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The Thomas A. Roe Institute for Economic Policy Studies

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HOW REGULATION IS DESTROYING AMERICAN JOBS

INTRODUCTION

During the 1980s, America's ability to create jobs was the envy of the world. No longer. The American job-generating machine has ground to a halt, and regulation deserves much of the blame. The regulatory burden on U.S. firms relaxed through most of the 1980s, and private-sector employment grew by 19 million jobs. Most of these new jobs were created by small businesses, which are most sensitive to regulatory costs. Over the last four years, however, the regulatory burden has grown substantially (especially for small and medium-sized businesses), and the private sector has lost nearly two million jobs since early 1990.

While government red tape is a costly frustration to American business, few business owners—or even government policy makers—appreciate the full impact of regulation. Among the little-known facts:

✓ **Government regulation costs at least $8,000 per household, and may reduce national output by as much as $1.1 trillion per year.**

Unnecessary and inefficient regulation at the federal, state, and local levels is now costing the American people somewhere between $810 billion and $1.7 trillion per year — even after taking account of the benefits of regulation — or between $8,400 and $17,100 per year per household.[1] A major portion of this cost consists of the additional goods and services that the American economy could have been producing today but is not because of over two decades of slower growth due to excessive and inefficient regulation. The value of this foregone output is somewhere between $450 billion and $1.1 trillion per year.[2]

1 Nancy A. Bord and William G. Laffer III, "George Bush's Hidden Tax: The Explosion in Regulation," Heritage Foundation *Backgrounder* No. 905, July 10, 1992, p. 19. Regulations may be treated as "unnecessary" if (1) the costs they impose exceed the benefits they produce, or (2) even though they produce benefits that may exceed costs, they do so in an unnecessarily costly manner because of an inefficient method or approach. The basis for the distinction between necessary and unnecessary regulations is discussed further in footnote 15 below.

2 *Ibid.*

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

✓ Regulation reduces total U.S. employment by at least three million jobs.

Another heavy cost of regulation is reduced employment opportunities for Americans. This toll is not usually apparent, because in most instances regulation merely leads to a slower growth in employment rather than to visible loss in existing jobs. Nonetheless, even by a fairly conservative estimate, there are at least three million fewer jobs in the American economy today than would have existed if the growth of regulation over the last twenty years had been slower and regulations more efficiently designed.[3]

Many regulations directly increase the cost of employing workers and thereby act like a hidden tax on job creation and employment. Among such regulations are minimum wage laws and federal labor laws. These regulations place especially heavy burdens on small businesses, the primary engines of job creation. And exempting smaller businesses from regulations generally does not solve the problem. Instead it simply creates a "Catch 22" situation in which growing small firms are penalized by an increase in the number of regulations they became subject to.

Officials currently face no explicit requirement to consider employment effects as they develop new rules. Nor do lawmakers. Even when the agencies or congressional committees do consider the employment effects of proposed rules or regulatory legislation, policy makers often do so in ways that are simplistic or that rely on faulty assumptions and models. The methodologies used vary from agency to agency, and from regulation to regulation even within agencies. Moreover, nowhere in the entire federal regulatory process does anyone consider the cumulative effects of existing regulations, or the possible combined effects of new and existing regulations.

To deal with the mounting employment costs of regulation, Congress and the Clinton Administration should institute several urgent reforms. Among the most important:

Reform #1: President Clinton should issue an executive order requiring explicit consideration of the employment effects of all new regulations.

Reform #2: Congress should extend the same requirement to all "independent" regulatory agencies that are outside the executive branch.

Reform #3: Congress should establish a federal regulatory budget. Such a budget means that a maximum total regulatory burden that government could impose on the economy — or regulatory budget — would be established. Whenever an agency planned to add a new regulation that would exceed the budget, it would be required to repeal or modify some other regulation so that the total burden imposed on the economy by federal regulation would not be increased. Alternatively, the government would have to arrange an offsetting reduction from another agency.

Reform #4: Congress should require the expected employment effects of all proposed regulations to be published in the *Federal Register*; even before such a requirement is imposed, executive and independent agencies

3 Footnote 17 below explains how this figure was calculated.

should voluntarily publish the expected employment effects of proposed regulations. This would permit the American people to know the expected magnitude of any job losses due to a new rule before it takes effect. Americans then could let officials and lawmakers know if they felt the benefits of the proposed rule were worth the job losses.

Enactment of these four reforms would reduce substantially the cost that federal regulations impose on the economy, while preserving or even increasing the benefits that regulations sometimes can provide. In particular, they would reduce the toll on employment and wages that the well-meaning pursuit of worthy ends often takes. A clean environment and safe and discrimination-free workplaces can be achieved without depriving three million or more Americans of jobs.

