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Eric A. Posner

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## ARTICLES

### USING NET BENEFIT ACCOUNTS TO DISCIPLINE AGENCIES: A THOUGHT EXPERIMENT

ERICA A. POSNER<sup>†</sup>

Executive orders extending back to 1981 direct regulatory agencies to perform cost-benefit analyses of major regulations,<sup>1</sup> and to comply with the analyses when not barred by statute, as is usually the case.<sup>2</sup> Indeed, some statutes require cost-benefit analysis, and courts increasingly have demanded it even when the statutes are vague.<sup>3</sup> Yet, though agencies issue cost-benefit analyses more frequently than in the past, and though their analyses tend to be more sophisticated, there is no evidence that regulatory performance has improved since 1981.<sup>4</sup>

One hypothesis for the lack of regulatory improvement is that the executive orders do not contain effective enforcement mechanisms. The regulatory process gives agencies the power to set the agenda, and institutional specialization gives agencies superior information about the effects of regulations. As a result, agencies can, in effect, make take-it-or-leave-it offers to the President (really, the Office of Management and Budget (OMB)). Agencies thus can formulate regulations so that they are better, from the OMB's perspective, than the

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<sup>†</sup> Professor of Law, University of Chicago. Thanks to Matthew Adler, Beth Garrett, Doug Lichtman, and Cass Sunstein for comments, to The Sarah Scaife Foundation Fund and The Lynde and Harry Bradley Foundation Fund for financial support, and to participants at a seminar at the Kennedy School of Government, Harvard University.

<sup>1</sup> See, e.g., Exec. Order No. 12,291, 3 C.F.R. 127 (1982) (imposing the use of cost-benefit analysis on regulatory agencies for the first time by presidential directive).

<sup>2</sup> For a brief discussion of statutes that bar the consideration of costs, see Cass R. Sunstein, *Cost-Benefit Default Principles*, 99 MICH. L. REV. 1651, 1663-64 (2001).

<sup>3</sup> See *id.* at 1668 (noting that in the absence of a clear congressional statement otherwise, agencies are expected to undertake cost-benefit analysis).

<sup>4</sup> For a summary of some of the empirical work on this point, see Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489; for further empirical information, see the discussion of studies and data in Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137, 1179-85 (2001).

status quo, while being biased in favor of the agencies' regulatory goals, rather than the requirements of cost-benefit analysis. The OMB cannot punish the agency without undermining the President's own political goals. And although legislation and judicial enforcement can improve agencies' incentives, legislators and judges are also vulnerable to the agencies' strategic and informational advantages.

If this portrait is accurate, supporters of cost-benefit analysis need to give greater attention to enforcement issues than they have in the past.<sup>5</sup> In this Article, I sketch out a mechanism for increasing agency incentives to comply with cost-benefit principles, so that agencies are more likely to issue cost-justified regulation, rather than reporting cost-benefit analyses while in fact ignoring the results, or complying by providing shoddy cost-benefit analyses designed to rationalize the agency's behavior. The proposed mechanism is, at this point, not fully worked out, but rather is intended as a thought experiment to provoke further discussion.<sup>6</sup>

Under my proposal, agencies would be given what I will call "Net Benefit Accounts" (NBAs). These are budget-like devices for accounting for the benefits and costs that regulations produce over time: the benefit of every regulation would take the form of an addition to the agency's NBA, and the cost would take the form of a subtraction. Agencies would be required to keep positive balances in their NBAs. Agencies with large surpluses in their NBAs would be permitted to draw down a portion of the surplus for the purpose of issuing cost-unjustified regulations for which the agency has a strong preference.

The NBA idea is not entirely new. It shares some of the characteristics of the "regulatory budget," an idea that has been knocked about

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<sup>5</sup> The recent literature focuses on theoretical questions like the consistency of cost-benefit analysis with normative principles, and on the ways to bring such analysis in line with these principles. See, e.g., COST-BENEFIT ANALYSIS: LEGAL, ECONOMIC, AND PHILOSOPHICAL PERSPECTIVES 1-4 (Matthew D. Adler & Eric A. Posner eds., 2001) (compiling papers from a recent cost-benefit analysis conference and suggesting that research regarding the normative justifications for cost-benefit analysis is a possible direction for future research); Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165, 168 (1999) (defending the use of cost-benefit analysis and arguing that its use is "consistent with a broad array of popular theories of the proper role of government").

