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A Primer on Regulatory Budgets

by

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A new and novel approach to controlling regulatory costs is the concept of the regulatory budget. This concept would require that governments account for regulatory expenditures in a similar way to fiscal expenditures. This article argues that there are analogies between fiscal and regulatory budgets as they both divert resources from the private sector, albeit by different policy instruments. Given that budgeting is universally used to manage fiscal resources, the article outlines the pros and cons of developing regulatory budgets to manage regulatory resources.

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1. Introduction

A widespread complaint raised by businesses and citizens in OECD countries concerns the amount and complexity of government regulation. In many policy areas, regulatory requirements have become extremely complex and cumbersome, and costs imposed on the economy as a whole are significant. Moreover, when excessive in number and complexity, regulations can impede innovation, create unnecessary barriers to trade, investment and economic efficiency, and even threaten the legitimacy of the rule of law.

In response to these challenges, governments of OECD countries have increasingly focused on reviewing and simplifying regulation over the past two decades. Although there is much anecdotal evidence that these simplification programmes have improved the cost effectiveness of many regulations, a number of OECD countries are exploring options for more permanent approaches to confronting regulatory costs.[1] A new and novel approach is the concept of the regulatory budget. Regulatory budgeting is based on the premise that regulatory costs are conceptually similar to government expenditures through the budget process. However, while governments are required to account in detail for their fiscal spending, regulatory costs or "expenditures" are still largely hidden and there is still no accountability for the total amount of regulatory expenditure which a government requires. The regulatory budgeting concept would require that governments account for regulatory expenditures in a similar way to fiscal expenditures.

The need for fiscal consolidation across nearly all OECD countries may also bring greater prominence to regulatory budgets. The need to bring public finances back into sustainable dynamics in the next few years may well limit the use of fiscal expenditure to meet a host of policy objectives. As an alternative, a number of countries are turning to regulatory policy as an approach to meeting these same objectives. However, regulatory interventions come with their own set of costs and need to be constrained. Thus, there may be interest in developing resource management and budgeting systems that treat fiscal and regulatory expenditures in an equal manner to address policy objectives, albeit through using different policy instruments.

2. How a regulatory budget would work

The regulatory budget operates by close analogy to the traditional fiscal process. For example, each year (or at some longer interval), the government would establish an upper limit on the costs of its regulatory activities to the economy and would apportion this sum among the individual regulatory agencies. This would presumably involve a budget proposal developed by a regulatory oversight body in negotiation with regulatory agencies, approved by the executive branch of government, and submitted for legislative review, revision and passage. Once final budget appropriations were in force, each agency would be obliged to live within its regulatory budget for the time period in question.

The budget, at the most ambitious level, would cover the total costs of all regulations past and present, not just new ones. The budget would allow agencies to offset the cost of new regulations with savings made by reducing existing expenditures. This would provide incentives for agencies to re-examine their regulatory stock, as simplification or removal of regulation would be treated as a credit and provide additional space to spend on new regulations.

The budget would need to provide flexibility for contingencies both over time and across agencies. In this regard, trading regulatory expenditure offsets between agencies would provide flexibility and encourage innovation in reducing regulatory costs. Likewise, carry-forwards among budget periods could be used to accommodate unforeseen regulatory actions (as well as reconcile differences between estimated and actual costs; see below).

Two institutional mechanisms would be required to introduce a regulatory budget. First, it would be necessary to measure regulatory costs on an estimated, *ex ante* basis when regulations were first issued and on an actual, *ex post* basis after the regulations had taken hold. Comprehensive regulatory impact assessment programmes would need to be used for the measurement of *ex ante* assessment of regulation. The actual costs of regulations would be determined by an *ex post* accounting over a given time frame, every five years for instance.

