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The following article appeared in the October 29, 2011 issue of *The Economist*. It discusses the new concept of the government running "regulatory policy" in the same type of way as it conducts fiscal policy and monetary policy. In particular, adjusting various "regulations" (regarding, for example, health issues, or financial market issues directly with which fiscal policy and monetary policy do not deal) as conditions in the overall economy (i.e., macroeconomic conditions) change.

The most specific types of regulatory policies the article discusses are those that would affect employment and unemployment en masse, which has lately been a very important issue in the U.S. as the unemployment rate has hovered between a very high nine to ten percent for well over two years now.

(As a further note: in any market, issues are driven fundamentally by problems on the supply side or by problems on the demand side. The article begins by citing new research by the Treasury department that it seems to **not** be problems on the labor-supply side keeping the labor market in such a sustained funk. Which thus points to issues or problems affecting firms' demand for labor.)

Economics focus

Clause and effect

The business cycle matters when assessing the cost of new regulations

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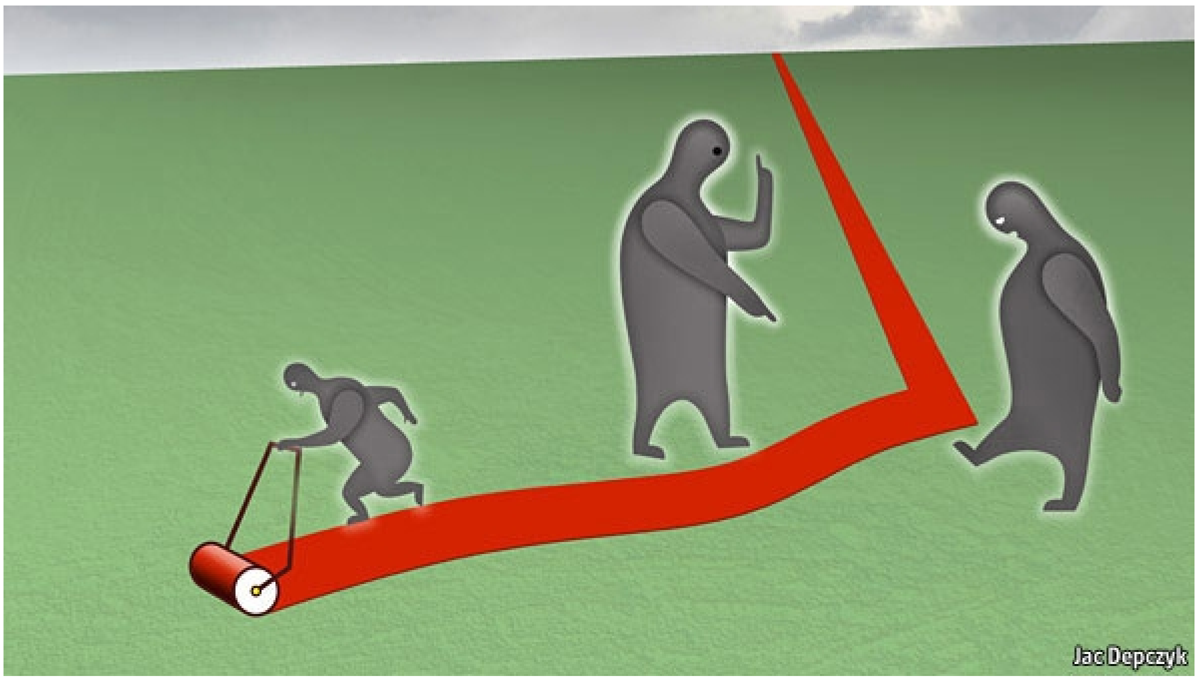

AMERICAN policymakers are pulling every lever they can to revive the economy, from fiscal stimulus to quantitative easing. The big exception has been regulatory policy. From environmental protection to bank oversight, the rule book has steadily thickened in recent years. Republican critics of Barack Obama think this explains America's economic malaise. Scrap the rules, they claim, and the economy will spring to life. Nonsense, responds the Treasury. In a recent article, Jan Eberly, an assistant secretary for economic policy, scrutinised the behaviour of corporate-bond yields, corporate profits and other indicators. She found no evidence that regulatory uncertainty is holding businesses back from hiring or investment; weak demand is the big culprit.

