tax and income support system than through the regulatory system.

Equity

In this essay I have generally concentrated on the issue of whether redistributing resources through the regulatory process is efficient. But is it fair? I think there are at least three respects in which it might be judged unfair, by which I mean not in accord with the values held by most members of society. They are: poor target efficiency, removal of redistributive decisions from scrutiny, and raising resources on an inequitable basis.

Poor target efficiency. Income-support systems, whatever their merits and deficiencies, are designed to help people whose needs are significant and who society or its legislative representatives decide

merit assistance. This cannot be said of a vast realm of programs that redistribute through the regulatory system. In many instances, even those who propose the regulation do not know who will benefit and to what extent. The control of gasoline prices, for example, is unlikely to help the very poor, who are less likely to own automobiles. It offers significant assistance to the family with three cars, whose members live in suburban splendor and commute long miles to their jobs and recreations. Such people are not likely to be poor. I do not wish to argue whether rich suburbanites receive too many benefits in our society; I merely observe that whatever groups we are trying to serve, the distributive effects of regulation are likely to serve them rather haphazardly at best.

Removal of decisions from public scrutiny. Though public hearings accompany many regulatory proceedings, only a handful of the affected public are likely to participate in them. When a regulatory agency is determining at what level some environmental air standard should be set, or what method of depreciation is appropriate for a utility, or how overhead costs should be allocated among the policyholders of an insurance company, it is considering issues that are not only outside the legislative limelight, but beyond many citizens' ability to understand. Yet, the allocation of overhead expenses in auto insurance - as the Massachusetts experience illustrated - can make more of a difference to the average policyholder than a 5% surcharge on his income taxes. The latter is an issue he can understand, and his legislator can speak up for him.

Resources raised on an inequitable basis. The expenditures involved in regulation are not dealt with in the appropriations process, which is one of the most accessible portions of legislative proceedings. This shielding from public view is particularly unfortunate, since the costs of a regulation that provides redistributive benefits are likely to be borne on a very uneven basis. Let us assume that we impose rent control on a community. This will obviously work to the disadvantage of individuals who hold real estate within the community. Some landlords will be rich corporations - whose stockholders, however, may be substantially poorer. Others will be downtrodden widows whose only means of support are the few apartments they inherited from their husbands. The rich lawyer in the community who may have invested in cattle and oil will not be affected at all. The issue is not whether cattle prices should have been controlled so that the lawyer might have borne his fair share, but rather that the burdens are distributed almost randomly. Whatever criteria of equity one might have, whether based on income, needs, or longevity, they are unlikely to be met by the redistributive arrangement, and in particular by the way the costs of supporting it are distributed.

Haphazard as equity may be among the individuals affected by rent control in the community, it is likely to be even more so among those who live outside. The family that might like to move to the community, and would be willing to pay a fair premium to do so, will find housing unavailable. Assessed valuations for rental housing will diminish in the community. If the state has any taxation equalization provisions, the community can effectively tax other communities within the state by imposing rent control on itself.

Redistribution through regulation generally involves people within a particular field, and leaves others mostly unaffected. The involved parties may be the individuals who purchase the product - in insurance, the rural drivers subsidize the urban drivers - or they could be the buyers and sellers of a product, as for example, with rental housing. Equity, it would seem, would be better served if these redistributive decisions were made out in the open. Even if we felt it essential to subsidize, let us say, urban drivers, would it not be more equitable to have the legislature make an appropriation to that purpose? That way we could be sure that costs were imposed in a manner that had been carefully determined to accord well with the canons of equity.

Lack of Efficiency Within Regulatory Arena

Assume that we are in a situation where a considerable amount of redistribution will be carried out through the regulatory system. Can we nevertheless hope to see a fairly efficient pattern? Here, too, I must paint a negative picture.

Lack of representation. Not all interested parties are likely to be actively represented at the time decisions are made. In particular, the diffuse and unorganized public will not be present.¹⁰ Our failure to adopt the use of effluent charges - which would require firms to pay a certain amount for each unit of pollution they discharge - is a case in point. Effluent charges, as widely revered by economists as they are rarely employed, offer numerous efficiency advantages over standards, our more traditional approach to environmental problems. (The firms that find it cheapest to clean up will do so; moreover, there will be an incentive to develop new technologies that reduce pollution.) But there is another significant advantage to the use of effluent charges, one which usually goes unnoticed. In contrast to standards, effluent charges do not allow firms to produce any initial amount of pollution without costs. The funds raised through effluent charges would be one of the few existing nondistorting sources of government revenue. However, it is hardly worthwhile for either environmentalists or industries subject to environmental standards to focus on this benefit. And the major beneficiaries, the general taxpayers, are hardly represented on this issue; much less are they fully informed on what it is all about.