<sup>6</sup> I assume throughout this Article that cost-benefit analysis is a desirable decision procedure. The proposal that follows can be attractive only on that assumption, although, as I explain below, it can be designed to give agencies needed flexibility when cost-benefit analysis falls short because of the difficulty of monetizing benefits. *Infra* text accompanying note 22.

in the literature for more than twenty years.<sup>7</sup> Under the regulatory budget proposal, agencies would not be able to issue regulations that in the aggregate impose costs on regulated entities greater than a ceiling enacted periodically by Congress. The regulatory budget system does not reflect the benefits generated by any particular regulation. By contrast, the NBA reflects both the benefits and the costs of each particular regulation.<sup>8</sup>

NBAs have, in the best case, two advantages over the status quo. First, they serve an auditing function: they aggregate information about agencies' regulatory activities in a way that facilitates monitoring by elected officials and commentators. The aggregation of information distinguishes the NBAs' auditing function from that of ordinary cost-benefit analysis as it is used in the status quo. Second, NBAs potentially improve the incentives of agencies to comply with cost-benefit analyses by rewarding them when they issue "socially valuable" regulations.<sup>9</sup> The current enforcement system, by contrast, depends not on systematic incentives, but rather on ad hoc intervention by the political branches when an agency's regulation fails cost-benefit analysis.

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<sup>7</sup> See, e.g., ROBERT E. LITAN & WILLIAM D. NORDHAUS, REFORMING FEDERAL REGULATION 133-58 (1983) (considering the elements and issues involved in instituting a regulatory budget); Christopher C. DeMuth, *Constraining Regulatory Costs—Part I: The White House Review Programs*, REGULATION, Jan./Feb. 1980, at 13, 15-18 (considering regulation review programs that have included cost-analysis requirements); Christopher C. DeMuth, *Constraining Regulatory Costs—Part II: The Regulatory Budget*, REGULATION, Mar./Apr. 1980, at 29, 30-31 [hereinafter DeMuth, *Regulatory II*] (detailing how a regulatory budget would work); Lance D. Wood et al., *Restraining the Regulators: Legal Perspectives on a Regulatory Budget for Federal Agencies*, 18 HARV. J. ON LEGIS. 1 (1981) (considering features and problems involved with potential regulatory budget legislation). The idea apparently originated within the government's Council of Economic Advisors. LESTER B. LAVE, THE STRATEGY OF SOCIAL REGULATION: DECISION FRAMEWORKS FOR POLICY 21 (1981). It has not been formally adopted by the government, perhaps because of the many difficulties of implementation or perhaps just because it is not an attractive idea, *infra* Part III.D. For a recent endorsement of the idea, see John D. Graham, *Legislative Approaches to Achieving More Protection Against Risk at Less Cost*, 1997 U. CHI. LEGAL F. 13, 41-56, which encourages Congress to pass a risk regulation statute sharing some characteristics of the regulatory budget system. The possibility of taking benefits into account, which would make the regulatory budget somewhat closer to the NBA system, is discussed but rejected by DeMuth, *Regulatory II, supra*, at 31-32.

<sup>8</sup> For a discussion of the differences in greater detail, see *infra* Part III.D.

<sup>9</sup> By "socially valuable" regulations I mean regulations that pass cost-benefit analysis (and, indeed, maximize the surplus of benefit over cost) when there are no nonmonetizable benefits, and that produce total benefits greater than costs when there are nonmonetizable benefits. This is a simplification, but it is one that keeps the discussion manageable.

The NBA system is, however, not a panacea. It would entail significant implementation problems, similar to those that afflict the regulatory budget proposal.<sup>10</sup> But given the potential advantages of the NBA system, and given the fact that the system is different enough from regulatory budgets to warrant separate consideration, I believe that NBAs could contribute to both cost-benefit scholarship and practice.

### I. THE PROBLEM

I will assume that agencies conceive of themselves as having a “mission”—to protect the environment, to help farmers, to ensure that drugs are safe and effective, and so forth.<sup>11</sup> In formal terms, agencies have preferences for policy outcomes that are generally more interventionist than those of the median voter or elected official. By contrast, some commentators assume that the preferences of agencies are determined by industries or groups that “capture” them, or by the political ambitions of the officials appointed to head them; or, conversely, by some general conception of the public interest.<sup>12</sup> Although all these factors clearly play a role—and there are agencies that do seem to be controlled by political appointees, such as the early Reagan-era EPA—I will stick to my simpler assumption.