HOW REGULATION KILLS JOBS

Between January 1, 1983, and March 31, 1990, private-sector employment in the U.S. economy grew by some 19 million jobs, rising from 72.8 million jobs in December 1982, to 91.8 million jobs in March 1990. However, over the next two years the private sector lost nearly 2.2 million jobs, reaching a low of just over 89.6 million jobs in January 1992. The number of private-sector jobs has recovered only slightly since then, rising to 90.1 million jobs as of January 1993.[4]

What accounts for the difference between the two periods? In particular, what caused employment to start rising in January 1983, and what caused it to begin to fall in April 1990? To be sure, there are many factors that affect employment levels, including taxation. Tax rates were reduced significantly in 1983, but increased somewhat in 1990.[5] But there is considerable evidence to suggest that changes in the total cost of federal and state regulation also played a major role, especially in the downturn that occurred in 1990.

As the graph on the following page indicates, regulatory costs generally were declining during the period of private-sector employment growth. The period of decline and stagnation, by contrast, started shortly after regulatory costs started to rise again. Moreover, as the graph on page 5 shows, there was a very close negative correlation between the number of federal regulators and private-sector employment. Fewer regulators coincided with an increase in job growth; an increase in regulators with a decline in job growth and even a decline in jobs.

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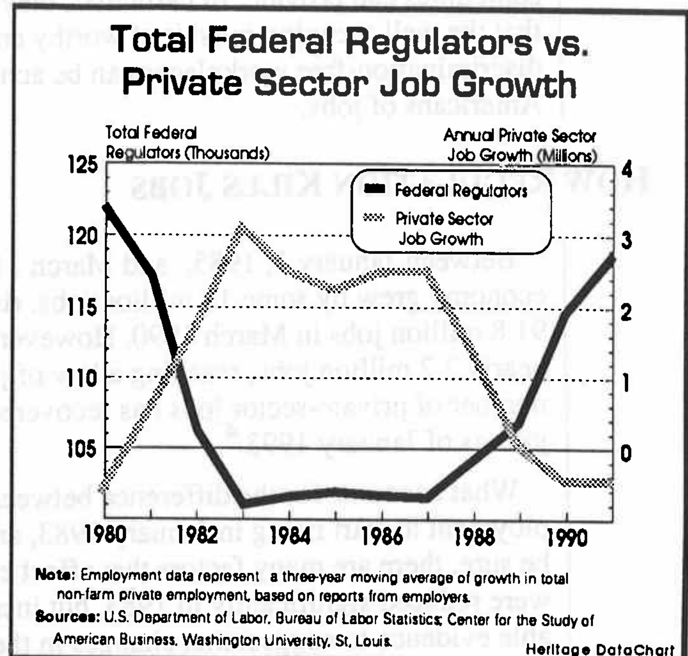
4 Source: U.S. Department of Labor, Bureau of Labor Statistics (BLS) ("establishment data," based on a monthly survey of employers, seasonally adjusted). These figures do not include agricultural employment or employment by federal, state, or local governments. Using BLS's figures for total civilian employment ("household data," based on household interviews conducted monthly by the Bureau of the Census, seasonally adjusted), including agricultural employment and non-military government employment, the relevant employment figures are 99 million jobs in December 1982, 118.3 million jobs in May 1990, 116.5 million jobs in August 1991, and 118 million jobs as of January 1993.

5 See Daniel J. Mitchell, "An Action Plan to Create Jobs," Heritage Foundation *Memo to President-Elect Clinton* No. 1, December 14, 1992, pp. 4-5. The tax cuts that were enacted in 1981 did not take full effect until January 1983. Although the 1990 tax increases were not signed into law until November 1990, President Bush renounced his "no new taxes" pledge and indicated his willingness to agree to a tax increase in June 1990.

Policy makers concerned about job creation need to understand the basic factors that determine the level of wages and employment. Explains economist Arthur B. Laffer:

> Firms base their decisions to employ workers . . . in part, on the total cost to the firm of employing workers. . . . All else equal, the greater the cost to the firm of employing each worker, the less workers the firm will employ. Conversely, the lower the cost per worker, the more workers the firm will hire.[6]

In a world without taxes or regulations, the cost to employers of hiring an additional hour of labor services and the benefit to a worker of working an additional hour would be the same. Taxes and regulations raise the cost to employers above the reward received by the employee. These government-mandated costs include such items as unemployment and disability insurance, government paperwork requirements, and the cost of lawyers to advise firms on how to comply with the rules. While some of these government-imposed costs do provide a benefit to the employee, many of them do not.



Note: Employment data represent a three-year moving average of growth in total non-farm private employment, based on reports from employers.
Sources: U.S. Department of Labor, Bureau of Labor Statistics; Center for the Study of American Business, Washington University, St. Louis.