Tradeoffs across issues are difficult. At any point in time, interest groups are not organized to make tradeoffs between gains in one area and losses in another. I believe this point is most dramatically illustrated by the vast array of regulatory programs that deal with risks to human beings. Most analysts, though by no means all, believe that nuclear power is much safer than its primary, presently available alternatives, such as coal.¹¹ This argument is unlikely to change the views of anti-nuclear activists, however. It is even less likely that people would welcome a nuclear plant (or for that matter a coal plant) to their community on the grounds that whatever risk they incur, some other community elsewhere is

securing an even greater reduction in risk.¹² People are attached to particular communities and particular issues. Though they may welcome gains to others outside their movement, they will not substitute these for gains to themselves. Quite simply, we do not have markets in which one can trade gains and losses from regulatory impositions.

Tradeoffs across time are infeasible. It is almost impossible to make and enforce tradeoffs across time. On virtually every piece of environmental legislation that arises, for example, there is a bitter debate between environmentalists and representatives of industry. Some logrolling across issues could provide improved results for all. But this is not possible. First, the characters change over time. In 1979, the major issue may involve the lead industry and one particular environmental group; in 1982, the chemical industry will be fighting another environmental organization. Since the participants change, any form of tradeoff over time is almost impossible. And since so few tradeoffs have been made traditional institutions of trust have not been established. Neither party to the debate would feel able to make a concession on a current issue in the confident expectation that comparable concessions would be made by the other side in the future.

The Future

Will this vogue for redistributing through the regulatory process pass away?

I see no powerful new forces on the horizon that are likely to bring about a swift reversal in the trend. Progress is likely to come in one of two ways, if at all. First, the tendency to redistribute through the regulatory process could be swept away through powerful societal forces. The deregulation movement might seem to be the most promising portent. Second, and I believe substantially more important, society could begin to perceive the important implications of redistribution through regulations, such as the costs it imposes and its contribution to overall growth of the government.

Potential of the Deregulation Movement to Curtail Redistribution Through Regulation

To date, the deregulation movement has had little effect on the trend towards increasing redistributive activity through regulation. Might this pattern reverse in the future? In particular, might efforts to curtail ineffective redistributive regulation be reinforced by a broader-based movement towards deregulation?

I believe the answer to be no, unfortunately, as a look to the conditions that seem to be required for deregulation will reveal. Experience suggests that substantial progress in deregulation is likely only if there are substantial direct efficiency benefits coupled with significant direct distributional benefits.¹³ If the direct distributional benefits were negative, as they would be if we were curtailing the type of program discussed in this paper, deregulation is likely to be exceedingly difficult to achieve. Indeed, a primary argument used against almost any deregulatory effort is that some people will be hurt. If those people are poor, or in some other way deserving, the argument is likely to be particularly telling.

There was a second argument lurking in the background relating to equity and help for the less privileged within society. Setting the price of a regulated commodity artificially high conjures up service competition. With airlines, such competition took the form of high-quality meals, inflight movies and, most significantly, frequency of service. As we move towards a more competitive mode, we can expect both price and quality to drop. This may be good for poor people, who on the whole would prefer lower quality and price, but bad for rich people.

A somewhat different set of forces is at work in rent control, but the lesson appears to be the same. Rent control provides a clear short-run benefit to the tenants in the controlled apartments. (This leaves aside the question of whether rents are jacked up in anticipation of such control.)

When, then, can we expect to see removal of rent control? Rarely, according to the argument above, so long as the tenants can be seen to be continuing to benefit from the program. Only in the long run, when the effects on housing availability and quality have become so severe that even tenants suffer significantly on average, can we be confident that rent control will be struck from the books.

Recognizing the Consequences of Redistribution Through Regulation

The best way to address the redistribution through regulation problem is head on. First, we must make sure that government officials and the general public recognize the problem. We must then attempt to marshal the conceptual arguments against it. Next, we must explain to the supposed beneficiaries why such programs are not truly in their interest. As I suggest below, each of these tasks is easier to state than to accomplish.

Perceiving the present trend. The first task is to demonstrate not only the widespread and growing use of regulation as a redistributive device, but also its consequences. This is quite different from mounting the more traditional attack on regulatory intrusions, which usually focuses on the ham-handedness or excessive costs of particular interventions. The major argument against redistribution through regulation is that the tool is being used in a manner contrary to the market-correcting purposes for which it was originally intended, and which are invariably used to justify the intervention.