If my assumption is correct, then it seems clear that when the EPA (for example) evaluates potential regulations, its conclusions will sometimes violate the results of a cost-benefit analysis. Put most simply, EPA officials will value some environmental amenity like clean air more than citizens do, as determined by studies of health benefits and the like. As a result, the EPA will want to regulate at a higher level than that which would be justified by a cost-benefit analysis. To rationalize the regulation, the EPA will be tempted to appeal to non-monetizable benefits excluded from the cost-benefit analysis by standard practice, or to argue that the cost estimates used in the cost-benefit analysis are exaggerated.

A president or Congress that has the political will could punish agencies that issue cost-unjustified regulations.<sup>13</sup> Agencies enjoy stra-

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<sup>10</sup> See *infra* Part III (discussing the complications of the NBA proposal).

<sup>11</sup> See JAMES Q. WILSON, *BUREAUCRACY* 95-96 (1989) (discussing organizational missions within the context of organizational culture).

<sup>12</sup> For a survey, see Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1 (1998).

<sup>13</sup> I assume throughout that elected officials seek “socially valuable” regulations.

tegic advantages over these actors, however. Agencies have a first-mover advantage. They look for problems, and they are generally the first to propose a regulation. The President and/or Congress can reverse, or interfere with, a proposed regulation *ex post*, but the agency generally will craft a proposed regulation so as to make elected officials slightly more than indifferent between implementation and nonimplementation (and years more of delay). Regulations will, then, tend to fall short of optimality, though perhaps not as much as if no cost-benefit analysis were performed and the agencies were completely autonomous.<sup>14</sup>

## II. A PROPOSED SOLUTION: NET BENEFIT ACCOUNTS

As a partial solution to these problems, I propose that each agency be given a Net Benefit Account. An NBA is an account that holds fictive dollars to which a regulation's social benefits are added and from which its social costs are subtracted. The NBA system is designed to force agencies to internalize (in a political, rather than financial, sense) the benefits and costs imposed by their regulations on industry and other groups.

Let me start with an example. Suppose that an agency has a certain mission to do *X* (protect the environment, enhance food safety, etc.). Congress gives the agency two separate budgets.<sup>15</sup> The first budget covers its ordinary operating expenses, such as the cost of office space and salaries for employees. This budget consists of actual dollars, to be used to pay these expenses. The second budget goes into an NBA. This budget consists of fictive dollars. For simplicity, let this amount be 100.

Under current executive orders, an agency performs a cost-benefit analysis whenever it issues a major regulation. Under the NBA system, the agency's own cost-benefit analysis is audited, either by a separate government agency like the General Accounting Office (GAO) or Office of Information and Regulatory Affairs (OIRA), or by a private accounting firm.<sup>16</sup> The audit verifies that the agency has followed good

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<sup>14</sup> The full story is more complex; for details, see Posner, *supra* note 4, at 1163-79, which examines the political conditions under which agencies regulate.

<sup>15</sup> I will note, but will not discuss here, that the NBA system could be promulgated by executive order or by legislation. Each possibility poses many legal complications, which are best left for future work. Some of the questions would be similar to those raised by the regulatory budget; for a good discussion of such questions, see Wood et al., *supra* note 7, at 13-26.

<sup>16</sup> The GAO already performs such audits, but only from time to time and not sys-

practices, such as relying on peer-reviewed studies and using consistent assumptions when calculating the impact of regulations. This audit, through its reliance on crude, bright-line rules, would permit only an approximation of the true social value of the regulation, just as audits of business firms permit only an approximation of the firms' financial health. If the regulation passes the audit, the agency's figures would be used for NBA calculations. If not, the auditor would either ask the agency to revise its figures or the auditor would substitute its own figures for those of the agency in NBA calculations.<sup>17</sup>

Let's suppose the first hypothetical regulation produces benefits of 40 and costs of 30 over one year (at which point it expires). This means that it produces a net benefit of 10, over one year. When the agency issues the regulation, 10 is added to the NBA, and its balance increases to 110. If a subsequent regulation produces a net benefit of -20, then promulgation of that regulation reduces the balance of the NBA from 110 to 90.

Under the NBA system, the agency is permitted to keep issuing regulations of any kind until the NBA reaches 0. At that point, it will be forbidden to issue any negative net benefit regulations; it can now issue only positive net benefit regulations. When it does so, the balance in the NBA rises back above 0.