Yet regulation, if not a prime suspect, could still be an accomplice. Rules raise costs by compelling businesses to do things differently. That is acceptable if the benefits—whether cleaner air or stabler banks—justify the costs. Ever since the administration of Ronald Reagan, presidents have required federal regulators to demonstrate precisely that. There is a growing view, however, that cost-benefit analysis should go further than just considering what a firm pays to comply with a rule or the premium a consumer pays as a result of new regulation. On this view, it should also incorporate the harm suffered by workers who lose their jobs.

Regulators in America do routinely estimate the impact of new rules on jobs, but such estimates do not enter the ledger when they calculate a rule's costs. This is not as odd as it sounds. In theory regulation rearranges the distribution of economic output, away from the newly regulated activity towards less regulated ones, but does not affect its overall volume. The calculations assume that, on average, workers who lose their jobs because of a new rule find other work at roughly the same pay.

In some circumstances, regulation can require more jobs. A 2002 study by Resources for the Future, a think-tank, found that mandated environmental spending by four heavily polluting industries—pulp and paper mills, plastics manufacturers, petroleum refiners, and iron and steel mills—resulted in slightly higher employment because displaced spending often went to more labour-intensive services than the activity curtailed by the rules.

But a study by Michael Greenstone of the Massachusetts Institute of Technology came to a more sobering conclusion. In the early 1970s the Clean Air Act divided the country into "attainment" counties that met federal standards for certain airborne pollutants and "non-attainment" counties in which polluters faced tougher regulatory oversight. After controlling for several factors, Mr Greenstone found that between 1972 and 1987 polluting industries in counties that were subject to heavier regulation lost 590,000 more jobs than the other counties.

The question of what becomes of such workers is the critical one. If they quickly find similar work in other counties or industries, then in aggregate the economy is no worse off. In reality job change is seldom so frictionless. A worker's pay is often tied to things like his specific knowledge and experience. Being forced to change occupations, employers or location destroys some of that human capital and thus lifetime earnings potential. A recent paper by Steven Davis of the University of Chicago and Till von Wachter of Columbia University estimates that being laid off costs a typical male worker 11% of his future earnings, in present-value dollars. During a recession, when longer spells of unemployment lead to more loss of human capital, that rises to 19%.

Would incorporating those effects into cost-benefit analysis change the equation for many new rules? Jonathan Masur and Eric Posner, both law professors at the University of Chicago, think so. In a recent paper they examine an Environmental Protection Agency (EPA) rule that limits pollution emissions from pulp and paper plants. The EPA estimated that the rule's benefits exceeded its costs by $27m. It also reckoned 900 workers, about 1% of the sector's total, would be displaced. After incorporating their lost lifetime earnings, the authors conclude the rule's costs surpassed its benefits by $63m.

Regulators do occasionally cite employment impacts as one of the reasons they sometimes turn down a rule. Mr Obama implicitly did so in September when he ordered the EPA not to proceed with a lower ozone-emissions standard. In the words of Cass

Sunstein, Mr Obama’s regulatory tsar, the rule came at an “economically challenging time”. But Messrs Masur and Posner say that making decisions on the ground of employment without properly incorporating this into cost-benefit analysis results in “ad hoc and incoherent” rule-making. Abuses can run in both directions: good rules may be killed because of politically unpalatable job losses.

Bridges and cycles

Ideally, cost-benefit analysis would consider not just the number of workers affected by a new rule but also the industry in question, the availability of other jobs nearby, the transferability of their skills and, crucially, the stage of the business cycle. Messrs Masur and Posner draw an analogy to public works. The government should build a bridge when the benefits exceed the costs. That trade-off changes during a recession because the opportunity cost of employing construction workers is lower: they are less likely to have alternative sources of work. By the same token, robbing consumers of a rule’s benefits may be more acceptable during a recession when unemployment costs may be higher.

Just as fiscal and monetary policy vary according to the economic cycle, so perhaps should regulatory policy: lighter when unemployment is high, heavier when it is low. The economics of incorporating employment considerations into regulatory policy is in its infancy. Mr Sunstein calls it a “frontiers question”. Given the sorry state of America’s job market, it is worth answering.