Mounting the conceptual arguments. Even if cogently expressed, the conceptual arguments against redistribution by regulation may not be readily accepted. Many people simply do not believe in negative incentive effects or that regulatory costs will influence actions.¹⁴ (Perhaps a few dramatic examples, such as the Chrysler situation, will change thinking in America on these issues.) Moreover, it is difficult to demonstrate that there are feedback effects from one form of redistributive program to another. Perhaps this is because the feedback loops are indirect. But when business investment falls precipitously, and productivity fails to advance, as is happening in the United States, these feedbacks certainly will be felt. Since those directly interested in business prosperity, namely the business sector, are likely to play the most active role when taxation decisions are made, we are likely to find ourselves with all manner of tax incentives to hire more people or invest more money. The end result, ironically, will be that the most efficient mechanism for redistributing resources - the tax system - is actually used to attack the problem we have created by trying to redistribute in the wrong way - through regulation.

Costs to the poor. However inefficient redistribution through regulation might be, a government official might counter by saying: I chose to redistribute here, because it was the one arena in which I could

have some impact.¹⁵ Clearly this argument makes sense for the regulator who wishes to accomplish something personally for the poor, or for whatever group he wishes to help. (Many redistributive regulations, for example, are designed to help small businessmen. Here the redistribution is prompted by a belief in the virtues of small business rather than a desire to help the small businessman per se.)

Let us concentrate for a moment on appropriate motivations on the part of the poor themselves. It could readily be argued that by knocking on every door - i.e., going to every regulatory agency - they will receive a little handout from each and will receive more on net.

The counterargument springs from what I choose to call the "Iron Law of Redistribution," which states: The non-poor are willing to spend only a certain amount of resources to assist the poor. Since it is the non-poor majority who control the political process, whatever the poor secure in one area, say, through the regulation of loan policies, they will be giving up in another, say income-support policy. If the Iron Law of Redistribution holds, then it is in the interest of the poor to have resources redistributed in the most efficient way possible. This would suggest that the poor themselves should oppose redistribution through regulation.

However, even if the Iron Law held and redistribution through regulation was clearly undesirable, this does not imply that it would not be pursued. The poor, after all, are far from a monolithic group. Certain component groups may find it in their personal interest to pursue a type of redistribution activity even though the net result might be that the poor on average would lose. Thus, for example, on a town-by-town basis poor residents might seek to impose rent control even though this would limit the mobility of other poor people into the town, perhaps in pursuit of a job. Poor people might favor rent control for their own community even if they knew that benefits would be more than offset, statewide, by reductions in the income-support program.

The Iron Law of Redistribution is overstated, of course. Benefits secured in one arena are unlikely to be fully offset by benefits lost in another. The more appropriate metal for our metaphor might be tin. The Tin Law of Redistribution states: The additional expenditures that the poor impose on the non-poor in one arena will be compensated or offset to some extent by lost expenditures in other arenas. Consider a situation of partial offset. In deciding whether to seek additional benefits in a particular arena, a representative of the poor would assess whether the offset factor (ratio of expenditure lost elsewhere per dollar of expenditure incurred here) was sufficiently small to justify the greater transfer inefficiency of this area relative to others. Thus, for example, let us assume that a dollar of expenditure by the non-poor offers \$.50 worth of benefit to the poor in Area A and offers \$.90 in area B. Then pushing for an additional dollar of expenditure by the non-poor in Area A would only be worthwhile if the offset factor were less than $\$.50/\$.90$, less than .55.

A number of factors could affect the magnitude of this offset factor, though it is not clear which way each would push. Increased redistributive efficiency, for instance, will have two competing effects. First, the non-poor will be happy because they are accomplishing more per dollar expended. Second, the poor will become better off, making it less urgent to assist them. These two competing factors suggest that the net expenditures the non-poor will make for redistribution may first increase and then decrease as efficiency rises.

Should We Fail - Pyramiding Intervention

If my gloomy prognosis proves correct - that is, if there is overall growth of redistribution through regulation - what secondary effects might we observe? We would see more regulation, the result of a process I call pyramiding intervention.

Much redistributive regulation takes the form of price control. Once such control is imposed, we lose the virtues of price not only as an incentive to induce correct behavior, but as a signal of real resource costs. We must now regulate because people will neither know what to do nor have appropriate incentives to do so.

In the rent control case, this means that we must impose building codes to keep landlords from responding in the natural way to the fact that they are receiving less than a fair market return - that is, by letting housing quality deteriorate. Let us assume that building codes are effectively enforced along with rent control. Then we will find that buildings are worth considerably less as rental stock than as condominiums. If we do not wish to end up hurting the very people we started out to try to help, we must then prevent individuals from converting to condominiums. If people refuse to build new rental housing, knowing full well that some day it will be placed under rent control, we must then subsidize housing construction. And the process of intervention continues.