The NBA keeps a record of the agency's net cost-benefit effect on society, excluding the agency's operating expenses (and also the nonmonetizable effects of the regulation). In this sense it is simply an *accounting mechanism*. An analogy to the business world might be helpful here. Businesses, like agencies, evaluate projects. Businesses, more so than agencies, use basic cost-benefit principles when they make these valuations—the business jargon is “net present value.” But

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tematically. See, e.g., U.S. GEN. ACCOUNTING OFFICE, CLEAN WATER ACT: PROPOSED REVISIONS TO EPA REGULATIONS TO CLEAN UP POLLUTED WATERS, GAO/RCED-00-206R (2000) (reviewing EPA's economic analysis of proposed clean water regulations). Such independent auditing would address the problem of shoddy cost-benefit analyses. Placing auditing authority in the legislative branch might create constitutional difficulties if the audit triggers an executive action. See *Bowsher v. Synar*, 478 U.S. 714, 726 (1986) (citing separation-of-powers concerns in holding that Congress cannot interfere with the execution of the laws by reserving “for itself the power of removal of an officer charged with the execution of the laws”). If these difficulties cannot be circumvented, the authority would have to be given to an executive branch agency such as the OMB, or possibly a private agency. I thank Elena Kagan for bringing this problem to my attention.

<sup>17</sup> If, as seems likely, the audit would take a great deal of time, the agency's original figures could be used for NBA purposes and then retroactively adjusted as necessary after completion of the audit.

shareholders, creditors, and other interested parties do not usually evaluate a particular firm on a project-by-project basis, insisting that every project have positive net present value. They understand that projects involve risk, that they usually involve costs and benefits that cannot be monetized reliably, and that it often makes sense to allow managers to rely on intuition. Rather than evaluating each project individually, observers look at the aggregate results: the amount of revenues produced, say, in a year or other appropriate period, minus costs, with the necessary adjustments—in other words, profits. The balance in their NBAs would be for agencies what profits are for firms: a reasonable, albeit crude, measure of success.

There is, however, an important difference between business accounting and agency accounting. A business pays for projects out of its own funds, and replenishes these funds with revenues from the projects, so that the balance sheet reflects something real—a prediction about whether the business will be able to continue to operate. An agency, by contrast, does not incur the (nonoperating) costs of its projects, and indeed does not usually obtain revenues to pay for those costs. As a result, the agency's NBA is not a prediction about whether the agency will be able to continue to operate. The agency will cease to operate only if political actors, provoked by a negative NBA, step in and shut it down.

The NBA, then, is at base an accounting mechanism, designed to enable elected officials to monitor agencies just as accounting statements enable investors and creditors to monitor businesses. The NBA system would make agencies' regulatory performances easier to evaluate and compare than they are under the current system, in which cost-benefit analyses are prepared for each major regulation but no aggregation across regulations occurs. If elected officials do not like what they see, they can (in theory) punish agencies by reducing their budgets, curtailing their jurisdiction, and subjecting them to greater oversight.

Through the introduction of an enforcement mechanism, the NBA system could be used more ambitiously as a device for *altering the payoffs of agencies*. One simple enforcement mechanism would be a law forbidding agencies to issue regulations that would reduce their NBA below 0. The law might create a right of action, so that parties who oppose the regulation would be able to obtain an injunction from a court. This is the "stick."

The "carrot" is the agency's right to use the surplus in its NBA (or a portion thereof) to "fund" regulations that are not cost-justified, but



are close to the agency's mission—what I will call “mission-sensitive” regulations. Currently, an agency that issues a regulation with a large net benefit obtains no greater reward than it receives when it issues a regulation with a small net benefit. In both cases it simply avoids whatever sanction, if any, would be attached to the failing of the cost-benefit test. The NBA system, by contrast, offers an incentive for issuing higher net benefit regulation; the size of the reward is an increasing function of the net benefit of a regulation. An excellent regulation increases the NBA balance more than a marginal regulation does. Thus, the agency that issues an excellent regulation will have the freedom in the future to issue a mission-sensitive, but cost-unjustified regulation; the agency that issues marginal or negative net benefit regulations will not.

Of course, a highly mission-centered agency will likely take away what it gives. If it builds up a large surplus at time 1, it will draw down that surplus at time 2 as it pursues mission-sensitive regulations; the net social effect will be zero. But since we want agencies to produce greater social benefits than this, we need one more element: we need to force the agency to “share” the surplus it generates with the public. The most direct way of doing this is to tax the agency's NBA. If an agency issues a regulation with net benefits of 100, let 40 go into the account. Even if the agency draws down the account, it still has produced 60 for society. Taxation could also take place informally, with Congress rewarding agencies periodically on the basis of their NBA performance. Congress could reward agencies by allowing them to retain a larger rather than smaller portion of their NBA balance.<sup>18</sup>