Second, a regulatory oversight body would be responsible for certifying individual agencies' calculations of regulatory costs. It should be recognised that agencies would have strong incentives to overstate estimated costs in order to obtain large initial appropriations, and later to understate actual costs in order to increase their discretion within budgeted amounts. Institutional mechanism would need to be designed to induce truthful cost estimates at every stage of the budgeting process (*e.g.* through the use of tools to overcome moral hazard). Even with the truthful revelation of costs, numerous differences of opinion and technique would remain to be resolved authoritatively, such as the proper treatment of joint costs.

3. A partial regulatory budget

While the full regulatory budgeting model clearly involves very considerable information requirements, it is also possible to suggest "partial" uses of its basic insight. For example, the government may choose to freeze regulatory expenditures at current levels. This would require that offsetting reductions in compliance costs, whether via reforms or revocation of regulation, be identified wherever new regulations were proposed. In this scenario, the information requirement becomes considerably less daunting, being restricted to assessment of the costs of those regulations being reformed and those being introduced – essentially an incremental approach. However, the key aspect of achieving some level of control over total regulatory costs is retained.

4. The fiscal budget analogy

The logic and workings of fiscal budgets are well known and would produce three major benefits when applied to regulatory expenditures. First, placing a fixed limit on the amount of resources available to an agency with a defined policy objective should result in more cost-effective allocation of those resources. Allowing agencies to treat regulatory resources as a "free good" offers little hope that those resources will be allocated in a cost-effective manner.

Second, a regulatory budget would require an explicit consideration of the aggregate economic costs of regulation. One of the most attractive features of the regulatory budget is that it would establish a clear upper limit on the government's regulatory activities and recognise trade-offs between competing priorities among various health, safety, environmental and economic policies. In establishing and agreeing this envelope, the technocratic and democratic process within a country should balance the public benefits of regulatory expenditures with the social cost of private resources used.

Third, the regulatory budget would rely more on decentralised decision making than a more centralised regulatory oversight model (where a central unit reviews the entire regulatory system to identify areas for simplification and improvement). The advantage of a more decentralised approach is that policy making at the agency and programme level should have access to more and better information with which to make cost-effective decisions within a budget constraint.

Yet the analogies between an expenditure budget and a regulatory budget can only go so far. In the case of the expenditure budget, the government's activities are limited by its tax revenues plus the extent of its willingness to go into debt or to inflate the supply of money. But the regulatory budget would be a one-sided ledger with no "receipts" with which to compare (and constrain) regulatory costs. Likewise, the business cycle would not affect the need or desirability to have larger or smaller regulatory outlays. These differences could weaken the underlying disciplines of the budget process. For instance, regulatory agencies might assume that their appropriations were continuously negotiable, presuming that when the issue of budget compliance came down to the decision of a particular regulatory controversy, the political pressures surrounding the controversy itself would secure the requisite supplemental appropriation or budget carry-forward.

5. Problems with regulatory budgets

The regulatory budget is an idea of considerable theoretical appeal. A number of serious and practical problems, however, may limit the successful application of this process. First is the problem of collecting and analysing the vast quantities of cost information that would be needed to establish and enforce the budget. Collecting this information would both represent a significant cost to the government and could create a considerable and expensive compliance burden on the private sector.

Another issue concerns estimating which regulatory expenditures were made because of regulatory requirements as compared to those that would have occurred in the absence of regulation. For example, in the absence of regulation for automobile safety standards, some level of safety would still be built into vehicles. Moreover, in some instances, regulations largely summarise the standards that are already being applied by firms. In these cases, though direct compliance costs might be significant, the marginal costs of meeting regulatory standards would be quite small. Discerning, let alone measuring, "business as usual" costs from the marginal costs of regulation is often extremely subjective.