CONCLUSION

The pervasive growth in regulatory activity intended to achieve distributional purposes is the natural result of a number of forces within society. However natural this development, I would argue it is an undesirable one. Unfortunately, the conceptual arguments against redistribution through regulation are often subtle, for they rely to a significant extent on incentive effects and indirect consequences. That is, as the regulatory instrument is applied to the world in an effort to accomplish redistributional purposes, the world changes around it in a manner that is invariably harmful to efficiency and often detrimental to equity.

Redistribution through regulation aggravates a major error of government, namely redistributing through the redirection of resources (expenditure programs and regulation) rather than through the tax and income support system. Moreover it invariably entails further government intervention as suppressed market forces attempt to reach equilibrium (controlling the price of oil makes it attractive to put mileage standards on cars). Regulatory redistribution provides substantially less benefit to the poorer members of society than would be available through less inefficient mechanisms, and makes it politically desirable for particular groups to prevent the rationalization of interventions that are undertaken.

FOOTNOTES

¹ The so-called Chicago School of regulatory theory suggests that regulation is employed in general to transfer income to well-organized groups. These groups give political support in return. See George Stigler, "The Theory of Economic Regulation," Bell Journal of Economics and Management Science, Vol. 3, 1971.

² See James Stone, Opinions, Findings and Order Regarding Massachusetts Automobile Insurance Rates for 1978; December, 1977, Boston, Massachusetts.

³ Errors of prediction should be distinguished from bias in prediction, which would suggest that the mean for a category was too high or too low.

⁴ It is important to distinguish between predictive power in an observational context and predictive power once a variable is used as a basis for policy. If the variable is subject to influence, and if the policy is important to people's lives, its predictive power will change once it is employed. The change may go in either direction. If red cars are an indication of bad drivers, and auto insurance is expensive, there will be few red cars once this criterion is used to establish insurance rates. By contrast, suppose satisfactory completion of a particular course of study with limited enrollment mildly predicts job success. Once completion of the course is made a basis for promotion, assuming that entry is competitive, its predictive value may increase.

⁵ For the record, the changes made in insurance rate-setting in the 1978 Massachusetts decision were to eliminate the use of sex and age as classifying variables (though driving experience was permitted) and to find other means of reducing the spread in rates previously charged different groups, e.g., different geographic regions, and drivers with two or more high-risk characteristics. Also, significantly, a return to the competitive rate-making experiment was not permitted.

⁶ There is an elaborate literature associated with the Coase theorem, which suggests that in free bargaining situations, no matter who is given property rights, the allocation of resources will minimize this sum. Talented people devote many of their talented hours to describing circumstances in which this theorem will and will not apply. It clearly does not apply, I would argue, once regulators step into the game. The divergence from the Coase result should be greatest when consequences are difficult to predict. See R. H. Coase, "The Problem of Social Cost," Journal of Law and Economics, Vol. 3, October, 1960, pp. 1 - 44, for the classic article. A good review of issues is in "Coase Theorem Symposium," Natural Resource Journal, Vol. 13(4), October, 1973, pp. 557 - 716 and Vol. 14(1), January, 1974, pp. 1 - 86.

⁷ I do not investigate whether workers ultimately end up paying some or all of these costs, a matter that is itself subject to considerable debate.

⁸ See the article by Stigler cited in footnote 1.

⁹ This argument is advanced rigorously in Aanund Hylland and Richard Zeckhauser, "Distributional Objectives Should Affect Taxes but not Program Choice or Design," Scandinavian Journal of Economics, June, 1979. Obviously, a number of additional assumptions are required to make this argument rigorous.

¹⁰ The Chicago School theory of regulation makes this exclusion a central phenomenon within the regulatory process.

¹¹ In this discussion I am not investigating the question whether expected lives lost is the appropriate criterion for choosing between energy sources. In general, I would argue that it is not. If energy producers are well-informed, and demand wage premiums as a consequence, the price of the energy source already reflects risks to them. To the extent that consumers or noninvolved parties are at risk, the costs to them must be added to the market costs of the resources to get a fair accounting.

¹² Proposals are occasionally made that communities should bid (quite possibly negatively) for facilities generating negative externalities. The "price system" would then reflect these costs, and no community would be imposed upon.

¹³ In emphasizing direct effects, I imply that indirect benefits that come about through offset factors are unlikely to play a major role in the political process. (See the section entitled "Costs to the poor" for a discussion of offset factors.)

¹⁴ The effectiveness of positive incentives, say a tax break for those who install storm windows in their houses, is readily accepted.

¹⁵ In personal conversation, former Governor Michael Dukakis of Massachusetts expressed just such thoughts in explaining why he was so eager to see reductions in urban auto insurance rates as part of the 1978 decision. This was an area where he could exert some control, and dramatically higher rates for the city - whatever their justification - seemed at strong variance with his urban policy.

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