Let us look at an example. Compare a proposed regulation *A*, which produces benefits of 100 and costs of 90, to regulation *B*, which produces benefits of 30 and costs of 10. Assuming, as I have, that the agency's preferences cause it to focus on the magnitude of benefits and to discount costs, an agency constrained by resources to choose only one regulation will prefer *A* to *B*. Although the agency is required to choose *B* rather than *A* under current executive orders, the

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<sup>18</sup> This is roughly the same thing that occurs when Congress punishes bad agencies by subjecting them to enhanced oversight, including hearings, and rewards good agencies by refraining from such harassment. Despite the fact that the agency would be permitted to retain some of the surplus, the potential gains are high. See Tammy O. Tengs & John D. Graham, *The Opportunity Costs of Haphazard Social Investments in Life-Saving*, in *RISKS, COSTS, AND LIVES SAVED: GETTING BETTER RESULTS FROM REGULATION* 167, 179 (Robert W. Hahn ed., 1996) (stating that if agencies only implement regulations with cost-effectiveness ratios below some threshold, the life-saving potential of regulations would double).

agency potentially can exploit its bargaining power and opt for *A* rather than *B*.<sup>19</sup> The NBA system would improve the agency's incentives. Assuming a tax rate of 50%, *B* would increase the NBA from, say, 0 to 10; *A* only from 0 to 5. With the higher NBA, the agency subsequently could issue regulation *Z*, which has benefits of 200 but costs of 206. The NBA system generates net social gains of 14 (counting both regulation *B* and *Z*); the cost-benefit system, on the other hand, generates net social gains of only 10 (counting regulation *A* alone).

As this example shows, the NBA improves on the status quo by enabling agencies to bank regulatory benefits and then use them to fund mission-sensitive regulations when the opportunity for them subsequently arises. The ability to bank regulatory benefits is valuable because regulatory opportunities are not continuous. Just as a business maintains cash on hand or a line of credit so that it can seize business opportunities as they arise, so would a regulatory agency want to build up an NBA surplus in order to have the capacity to seize future regulatory opportunities as they arise.

Although the above example alluded to NBA taxation, it is possible that Congress would not have to tax NBAs or directly reward or punish agencies on the basis of their NBAs. Instead, an agency's NBA would become a politically salient measure of an agency's performance.<sup>20</sup> Agency heads who leave an agency with a high NBA would receive praise from the press and elected officials, just as the Federal Reserve chief does when the economy does well and inflation stays in control. Even if agency heads would prefer to deplete NBA accounts, agency staffs might resist efforts by agency heads to draw down their NBAs on politically expedient projects: staffs might become jealous guardians of their agencies' NBAs as a measure of the quality of the agency. One could imagine agencies competing for the highest NBA, which would introduce an element of competition to the bureaucracy. In this way, the NBA could subtly change the agency's sense of mission, bringing the agency's regulatory preferences more closely in line with those of the public and elected officials, who place as much

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<sup>19</sup> See *supra* Part I (discussing agencies' strategic advantages under the current regulatory system). Again, the current problem is not that cost-benefit analysis produces wrong results (such as not being able to distinguish between *A* and *B*); it is that it is hard to enforce because of the agency's superior information and bargaining power. A president who prefers *A* to the status quo will find it difficult to interfere with the regulation, especially if the agency can make a plausible claim that *A* produces additional nonmonetizable benefits.

<sup>20</sup> This was one of the rationales for the regulatory budget. LITAN & NORDHAUS, *supra* note 7, at 4.

weight on cost as on benefit.

Some readers will make the following objection: Why should we ever permit agencies to issue a net negative benefit regulation, as might occur if an agency starts with an NBA balance greater than zero, or builds up a balance with net positive benefit regulations? Why not interfere whenever an agency proposes a socially costly regulation? To see the force of this objection, imagine that an agency starts out by issuing a highly beneficial regulation, which increases its balance from (say) 10 million to 110 million. In theory, the agency could follow up this success with a highly inefficient but ideologically or politically attractive regulation that produces net costs of 110 million (or an amount equal to the after tax balance of the NBA).

Much better, one might argue, would be to congratulate the agency for the first regulation and then prohibit the second. The problem with this argument is that it assumes that elected officials already control agencies perfectly. The proper comparison is between the status quo—in which agencies report (frequently imperfect) cost-benefit analyses but do not comply with them consistently—and the NBA system. The failure of the existing system is due, in part, to the agency's superior information and bargaining power. Principal-agent theory teaches that in these circumstances some efficiency can be lost when agents have information advantages, and mechanisms designed to enhance performance often will do so by giving some of the "surplus" to the agent.<sup>21</sup> In business, monetary incentives are used to extract effort from agents: wages and benefits are made a function of output. In government, monetary incentives are constrained, and the NBA system—unlike the current system established by the cost-benefit executive orders—instead holds out a political or ideological incentive for good behavior. Under the current quasi-enforced cost-benefit system, agencies continue to have incentives to bias regulation in the direction of their own preferences; under the NBA system, agencies' ability to do this would be diminished though not eliminated, and would also be made more transparent to elected officials and the public. In other words, the NBA system would formalize what is currently a surreptitious, haphazard practice, thus legitimating mission-sensitive regulation, but also improving agencies' incentives.