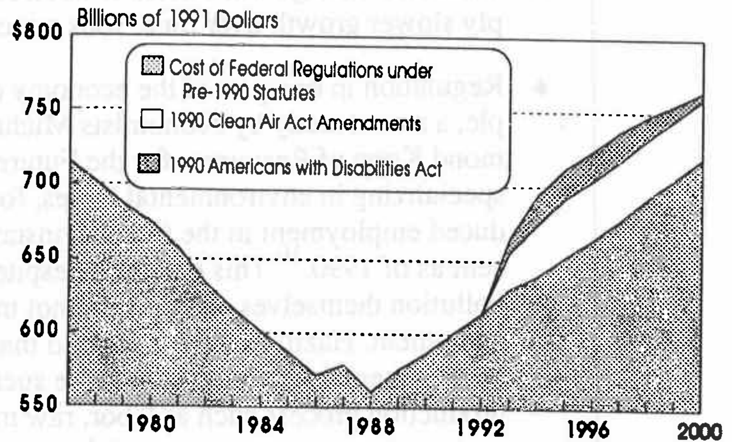
The difference between what it costs a firm to employ a worker and the net benefit the worker receives is commonly referred to by economists as the "regulation and tax wedge." Any increase in the wedge, whether caused by regulations or by taxes, will tend to raise the cost to employers of hiring an additional employee, thereby reducing the demand for labor, and reduce the net wages and benefits workers receive, thereby reducing the supply of labor as well. Thus, the basic laws of economics indicate that if regulatory burdens rise (and tax burdens do not fall by an equal or greater amount), employment and wages will fall.

THE DIRECT AND INDIRECT EFFECTS OF REGULATION

Some regulations have a direct and immediate impact on wages or employment. The minimum wage law and federal labor laws, for example, tend to increase the cost of employing workers and thereby decrease wages or employment, and sometimes both. Other regulations affect wages and employment indirectly, but just as significantly. Banking and environmental regulations, for example, have a considerable negative effect on the overall level of economic activity. And when output slows, employment usually slows with it.

6 Arthur B. Laffer, "Supply-Side Economics," *Financial Analysts Journal*, September/October 1981, pp. 32-33.

More often than not, the effects of regulation on employment are hidden by other factors, such as tax policy or general economic changes. But in other instances, the impact on jobs is very clear.



Sources: Thomas D. Hopkins, "Cost of Regulation," Rochester Institute of Technology, December 1991; Murray Weidenbaum, "The New Wave of Business Regulation," Center for the Study of American Business, December 1990; Robert Genetski, "The True Cost of Government," *The Wall Street Journal*, February 19, 1992.

Heritage DataChart

Example: The federal government's efforts to protect the northern spotted owl, under the Endangered Species Act and other related laws, means millions of acres of land in Washington, Oregon, and northern California have been closed to logging operations. Tens of thousands of loggers have lost or will lose their jobs because of these regulations, and thousands more jobs have been lost in communities dependent on logging as the principal industry.

Example: California has increased regulation sharply over the last two years, driving businesses and jobs from the state. California has lost approximately 700,000 jobs since May 1990.[7] Indeed, for the first time in nearly twenty years, more people are leaving California than arriving.[8] While California's job exodus of course is due to many factors, including higher taxes, several studies and surveys have concluded that regulations—especially onerous new environmental regulations—are the principal factor driving businesses' decisions to leave the state.[9]

Why the Regulatory Cost Is Usually Hidden

Still, cases in which regulation can be clearly identified as the culprit for specific job losses are the exception rather than the rule. There are several reasons why there is rarely a smoking gun:

7 George F. Will, "Can California Compete?" *The Washington Post*, September 27, 1992, p. C7.

8 "Californians leaving state in record numbers," *The Washington Times*, September 4, 1992, p. A2.

9 The most important of these studies is *California's Jobs and Future* (April 23, 1992), a detailed report prepared by the Council on California Competitiveness, led by Peter Ueberroth, the former baseball commissioner and organizer of the 1984 Olympic Games in Los Angeles. Another is Mark Baldassare and Associates, "Department of Commerce Survey of California Manufacturers" (Sacramento: California Department of Commerce, Office of Business Development, December 13, 1989). Two additional surveys are cited in Philip K. Verleger Jr., "Clean Air Regulation and the L.A. Riots," *The Wall Street Journal*, May 19, 1992, p. A14.

- Businesses usually base their decisions on such matters as whether or where to build a new plant, and how many people they will hire, on a variety of considerations. It is rarely clear which consideration was decisive.
- The result of regulation often is not a cut in wages or employment levels, but simply slower growth over time. Jobs not created are much less visible than layoffs.
- Regulation in one part of the economy can have an impact in other areas. For example, a recent study by economists Michael Hazilla of American University and Raymond Kopp of Resources for the Future, a Washington, D.C.-based research group specializing in environmental issues, found that environmental regulations had reduced employment in the finance, insurance, and real estate industries by 2.64 percent as of 1990.[10] This occurred despite the fact that these industries produce no pollution themselves and thus did not incur the direct cost of pollution abatement equipment. Hazilla and Kopp found that all sectors of the economy are affected by environmental regulations, because such regulations cause the cost of inputs to the production process such as labor, raw materials, and electricity to rise, and cause savings, investment and capital formation to fall.