Another serious problem is the measurement of the indirect costs of regulation.[2] The measurement of these costs is inherently difficult and requires estimations of elasticity of demand and supply, adjustments to account for risk aversion, and accounting for the effects of a number of exogenous variables. It could be argued that combining estimates of indirect costs with direct compliance costs of regulation could undermine the budgeting process and its programmatic neutrality. Yet including only direct costs may limit the scope of a regulatory budget to such a degree that it could be easily evaded. Agencies would be inclined to prohibit certain activities or products outright (avoiding direct costs) rather than allowing that they be undertaken or produced in a certain manner (incurring mainly indirect costs). Limiting budgeted costs to the expenditures of firms would reinforce the tendency of regulation to freeze production technology and stifle innovation. Such an approach would also encourage the perception that the "incidence" of regulatory redistributions is generally progressive.

An important feature of the regulatory budget, and a significant shortcoming, is the exclusive focus on regulatory costs with no concern for the benefits that accrue from regulation. The regulatory costs allocated to the agencies would be composed of measurable expenditures (either financial or in time) by business and individuals required to meet a regulatory obligation. This implies that the social benefits created by regulations would not offset the regulatory costs. As an example:

- for environmental regulations, regulatory costs would include the expenditures of firms on pollution abatement but would not be offset by resulting benefits, such as increased property values or reduced expenditures on medical care; or
- for product safety regulations, the costs of complying with safety standards would not be offset by the benefits of a lower incidence of risk.

The exclusion of benefits from regulatory budgets presents a number of problems. It may lead to the non-pursuit of measures that would have delivered benefits in order to keep the costs of complying with regulation within budget. Likewise, the exclusion of benefits creates a bias towards low-cost regulatory options at the expense of solutions that may be more costly but that deliver greater economic benefits.[3]

6. Possible solutions

The practical problems outlined above are not insurmountable and mainly differ in degree from their fiscal analogues. On the issue of collecting cost information, a regulatory budget might not have to be applied with a high degree of precision, unlike the expenditure budget. So long as cost estimates are not systematically underestimated, they can make reliable ceilings and act as a constraint on regulatory expenditures. As regards the actual measurement of these data, a great deal is already being invested in measuring regulatory costs, particularly administrative burdens. Many OECD countries have invested significantly in developing regulatory burden reduction programmes based around the Standard Cost Model. A number of countries have already established a "baseline" measurement of administrative burdens across the economy. A smaller number of countries are experimenting with the quantification of direct compliance costs. It appears that measuring these costs is much more difficult than measuring administrative burdens and will require considerably more time and resources.

A number of countries have struggled with distinguishing and estimating business as usual as opposed to marginal costs. This problem may be somewhat less problematic when using an incremental budget approach. For example, the amount of workplace safety that a firm provides is not likely to change drastically from one year to the next in the absence of new regulations.

Whereas countries have made considerable progress measuring direct costs, quantifying the indirect costs of regulation remains a challenge, especially on an economy-wide basis. At the same time, estimation techniques have improved significantly and workable approaches could be designed. For instance, simple assumptions on economic modelling of demand-and-supply relationships of regulated or banned products could be developed and used to proxy for the value of the loss to consumers of the forgone output caused by regulation.

The exclusion of benefits in the regulatory budget cannot be easily solved. Perhaps the simplest solution would be to present the regulatory budget alongside with anticipated benefits and ensure that both are prepared with consistent methodologies. While this would not solve the problems outlined above, this approach would inform the public of the potential "upside" of the regulatory budget. The exclusion of benefits is not an issue unique to regulatory budgets. Fiscal budgets will typically not quantify the benefits brought by programme spending, or at least not systematically. Presumably benefits are taken into account when choosing between different spending programmes, but the fact that they are not part of the budget equation has not prevented fiscal budgets from being used as a control mechanism.