A final point to consider is that the NBA system would give agen-

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<sup>21</sup> For an introductory discussion, with citations, on the implications of the principal-agent theory, see Eric A. Posner, *Agency Models in Law and Economics*, in CHICAGO LECTURES IN LAW AND ECONOMICS 225, 225-29 (Eric A. Posner ed., 2000).

cies needed flexibility. If Congress believes that regulation of a particular industry will produce unusually large nonmonetizable benefits,<sup>22</sup> then it could give the relevant agency a large initial NBA account—say, 200 rather than 100. Similarly, if Congress or the President trusts one agency more than the other—as will occur when the agency’s mission is relatively closely aligned with current political preferences<sup>23</sup>—they can give that agency a larger account. The NBA system is of particular value here because, in contrast to a “good reason” requirement for deviating from ordinary cost-benefit analysis, the NBA system gives Congress both the means of controlling the amount of flexibility to be given to various agencies, and also the means to track how frequently agencies take advantage of the flexibility given to them.<sup>24</sup>

To sum up, while the NBA is mainly an accounting device, useful for keeping track of the costs and benefits of an agency’s regulations in the aggregate,<sup>25</sup> it could also be used to directly improve agencies’ incentives. If political officials or courts can enforce positive balances, then agencies will be influenced by the costs as well as the benefits of their regulations. Though effective enforcement relies heavily on the political salience of NBAs, experience with congressional budgetary rules suggests that political salience alone can do some good.<sup>26</sup> Indeed, congressional budget rules and NBAs reflect the same idea: the best way to exploit the general public’s reactions against bad policies

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<sup>22</sup> In many cases, nonmonetizable benefits are invoked by the agency against critics. See Adler & Posner, *supra* note 5, at 175-76 (“[A]gencies often do not monetize benefits and do not explicitly compare benefits with costs.”).

<sup>23</sup> See Posner, *supra* note 4, at 1176-77 (citing the appointment power as a means to ensure that agencies’ goals will be to the President’s liking).

<sup>24</sup> Matthew Adler and I argue that such a requirement might be a sensible way for mitigating some of the perverse effects of cost-benefit analysis. Matthew D. Adler & Eric A. Posner, *Implementing Cost-Benefit Analysis When Preferences Are Distorted*, 29 J. LEGAL STUD. 1105, 1141-42 (2000). The Net Benefit Account might serve the same purpose, albeit in a more formal and reviewable way, as a discretionary fund.

<sup>25</sup> For this reason, the simplest nonenforced version could be administered not by the government, but by third parties, who already keep track of agency performance using “regulatory scorecards” and the like. See, e.g., Robert W. Hahn et al., *Assessing Regulatory Impact Analyses: The Failure of Agencies to Comply with Executive Order 12,866*, 23 HARV. J.L. & PUB. POL’Y 859, 864 (2000) (using a “regulatory scorecard” to assess the impact of Regulatory Impact Analysis). Still, official tracking of agency NBAs by a government agency such as the GAO would likely raise the political importance of these accounts.

<sup>26</sup> See Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 504 (1998) (arguing that budget rules “are a mechanism to harness the interest group activity that is already ubiquitous in the tax legislative arena in order to reach substantive policy goals more easily”).

is to channel them. If the public gets upset at bad outcomes (budget deficits, bad regulations), elected officials have an incentive to enter agreements intended to avoid these outcomes (budget rules, NBAs). These agreements can be designed to give officials more refined incentives (both rewards and punishments tied to performance) than those provided by the often inchoate and largely negative public response.

### III. SOME COMPLICATIONS

#### A. *Actual Versus Estimated Costs and Benefits*

I have assumed thus far that an agency's NBA will be adjusted only when the agency issues a final regulation. The account balance could, in addition, be subsequently adjusted if the cost-benefit estimates turn out to be false. Suppose, for example, that an agency's audited *estimated* net benefits for regulation *X* are 20, but that subsequent research shows that the *actual* net benefits were only 15. A hearing could validate the subsequent research and result in the subtraction of 5 from the account. Alternatively, the NBA could be left unadjusted when the regulation is issued and adjusted only as the costs and benefits of the regulation become clear, perhaps on an annual basis. Under such an annual adjustment program, if the regulation produces net benefits of 5 the first year, the account balance would be increased accordingly at the end of the year; if the regulation then produces net benefits of -10 the second year, the balance would be reduced; and so forth.