Unfortunately for workers, the indirect causal links whose effects Hazilla and Kopp attempted to measure are invisible to most observers. Nonetheless, Hazilla and Kopp found the employment effects of environmental regulation for the economy as a whole to be substantial. By their estimates, environmental regulations alone had by 1990 reduced the overall employment level by 1.18 percent.[11] This would mean between 1.1 million and 1.4 million fewer jobs than would have existed without environmental regulation.[12] Moreover, environmental regulation significantly altered the distribution of labor employment across the economy. Although a few sectors, such as the natural gas industry and the wholesale and retail trade sectors, experienced modest increases in employment, most sectors experienced reductions.

THE TOTAL COST TO THE ECONOMY

Most studies analyzing the cost of regulation examine only direct compliance expenditures. They do not consider the indirect effects of regulation on output and employment. But some other studies, such as that by Hazilla and Kopp, suggest that the indirect effects may be as large as or even significantly larger than the direct compliance costs, at least in the case of environmental regulations.[13] The reason for this is that reductions in investment due to regulation have cumulative effects over time on output and employment.

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10 Michael Hazilla and Raymond J. Kopp, "Social Cost of Environmental Quality Regulations: A General Equilibrium Analysis," *Journal of Political Economy*, Vol. 98, No. 4 (1990), p. 869.

11 *Ibid.*, p. 867.

12 The average number of Americans employed in 1990 was between 91.5 million and 117.9 million, depending on which BLS data series one uses. 91.5 million x 1.18% = 1.1 million. 117.9 million x 1.18% = 1.4 million. Of course, the number of jobs eliminated by environmental regulation might be smaller if some of the 1.18 percent reduction in labor supply were simply due to people working fewer hours in existing jobs.

13 Another such study, with similar results, was done by economists Dale Jorgenson of Harvard University and Peter Wilcoxen of the University of Texas. See Dale W. Jorgenson and Peter J. Wilcoxen, "Environmental Regulation and U.S. Economic Growth," *RAND Journal of Economics*, Vol. 21, No. 2 (Summer 1990), pp. 314-40.

The most widely cited estimates of the combined cost of all federal regulations put the figure between $595 billion and $667 billion per year for 1992, measured in 1991 dollars.[14] However, these estimates do not take any account of the indirect effects of regulation on output and employment. A recent study by Nancy Bord and William Laffer, of The Heritage Foundation, attempted to estimate the indirect effects of all regulations—state as well as federal —by extrapolating from the results of other studies, such as that of Hazilla and Kopp. Bord and Laffer calculate that, in the absence of all unnecessary regulatory costs,[15] annual gross domestic product (GDP) would exceed its current level of $5.672 trillion as of 1991 by at least some $450 billion, and possibly by as much as $1.1 trillion.[16] This additional output would mean the existence of several million additional jobs. Even a conservative estimate would put the figure at well over three million jobs.[17]

EXAMPLES OF JOB-DESTROYING REGULATIONS

As noted earlier, some regulations directly increase the cost of employing workers and thereby act like a tax on job creation and employment. Three examples show in practical terms how this happens.

Example #1: Minimum Wage Legislation

It is now almost universally accepted that minimum wage laws reduce the employment of low-skilled workers whose productivity simply is not worth what the employers are required by law to pay.[18] The only major disagreement today is over the degree of employment reductions caused by the minimum wage requirement.[19]

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14 Thomas D. Hopkins, *Cost of Regulation*, Rochester Institute of Technology Public Policy Working Paper (December 1991); Robert W. Hahn and John A. Hird, "The Costs and Benefits of Regulation: Review and Synthesis," *Yale Journal on Regulation*, Vol. 8, No. 1 (Winter 1991), pp. 233-278. The figures in the text are arrived at by taking Hopkins's estimate of the total cost of regulation as of 1992, substituting Hahn's and Hird's original estimate of the gross cost of economic regulation for the figure Hopkins used (which was a modified version of Hahn's and Hird's estimate), substituting Hopkins's updated but as yet unpublished figure for the federal paperwork burden, and converting the new total from 1988 to 1991 dollars.

15 Insofar as some types of regulation—environmental regulation in particular—produce benefits as well as costs, one may not simply assume that all of the costs of regulation can be eliminated. However, even where existing regulations may produce benefits that exceed costs, it often appears that the same or even greater benefits could be obtained at a significantly lower cost by using better-designed, more efficient forms of regulation. Consequently, in calculating the foregoing figures, wherever a regulation appeared to produce net benefits, no cost was counted except the difference (if any) between the actual cost imposed by the regulation in question and the lower cost that would be incurred under a more efficient regulatory scheme.

