THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

September 29, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze CLS

SUBJECT: Warren-Speth Memo on "Inflation and Environmental and Health Regulations"

Charles Warren and Gus Speth's memo to you of September 18 was not sent to CEA for comment prior to its submission to you. The memo reflects the views of the CEQ members with respect to the Administration's regulatory reform efforts. However, it contains factual statements about the impact of regulation and the political consequences of our regulatory reform efforts that are, in my view, misleading. In light of your comment, "I agree," on the memo, I felt it important to bring to your attention my concerns with this memo.

The Economic Impact of Regulations

The CEQ memo cites the results of a study, by Chase Econometrics, Inc., of the impact of environmental regulations on inflation. The study estimated that environmental regulations will increase the average annual rate of inflation by .35 percent for the period 1970 to 1983. On the basis of this evidence, CEQ concluded that environmental regulations "do not contribute substantially to inflation." I have three comments.

First, an impact even of the magnitude cited in the CEQ memo is not insubstantial in my view. However, the study to which CEQ refers actually found a greater impact from environmental regulations in the latter part of the period. Chase estimated that between 1976 and 1983 environmental regulations would raise the average annual inflation rate by .44 percentage point.

Second, the Chase study assumed a recession in 1978 during which unemployment reached 10 percent. Such an outcome is unlikely, in my view. Without a recession of the magnitude assumed, the cost increases due to regulation would have been more fully reflected in higher prices. In the absence of a recession, the Chase study showed that environmental regulations would raise the average annual inflation rate by .53 percentage point from 1976 to 1983.

Third, the CEQ memo and the Chase study refer only to the economic effects of environmental regulations. The economic impact of other forms of Federal regulations, including regulations issued by OSHA, HEW, FDA, USDA, and other agencies also is substantial. Although studies of the economic impact of regulations are far from perfect, they do indicate that the total costs of regulation are very large. For example:

-- The economic costs of regulations are directly reflected in reduced labor productivity. The rate of growth of productivity has virtually collapsed - from about 3 percent annually in the 1950s and 1960s to about 1-1/2 percent in this decade. It would be a gross exaggeration to state that regulation has been the sole cause of this slowdown, but academic studies conclude that regulation is a major factor. Edward Denison of Brookings has estimated that anti-pollution and workplace health and safety regulations alone reduced the rate of productivity increase by about 0.4 percentage point in 1975 and that the impact of these regulations on productivity has been growing steadily throughout the 1970s. The Chase study of the 1976 and 1983 period found that the level of productivity in 1983 would be 2.2 percent below the level in the absence of environmental regulations. The decline in productivity growth contributes significantly to economic problems such as inflation and the slow growth of real incomes, the weakness of the dollar, and perhaps to the general malaise among consumers.

- The impact of regulations on individual industries can be dramatic. Mine safety regulations, for example, are cited as the primary cause of a decline in labor productivity since 1969 of 40 percent in underground coal mining and 28 percent in surface mining. Similarly, EPA estimates that its own regulations have raised costs by 12 percent in the copper industry, which today faces considerable import competition. Chase Econometrics also estimates that automobile prices between now and 1985 will rise $750 per car due to new safety, emission, and fuel-economy standards, and that prices will rise a further 1 percentage point per year to accommodate the cost of new light-weight metals.

-- Current regulatory procedures often leave firms highly uncertain about the future requirements. Moreover, many licensing requirements substantially lengthen planning and construction periods and require firms to plan beyond the period for which reasonable forecasts of capacity needs can be made. Thus, new investments are discouraged, and our productivity problems made worse.

I recognize that the nation gets very important benefits from environmental and other regulations that are not counted in the standard measures of GNP and productivity. But so also do Federal health, welfare, and other budget programs provide benefits that are not fully measured in the GNP. Yet no one would suggest:

- that the size and timing of those programs should be immune from review by the Executive Office of the President;
- or that we should not make every effort to secure the benefits at the least possible cost to the nation.

I do not conceive of regulatory reform as a device to halt progress toward environmental, health and safety objectives. But I do believe that major proposals of the regulatory agencies, even in these sensitive areas, should be subject to analysis and review.

Political Aspects of Regulatory Reform

The CEQ memo raises the prospect of enormous political cost to the Administration from active pursuit of your regulatory reform objectives. In particular, it cites criticism that the Regulatory Analysis Program is "undermining your support with many of those who have been your strongest supporters," i.e., those in the environment movement. There is no question that efforts to reform the regulatory process will entail heated political debate. Environmental and labor groups are dedicated to the objectives of the Government's regulatory program and view with suspicion any effort to introduce into the process concerns that compete with their own. Similarly, as we have seen with the airline deregulation bill, regulated industries also resist strongly efforts to limit the Federal role in price- or rate-setting and market entry.

Your Administration has been forthright in pointing out the glaring need to face up to the costs and inefficiencies of our regulatory program. Often, the costs of particular regulations are excessive. The failings of the regulatory process have aroused anger and deep concern in the private sector. Corporations are sponsoring major publicity campaigns to point up the economic burden of regulation. Although still in its infancy, the Regulatory Analysis Program is certainly one of our most popular programs with the business community as a result of this growing concern with regulation.

Twice this year, the Senate has acted against OSHA regulations -- first when it voted to exempt small businesses from OSHA rules, and last Monday when it voted to delay the effective date of the cotton dust rule. If erosion of environmental and health and safety objectives by such *ad hoc* and ill-advised Congressional actions is to be avoided, and if the legitimate concerns of the nation with regard to regulation are to be met, we must move forward with regulatory reform efforts.

Therefore, I disagree strongly -- on economic and on political grounds -- with CEQ's recommendation that "Administration regulatory review efforts should focus more on ferreting out old regulations that are anti-competitive or no longer serve a useful purpose, and much less on new regulatory proposals in the health and environmental areas." Today, I also sent you separately a report of the interagency group that conducted the six-month review of the Regulatory Analysis Program. It outlines several improvements in the program, and recommends that you extend the program's life. I recommend that you endorse this program and give it your full backing in the months ahead. Regulatory reform is a vital ingredient in our anti-inflation effort, a popular program with the American people, and essential in the long run to achieving our environmental and health and safety objectives without incurring unacceptable costs.

CEA, DPS, OMB and other agencies are exploring ways to further enhance the regulatory reform effort. We also are working to build better bridges to the environmentalist and labor communities in order to reduce their opposition to these programs, if not gain their support. Your continued strong support for these efforts, both publicly and in the process of Administration decision making, is of critical importance to its success.