Research suggests that there is a general bias against regulation resulting from the fact that agencies often overestimate the costs of a regulation because of underestimates of the ability of industry to develop new technologies.<sup>27</sup> Using actual, rather than estimated, costs would correct this bias against regulation, at least in the aggregate over time, though certain accounting adjustments would need to be made in order to avoid a prejudice against regulations that produce costs earlier than benefits.<sup>28</sup> Using actual costs would also allow agen-

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<sup>27</sup> See WINSTON HARRINGTON ET AL., ON THE ACCURACY OF REGULATORY COST ESTIMATES 23 (Res. for the Future, Discussion Paper No. 99-18, Jan. 1999) ("We find numerous instances in the case studies where actual compliance costs are lower than predicted costs because of unanticipated use of new technology."), [http://www.rff.org/disc\\_papers/pdf\\_files/9918.pdf](http://www.rff.org/disc_papers/pdf_files/9918.pdf).

<sup>28</sup> For example, an agency with an NBA of 0 would not be able to issue a regulation that has costs of 5 this year and benefits of 10 next year; accounting devices could

cies to take advantage of their built-up expertise, enabling agency officials to rely on intuitions rather than studies, with the reward or penalty arriving as data on the actual costs and benefits finally arrive. In general, though, the NBA system would present accounting challenges similar to those presented by regulatory budgets; the literature on regulatory budgets is a fruitful source of ideas for meeting these challenges, if indeed they can be met.<sup>29</sup>

### B. *Electoral Cycles and Turnover*

A low NBA account constrains agencies by preventing them from implementing regulations that are marginal from a cost-benefit perspective, but close to the agency's sense of mission. But, as mentioned above, if you endow an agency with a surplus in its NBA—say, 100—at its inception, it might draw down that surplus to 0 by the time that its political appointees have left office at the next election. Indeed, even if you do not, agency leaders will be tempted in their last years to draw down the surplus they generated through good regulation in their early years. It is not clear that this is a good thing; the agency will tend to overregulate against the interest of its successors.

This problem is important, but its magnitude should not be exaggerated. Law, tradition, and the ideological commitments of those who are drawn to work for the agency constrain the freedom of temporary political chiefs. The NBA system will work best if the NBA becomes a measure of the quality of the agency to the outside world. Employees will then resist the efforts of agency heads to draw down the NBA for political reasons, just as they already resist the efforts of agency heads to lead the agency away from its traditional mission.

### C. *Regulation Through Adjudication and Other Alternative Instruments*

Another danger posed by the NBA system is that agencies will substitute to alternative forms of regulation that cannot be so easily controlled. For example, an agency might seek to regulate, not by issuing rules, but by litigating against firms and seeking internal adjudicative rulings or consent decrees from courts. Agencies might also issue, instead of rules, nonbinding guidelines in the hope that courts would use them to set standards of care in private litigation.

These problems, however, apply to the cost-benefit executive or-

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be used to overcome this problem.

<sup>29</sup> LITAN & NORDHAUS, *supra* note 7, at 146-47.

ders as well, and they are not more severe for the NBA system. In addition, agencies are constrained in various ways by the relative usefulness of alternative policy instruments. Finally, it might be possible to take account of these alternative instruments in the NBA system itself, by, for example, providing that their net benefits (or costs)—determined by private or GAO studies—be added to (subtracted from) the agency's NBA. An ambitious, but possibly unworkable, form of the NBA system would account for all the costs and benefits flowing from an agency's actions—whatever policy instrument it uses—so that a running tally would be kept of the agency's effect on social welfare.

D. *Net Benefit Accounts Versus External Cost Accounts*  
(or *Regulatory Budgets*)

An alternative to the NBA would be to give agencies External Cost Accounts, which would set a limit on how much cost the agency can impose on society through its regulations, but which would not be replenished from the benefits. Just such a proposal—under the rubric of “regulatory budget”—was made twenty years ago by Christopher DeMuth, Robert Litan, William Nordhaus, and others.<sup>30</sup> Despite some initial excitement, it has had little influence.