16 Bord and Laffer, *op. cit.*, p. 19. Bord and Laffer used a very wide range of estimates of the ratio of indirect costs to direct costs because of the inherent uncertainty involved in estimating how much output *is not* produced. That is why their lower and upper bounds are so far apart.

17 Based on the ratio of 1991 GDP to average private-sector employment in 1991, the production of an additional $450 billion to $1.1 trillion in annual GDP would mean the creation of an additional 7.2 million to 19.2 million jobs, depending on which figure is used for private-sector employment. However, because much of the additional GDP would have come from increased productivity, rather than increased employment, the actual job growth figures would likely be much smaller. Assuming that half of any increase in annual GDP came from increased employment, the additional jobs that would have been created in the absence of all unnecessary regulatory costs would number between 3.6 million and 9.6 million.

For the nine years running from January 1981 through March 1990, the federal minimum wage remained fixed at $3.35 per hour. Because of inflation, however, the real value of the minimum wage—and therefore the real cost to businesses of employing less-skilled workers—declined. Not surprisingly, the percentage of teenagers with jobs climbed from 41 percent to over 48 percent over the same period.[20]

Congress decided in 1989 to increase the federal minimum wage to $3.80 per hour as of April 1, 1990, and to $4.25 per hour as of April 1, 1991. Again, not surprisingly, teenage employment fell immediately after each of these increases. Just four months after the 1990 increase, for instance, the percentage of teenagers with jobs had fallen from over 48 percent to less than 43 percent, undoing most of the previous nine years' improvement.[21]

In total, the federal minimum wage rose by 27 percent, and teenage employment fell by 11 percent.[22] The 1990 and 1991 minimum wage increases made it harder for teenage workers to get summer and Christmas vacation jobs. The hikes made it harder for young adults with little education, skill, or experience to obtain their first full-time entry-level jobs. These are the jobs where they would acquire the training, experience, and work habits that eventually would make their labor worth more than the legal minimum. And the increases in the minimum wage made it harder for unskilled housewives trying to supplement their family's income while their children are in school to obtain part-time work.

Calculations by economists Lowell Gallaway and Richard Vedder of Ohio University show that the total cost to a business for each worker hired and for each hour worked rose sharply after each of these increases in the minimum wage, but especially after the first—which was the larger of the two increases in percentage terms.[23] Furthermore, calculations by Gallaway and economist Gary Anderson of the Joint Economic Committee (JEC) of Congress suggest that the total cost per worker hired and per hour worked rose particularly sharply for smaller businesses.[24] Larger corporations tend to be less affected (at least directly) by increases in the minimum wage, since they already pay most if not all of their workers wages well above the legal minimum. By contrast, the overwhelming majority of businesses that employ people at the minimum wage are small and medium-sized. Consequently, increases in the minimum wage—like most other increases in the regulatory burden—tend to have a greater impact on smaller firms, and to exacerbate the disparity that already exists between small and large firms.[25]

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18 See, e.g., Simon Rottenberg, ed., *The Economics of Legal Minimum Wages* (Washington, D.C.: American Enterprise Institute, 1981).

19 Some studies note, for example, that while the minimum wage law reduces employment of low-skilled workers, it may increase employment of medium-skilled workers who, to some extent, can be used in lieu of the low-skilled workers whose labor the minimum wage renders too expensive. However, the increase in employment of medium-skilled workers is never enough to fully offset the decrease in employment of low-skilled workers.

20 Alan Reynolds, "Cruel Costs of the 1991 Minimum Wage," *The Wall Street Journal*, July 7, 1992, p. A14.

21 *Ibid.*

22 *Ibid.*

23 Lowell Gallaway and Richard Vedder, "Why Johnny Can't Work: The Causes of Unemployment," *Policy Review*, Fall 1992, p. 29.