The alternative would be to take explicit account of monetised benefits in budgets, for instance on net costs. In effect this would amount to setting a minimum benefit-cost ratio requirement for new regulations (either in aggregate or at an individual regulation level). While such an approach could incentivise departments to seek regulations with the highest estimated net benefit, it may not provide sufficient incentive to search for the most cost-effective options. Nor would it constrain the total costs introduced from regulation over a period – a department may continue to introduce regulations with significant costs as long as it can demonstrate that they are estimated to yield more in benefits.[4]

7. Implementing the regulatory budget

A small number of OECD countries have taken a number of steps toward the regulatory budget, although no official policies for implementing the concept have been adopted. The United Kingdom has made the most recent and ambitious effort to introduce a regulatory budget (see the Annex for a brief description). The United States (in the 1990s) and the Netherlands (more recently) have also discussed the introduction of more simplified regulatory budgets.

A number of partial approaches have been implemented in OECD countries with greater success. The United Kingdom requires agencies to identify offsetting simplification measures for all major proposals, and they are expected to consider the scope for offsetting measures for all other proposals. The Australian government has proposed the general policy commitment of "no net increase in regulation". The Portuguese government launched a "one in, one out" rule for all new regulation in May 2010. The aim of these approaches is to discipline agencies to identify reform opportunities to reduce the regulatory burden at least in equal measure to the burden of new regulations. While these efforts follow the spirit of the regulatory budget, they lack the overall discipline which the hard budget constraint imposes.

8. Conclusion

Is the development of the regulatory budget a possible approach to support fiscal consolidation efforts across OECD countries? Moreover, should governments pursue the long-term goal of developing management and budgeting systems that treat fiscal and regulatory expenditures in an equal manner? As this article has argued, there are analogies between fiscal and regulatory budgets as they both divert resources from the private sector, albeit by different policy instruments. Given that budgeting is universally used to manage fiscal resources, it appears a logical step to develop regulatory budgets to manage regulatory resources. The development of a "super budget" which would integrate fiscal and regulatory budgets does appear a long way off. The practical problems of developing regulatory budgets would be the limiting factor over the short term. A number of more profound institutional and governance considerations would need to be tackled over the longer term. In the interim, however, the successful management of regulatory expenditures can be advanced and should be pursued in its own right.

Notes

1. Regulatory costs refer to the broad direct and indirect costs to regulation, including financial costs (taxes, fees), administrative costs (reporting requirements), substantive compliance costs (investment, training) and indirect costs (market structure, consumption patterns).
2. Indirect costs result when regulation reduces otherwise desirable economic activities by raising production costs, by making products less desirable or, in the extreme, by banning products or making them unprofitable to produce. Another important class of indirect costs is the decline in innovation that may occur with some types of regulation.
3. It should also be noted that, while the estimation of indirect costs is relatively well understood, the estimation of both direct and indirect benefits is not. There is also some controversy surrounding techniques to measure the benefits of regulation.
4. Welfare economics would argue that maximising net benefits is more important than minimising costs. Indeed, in many jurisdictions, to be approved regulations must have positive net benefits.

ANNEX

The United Kingdom's Proposals for the Introduction of Regulatory Budgets

The United Kingdom prepared a consultation document (*www.berr.gov.uk/files/file47129.pdf*) in 2008 which outlined the general principles, the processes and institutions, and the legislative and organisational boundaries for a proposed regulatory budget.*

General principles

The proposals include:

- Creating a rolling limit on the costs of new regulation that could be introduced for each department.
- Setting initial budgets allowing departments to offset the cost of new regulation with savings made by reducing the existing regulatory burden and trading with other departments.
- Mechanism for managing the total cost of new regulations could be introduced within a budget period of three to five years.
- Flexibility for contingencies and over time and between departments. Departmental regulatory budgets would be set, limiting the regulatory costs they can impose.
- Reporting process that would hold departments to account if they exceed their budgets, which could include provision for parliamentary scrutiny (model similar to financial budget processes).
- Budgets set at departmental level, covering all the costs of all new regulation with an impact on business. Incentive for departments to re-examine their regulatory stock as simplification/removal of a regulation would be treated as "income" and provide additional headroom to "spend" on new regulation.
- The system will not include the regulatory costs of climate change measures, which are spread across many departments.