One reason for its lack of influence is the inherent difficulty of implementing the proper accounting procedures. If these difficulties are indeed insurmountable, then the NBA would be a bad idea as well. NBAs require all the information about costs that regulatory budgets require, plus information about benefits, which if anything is even harder to acquire than information about costs. Nonetheless, if cost-benefit analysis is a viable decision procedure—which is the premise of this paper—these problems are in principle surmountable.

NBAs are superior to regulatory budgets for two reasons. First, because regulatory budgets do not, as an accounting matter, incorporate the benefits of the regulation, they do not measure the social value of the regulation. This obscures the normative basis for imposing a regulatory budget. As critics have pointed out,<sup>31</sup> a regulatory budget prevents an agency from issuing a regulation whenever the regulation's costs would deplete the budget, regardless of whether the

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<sup>30</sup> See *supra* note 7 (citing sources).

<sup>31</sup> See Sidney A. Shapiro, *Political Oversight and the Deterioration of Regulatory Policy*, 46 ADMIN. L. REV. 1, 34 (1994) (summarizing the disadvantages of the regulatory budget).

regulation's benefits exceed its costs.<sup>32</sup>

Second, regulatory budgets come with crude sanctioning mechanisms: a stick but no carrot, or at least not the right kind of carrot. Agencies would be prevented from regulating when a new regulation would break the regulatory budget.<sup>33</sup> That's the stick. But agencies receive no benefit when they produce highly valuable regulations. Instead, the agency can benefit only by issuing a low-cost regulation. Consider the choice between regulation *R*, which produces benefits of 100 and costs of 80, and regulation *S*, which produces benefits of 60 and costs of 50. Although *R* is better than *S*, the regulatory budget encourages the agency to choose *S* over *R*, because *S* produces lower costs; the NBA encourages the agency to choose *R* over *S*, because *R* produces greater net benefits. The problem with regulatory budgets, then, is that they reward agencies only for minimizing regulatory costs when we want to reward agencies for maximizing net benefits.

#### CONCLUSION

NBAs will not appeal to critics of quantification,<sup>34</sup> but for those people who think that cost-benefit principles provide adequate guidance for agencies and are frustrated by agencies' resistance to this decision procedure, NBAs are worth consideration. They would generate better information about regulations than the current cost-benefit executive orders do. In addition, they might make agency performance a more politically salient issue, providing elected officials with new mechanisms for disciplining agencies. Most important, if NBAs tie an agency's incentives to its performance—by rewarding agencies either with prestige or flexibility when they issue socially valuable regulations—they mitigate the moral hazard problem characteristic of

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<sup>32</sup> Christopher DeMuth says that benefits are taken into account *ex ante* when the regulatory budget is calculated, but he does not explain how this would work, or why it would be superior to accounting for benefits directly. DeMuth, *Regulatory II*, *supra* note 7, at 32-34. Indeed, his claim is puzzling because the reason he gives for rejecting the latter strategy—namely, the difficulty of calculating benefits—applies as well to the regulatory budget proposal.

<sup>33</sup> Robert Litan and William Nordhaus do not clearly explain how sanctioning would work, and they do not in fact endorse such an extreme approach. See LITAN & NORDHAUS, *supra* note 7, at 154-56 (providing an overview of different types of sanctions and problems that inevitably arise from sanctioning).

<sup>34</sup> See Frank Ackerman & Lisa Heinzerling, *Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection*, 150 U. PA. L. REV. 1553, 1553 (2002) (describing cost-benefit analysis with respect to environmental standards as "a little cold" and "a little crazy").



principal-agent relationships.

NBAs do pose problems, but they should not be exaggerated. The NBA system would require agencies to generate a great deal of information, but the cost-benefit executive orders already do that. What is new is how this information is used. Difficulties in choosing the appropriate accounting procedures, including those that would prevent gaming by agencies, would need to be addressed, and the literature on regulatory budgets suggests that this would not be an easy task. But as accountants know, business accounting is also a very crude process, one that is vulnerable to gaming, as the Enron bankruptcy illustrates, but one that is still quite useful for shedding light on the financial health of firms. Finally, it is not clear how effective the NBA system's sanctioning devices would be in practice. At the least, Congress would need to avoid meddling with NBAs except when there is a good reason. One might doubt whether Congress can be expected to restrain itself, but there might be grounds for optimism in Congress's experience with its own budgetary procedures.

In the end, all I am arguing is that the accounting methods used to evaluate agency performance should be brought up to date and put on par with the accounting methods used for businesses, with the hope that as better information becomes available, the political process will kick in and supply the needed discipline. The NBA system could be a first step in this complex process.