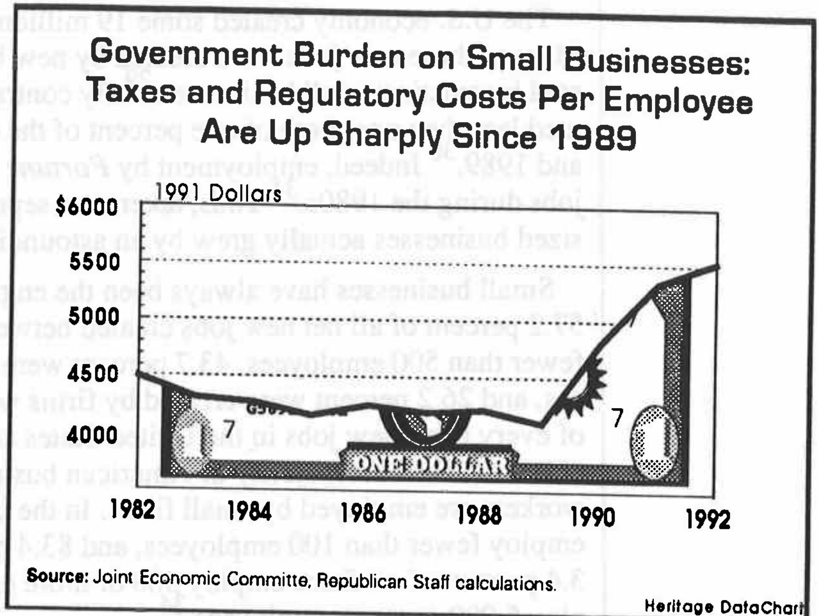
24 Gary Anderson and Lowell Gallaway, "Derailing the Small Business Job Express" (Washington, D.C.: Joint Economic Committee, November 7, 1992), pp. 25-28.

25 For a discussion of the disparate impact of regulation on small business, and of the importance of this disparity from the standpoint of job creation, see pages 10-12 below.

Private-sector employment peaked in March 1990, and started declining sharply in April 1990. It appears likely, therefore, that the legally mandated explosion in the cost of employing relatively unskilled workers was a significant factor contributing to the 1990-1991 recession and the stagnation of the past year. (See chart below.)

Example #2: Federal Labor Laws

Federal labor laws regulate employers' dealings with their employees and with organized labor unions. Under these laws, the flexibility of companies to hire and fire workers is restricted, and often they are required to engage in costly negotiations with labor unions. Far from being balanced, federal labor laws deliberately tilt the scales in favor of unions and against employers, as well as against employees who do not wish to join a union.[26]



Source: Joint Economic Committe, Republican Staff calculations.

There is, however, no free lunch. Restrictions imposed on employers (and employees) by federal labor laws inevitably increase the cost of employing workers, resulting in fewer jobs and lower wages, or at least in slower growth in employment and wages over time.[27]

Example #3: Mandated Benefits

Regulations that require employers to provide various benefits to their employees, such as health insurance, unemployment insurance, workers' compensation, retirement benefits, or child care, all tend to reduce wages and employment. They increase the cost of employing workers, which can lead to a slowdown in the creation of new jobs or even to layoffs.

In the long run, employers will seek to offset their increased costs, either by reducing wage and salary payments or by cutting back on other benefits that the employer previously might have provided voluntarily as a means of attracting workers. As a result, the total value of the employees' compensation eventually may be no higher than it would have been in the absence of the regulation. In fact, the value to the employee may even end up being less than it would have been, while the cost to the employer may still be greater. In this case, the regula-

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26 See, e.g., Richard A. Epstein, "A Common Law for Labor Relations: A Critique of the New Deal Labor Legislation," *Yale Law Journal*, Vol. 92 (1983), p. 1357; Daniel J. Mitchell, "Government Intervention in Labor Markets: A Property Rights Perspective," *Villanova Law Review*, Vol. 33, No. 6 (1988), pp. 1043-1057.

27 See, e.g., John T. Addison and Barry T. Hirsch, "Union Effects on Productivity, Profits, and Growth: Has the Long Run Arrived?" *Journal of Labor Economics*, Vol. 7 (January 1989), pp. 72-106. In addition, compulsory union dues reduce the net benefits workers receive for working, thereby reducing the supply of labor as well as demand.

tion will end up reducing the supply of labor as well as demand. Thus, one way or another, much of the cost of the regulation will end up being borne by the workers, whether in the form of fewer jobs, fewer fringe benefits, a reduction in the growth of wages over time, or some combination of the three.[28]

Regulation and Small Business

The U.S. economy created some 19 million net new private-sector jobs during the 1980s. Most of these new jobs were created by new businesses, and most of the remainder were created by existing small businesses.[29] By contrast, large U.S. multinational corporations contributed less than one-tenth of one percent of the employment growth that occurred between 1982 and 1989.[30] Indeed, employment by *Fortune* 500 corporations actually fell by about 4 million jobs during the 1980s.[31] Thus, taken as a separate sector, employment in small and medium-sized businesses actually grew by an astounding 23 million jobs.