Processes and institutions

The stated aims are to prevent unintended consequences and perverse incentives, to ensure that benefits of regulation are taken into account, and to minimise additional

* This information is based on OECD (2010), *Better Regulation in Europe: United Kingdom*, OECD Publishing, Paris.

bureaucracy. The consultation seeks input on the following issues:

- Length of budgetary period: Flow of regulations over time is uneven; longer period helps and supports trade-offs. But data are hard to develop over longer periods. Is three years the right period for the regulatory budget?
- Setting the budgets: Departments to produce forward estimates of costs and benefits. Aim to maximise external input. Government would then use the estimates to set budgets, reflecting regulatory priorities. This would be similar to financial budgets. Need to take benefits into account. Likely that regulations with a high benefit-to-cost ratio would have priority. Savings from new simplification measures would be taken into account; budgets would be net of these savings. Budgets would be announced to the parliament and made public.
- Allowing flexibility: To allow for unforeseen events or unanticipated changes in regulatory costs outside the budget holder's control. As with financial budgeting systems, end-of-period flexibility, cross-departmental flexibility through trading, and a centrally managed exceptional provision.
- Accountability and reporting: Regular reporting from departments and regulators, via annual reports or a central report. Accountability, *e.g.* the parliamentary committee could ask a minister why budget exceeded.
- Shadow running: Start with a shadow roll out to all departments and relevant regulators for a year from April 2009, in which arrangements will be trialled.
- From 2010, subsume administrative burdens target into regulatory budgets.

Legislative boundaries

- National level only. Not local authority regulations.
- Regulations within the scope. Starting point is Standard Cost Model. Includes directly applicable EU regulations, directly applicable acts of parliament, statutory instruments, rules, orders, schemes, regulations, etc., made under statutory powers, licenses and permits issued under central government authority, codes of practice with statutory force, codes of practice/self regulation/industry agreements with government backing, bye-laws of central government. Excludes codes, agreements etc without government backing, local authority regulations. Better Regulation Executive will arbitrate where it is not clear.
- EU-origin regulations (including comitology). As far as possible this should be "treated consistently with other forms of regulation".
- Cost elements. Enforcement, self funding, contractual obligations, legal proceedings. Should they be measured and captured? Exclude enforcement, contractual costs, legal proceedings, include some self funding.

Budgeted costs

Budgets at departmental and regulator level covering all policy areas. Departments would score the cost of a specific regulation against their budget. Avoids double counting. But room is needed for policy priorities; how to do this needs to be explored. All costs that have an impact on business or third sector. Some of the impacts on the public sector also covered.

Assessment methodology

The consultation document notes that a robust measurement and comparison of likely costs and benefits of different policy options is needed, and that this raises "serious methodological challenges".

A key challenge which is carefully addressed in the consultation document from all angles is how to quantify correctly costs and benefits, achieve a correct balance between costs and benefits, and how to capture the benefits of regulation. The document notes the need to take account of direct as well as indirect costs and benefits, across the whole economy. "However it is acknowledged that the monetary valuation of some costs and benefits… can be difficult." Budgets should cover gross costs, *i.e.* estimated benefits will not be netted off. This may create an incentive to underestimate costs. In addition, some measures will not be pursued in order to keep costs within the budget, or create a bias toward low-cost options at the expense of solutions that may be more costly but deliver greater benefits. It is therefore important to consider benefits. The proposal is that budgets would be announced alongside anticipated benefits and consistent with the new public service agreement indicators, where departments already have to collate and report on benefits and costs of new regulations. The alternative of including monetised benefits in the calculations would amount to setting a minimum benefit-cost ratio requirement for new regulations. This does not provide an incentive to seek out least cost options, nor constrain the total costs over time as a department could continue to introduce regulations with significant costs so long as the department shows more in benefits. Transitional costs are also addressed. Should there be separate budgets to cover transitional and annually recurring costs, or a single budget for both?