CALIFORNIA'S NEW OPPORTUNITY TO IMPROVE REGULATION

A FACT SHEET BASED ON A PAPER BY ROBERT W. HAHN AND PETER PASSELL

California Governor Gray Davis recently called for establishing a new Office of Economic Development within the California Public Utilities Commission to review major regulatory proposals and assess their impact on "the economy, infrastructure and job creation."

In a just-released paper, economists Robert W. Hahn, Executive Director of the American Enterprise Institute-Brookings Joint Center for Regulatory Studies and Peter Passell, senior fellow at the Milken Institute and former economics columnist for *The New York Times*, argue that **Governor Davis's proposal "presents an important opportunity to bring rational economic analysis into the world of public utilities regulation."**

Hahn and Passell outline 10 principles to help guide regulators in ensuring that government regulation serves the public interest.

10 PRINCIPLES FOR EFFECTIVE REGULATION

Regulation is not inherently good or bad, argue Hahn and Passell. However, proposed rules should be evaluated based on their expected costs and benefits.

1. **First, do no harm.**
   In industries that are workably competitive and that do not generate significant externalities, the presumption should be strongly in favor of letting market forces work and against regulating price, entry, or service quality.

2. **Do costs outweigh benefits?**
   The PUC should formally weigh the likely costs of all major proposed regulations against their likely benefits, rejecting rules that cannot pass a cost-benefit test. Where possible, benefits and costs should be quantified and expressed in monetary terms.

3. **Consider alternatives to command regulation.**
   Where legislative mandates effectively preclude the use of cost-benefit tests, regulators should design rules to minimize costs. And before imposing traditional command regulation, regulators should assess the workability of alternatives to direct regulation, such as market-based economic incentives.

4. **Use sound economic principles.**
   The cost-benefit methodology used by the PUC should be based on widely accepted economic principles. Where analytic methods differ from standard practice, the reasons should be made explicit.

5. **Keep an eye on costs.**
   While the total benefits of a rule may exceed the total costs for a wide range of standards, in order to minimize the burden on society regulations must be set so that the incremental benefits exceed the incremental costs.

6. **Provide more information rather than less.**
   The often-irreducible uncertainty about costs and benefits implies that, while best estimates should be used in tests of proposed rules, information about plausible ranges of values should also be made available.

7. **Consider the impact on different social groups.**
   Cost-benefit estimates of proposed rules should weigh the differential impact on the welfare of consumers, producers and third parties. At the very least, analyses of rules should include information about the potential impact on different groups with a discussion of ways to mitigate the impact on those adversely affected.

8. **What is the impact <u>today</u>?**
   Considerations of fairness between generations as well as economic efficiency require that benefits and costs experienced far in the future be given less weight in decisions than those experienced today.

9. **Review regulations on a regular basis.**
   Existing regulations should be reviewed on a regular basis to verify that benefits still exceed costs and that they are being implemented in a cost-effective manner. Rules that don't meet this standard and can't be easily modified to meet the standard should be eliminated.

10. **Say it in plain language.**
    The PUC should issue regular reports outlining the benefits and costs associated with new rules. These reports should be written with the minimum use of technical language in order to make them accessible to non-professionals.

Applying Principles to Real World Cases: Airlines

How should a new Office of Economic Development apply these principles to real world cases? Hahn and Passell highlight the airline industry as an historical example in concluding that there is "considerable evidence that price and entry regulations imposed on competitive markets reduce economic welfare."

In the 1960s, California chose not to regulate intrastate airfares, while the federal government regulated both fares and carrier entry on interstate routes. As a result, flights between Los Angeles and San Francisco cost less than even shorter flights between Washington, DC and New York.

CONCLUSION

Today, according to Hahn and Passell, the wireless industry offers an example of a market that is working. The wireless market is characterized by dramatically falling prices, enhanced service and a skyrocketing number of users – evidence that "regulation is likely to do more harm than good."