Small businesses have always been the engine of job creation in the U.S. economy. Some 57.2 percent of all net new jobs created between 1976 and 1986 were created by firms with fewer than 500 employees, 43.7 percent were created by firms with fewer than 100 employees, and 26.2 percent were created by firms with fewer than 20 employees.[32] Today, two out of every three new jobs in the United States are created by small and medium-sized businesses.[33] The vast majority of American businesses are small, and the majority of American workers are employed by small firms. In the U.S., 93.3 percent of all business establishments employ fewer than 100 employees, and 83.4 percent employ fewer than 20 employees. Only 3.4 percent of all firms employ 500 or more employees, and only 1.5 percent of all firms employ 5,000 or more employees.[34]

How Regulation Hurts Small Business

Regulation does not affect all businesses equally. It imposes the heaviest burdens on small and medium-sized businesses. The reason is that small and medium-sized firms find it harder to spread the high overhead costs of processing paperwork, attorney and accountant fees, and the staff time needed to negotiate the federal regulatory maze. Direct labor regulations, such as increases in the minimum wage, also represent a comparatively larger burden for small firms. Consequently, increasing levels of regulation tend to put small and medium-sized businesses at a competitive cost disadvantage compared with larger firms.[35]

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28 See, e.g., Richard B. McKenzie, *The American Job Machine* (New York: Universe Books, 1988), pp. 218-31; Don Bellante and Philip K. Porter, "A Subjectivist Economic Analysis of Government-Mandated Employee Benefits," *Harvard Journal of Law and Public Policy*, Vol. 13, No. 2 (Spring 1990), pp. 657-687.

29 Lawrence A. Kudlow, "Small Business Is Big Business," *Global Spectator*, February 28, 1992, reprinted in *Congressional Record*, March 10, 1992, p. S3153.

30 *Ibid.*

31 George F. Will, "A refresher course on what ails us," *The Providence Journal-Bulletin*, September 14, 1992, p. A6.

32 U.S. Small Business Administration, *The State of Small Business: A Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1989), p. 48.

33 Kudlow, *op. cit.*

34 David L. Birch, *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: The Free Press, 1987), p. 9.

Future regulation will compound this problem. For example, although President Clinton has yet to finalize his health care proposals, he has indicated tentative support for proposals to require firms to shoulder much of the cost of universal coverage for workers and their families. This would significantly increase the cost of hiring workers in the small business sector, where many firms currently do not provide coverage. While 98 percent of all firms with 100 or more employees already provide health benefits, only 27 percent of firms with fewer than 10 employees offer health benefits at present.[36] In other words, while 73 percent of firms with fewer than 10 employees would see their cost of employing workers rise under either of these proposals, only 2 percent of firms with 100 or more employees would be significantly affected.

Out of the Frying Pan and into the Fire. To its credit, Congress generally has tried to compensate for the disproportionate burden of regulation on smaller firms by exempting firms below a certain size—measured by the number of employees—from various regulations. For example, the Worker Adjustment and Retraining Notification Act of 1988, which requires employers to give employees and local government officials advance notice before closing a plant or laying off workers, only applies to firms with 100 or more employees. Likewise, the Americans with Disabilities Act (ADA) of 1990 currently applies only to firms with 25 or more employees. After July 26, 1994, however, the ADA will apply to firms with 15 or more employees.

Unfortunately, this well-intentioned approach does not really solve the problem; it merely changes the form of the problem. In some respects it may even make the problem worse, for it gives businesses an incentive not to grow beyond a certain size. If a firm stays small enough, it remains exempt from regulations. However, if it hires "too many" workers, it becomes subject to various costly regulations. Thus, instead of punishing firms merely for being small, federal regulations also punish small firms for growing and creating more jobs.

As a result, firms nearing the relevant threshold for a rule have a powerful incentive to avoid hiring additional employees. For example, in a letter to *The Washington Times*, the president of Schonstedt Instrument Company of Reston, Virginia, tells how he has deliberately kept his company below 50 employees in order to avoid having to file certain forms with the federal government, because of the cost and time involved.[37]

Worse still, the prospect of an exemption from a regulation can make it profitable for firms actually to reduce their workforces in order to fall below the relevant threshold. For example, the Family and Medical Leave Act of 1993, recently signed into law by President Clinton, will apply to firms with 50 or more employees. Calculations by the Joint Economic Commit-

35 See, e.g., Ann P. Bartel and Lacy Glenn Thomas, "Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact," *Journal of Law and Economics*, Vol. 28, No. 1 (April 1985), pp. 1-25; Ann P. Bartel and Lacy Glenn Thomas, "Predation Through Regulation: The Wage and Profit Effects of the Occupational Safety and Health Administration and the Environmental Protection Agency," *Journal of Law and Economics*, Vol. 30, No. 2 (October 1987), pp. 239-264; B. Peter Pashigian, "The Effects of Regulation on Optimal Plant Size and Factor Shares," *Journal of Law and Economics*, Vol. 27, No. 1 (April 1984), pp. 1-28; B. Peter Pashigian, "Environmental Regulation: Whose Self Interests Are Being Protected?" *Economic Inquiry*, Vol. 23, No. 4 (October 1985), pp. 551-584.

36 Health Insurance Association of America, *Source Book of Health Insurance Data 1991* (Washington, D.C.: Health Insurance Association of America, 1991), p. 27 (Table 2.5).

37 E.O. Schonstedt, letter to the editors, *The Washington Times*, February 16, 1992, p. B5.

tee (JEC) of Congress suggest that under this law, a firm whose optimal size before the regulation was 60 employees might actually find it profitable to cut back to 49 employees.[38] As the JEC report puts it, "Exemption from government regulations and mandates on the basis of the size of a company is a guaranteed recipe for making small businesses smaller."[39]

The Myth That Regulation Creates Jobs

Defenders of regulation sometimes argue that while regulation may cut jobs in some firms, in general it is good for the economy and creates jobs. A number of writers recently have made this argument in connection with environmental regulation.[40] For example, it is pointed out that environmental regulations stimulate employment in industries that manufacture special devices required by government, such as scrubbers for smokestacks, and create jobs in environmental clean-up firms. Similarly, it is argued that securities regulations and the Treasury's regulations interpreting the Internal Revenue Code create employment for lawyers and accountants.

These arguments almost always rest on a basic economic fallacy: they confuse the creation of jobs in a particular industry with the creation of jobs for the economy as a whole. Thus while jobs are indeed created in firms that assist in helping companies comply with rules, these rules also cost jobs in the regulated industry. The fallacy that adding costs to firms actually creates jobs in the economy is a persistent fallacy that was refuted decades ago. Rather than creating jobs, regulation simply diverts employment from productive to unproductive activities, with a net loss in efficiency and jobs.[41] In particular instances, the jobs created may be more or less numerous than those destroyed. For example, if a new Medicare regulation increases the cost of doing brain surgery, a hospital may lay off one $300,000-per-year brain surgeon and hire three $30,000-per-year administrators to fill in the relevant Medicare forms. In other instances, however, a firm may lay off three blue-collar workers and replace them with one higher-paid engineer. There is no reason to expect the jobs that are created because of regulation to systematically outnumber—or pay more than—the jobs that are destroyed.

How to Avoid Unnecessary Job Losses

Jobs are lost unnecessarily though regulation because currently there is no explicit requirement that the employment effects of regulation be considered, either by Congress when it legislates or by federal regulatory agencies in the rule-making and enforcement process.

Executive Order (EO) 12291, issued by President Reagan in February 1981, does require executive branch agencies to inquire into the overall costs and benefits of proposed regula-

38 Anderson and Gallaway, *op. cit.*, pp. 21-24.

39 *Ibid.*, p. 24.

40 E.g., Timothy E. Wirth, "Easy Being Green... Lighten Up, Loggers—Environmentalism Actually Creates Jobs," *The Washington Post*, October 4, 1992, p. C3; Michael Silverstein, "Bush's Polluter Protectionism Isn't Pro-Business," *The Wall Street Journal*, May 28, 1992, p. A21; Curtis Moore, "Bush's Nonsense on Jobs and the Environment," *The New York Times*, September 25, 1992, p. A33.

41 See Frederic Bastiat, "What Is Seen and What Is Not Seen," in Frederic Bastiat, *Selected Essays on Political Economy*, trans. Seymour Cain, ed. George B. de Huszar (Irvington-on-Hudson, New York: Foundation for Economic Education, 1964); Henry Hazlitt, *Economics in One Lesson* (Westport, Connecticut: Arlington House, 1979).

tions. However, EO 12291 does not explicitly require any particular kind of costs or benefits to be counted. Thus, while the negative effects of a proposed regulation on wages or employment levels can be counted as costs, they do not have to be. Likewise, the employment-enhancing effects (if any) of a proposed regulation can be counted as benefits, but need not be. An agency thus may compute benefits and costs in dollars without ever counting how many jobs would be gained or lost. Moreover, EO 12291 applies only to new regulations, not regulations that are already on the books. And EO 12291 does not apply to any of the "independent" regulatory agencies that lie outside the executive branch, such as the Securities and Exchange Commission or the Federal Communications Commission.

This is not merely a problem in theory. A recent study by the National Commission for Employment Policy examined the regulatory review practices of seven federal agencies with major responsibility for preparing and enforcing regulation. The study found that "federal regulatory agencies . . . do not explicitly or systematically take potential employment effects into consideration during the review process, or in enforcement decisions."[42] Even when employment effects are considered by the agencies, they are considered either in a simplistic way, or on the basis of faulty assumptions and models. The methodologies used vary from agency to agency, and even from regulation to regulation within agencies. The study also found that federal regulatory agencies generally fail to consider the cumulative effects of existing regulations and the possible effects of new regulations on existing rules.

Because regulation of one part of the economy can affect other parts, and because regulations often interact with each other in significant ways, no regulation can properly be judged or measured in isolation.[43] In fact, this interaction means the adoption of a new regulation can increase the cost imposed by existing regulations. Therefore, computing the total costs and benefits of any new regulation would require determination of the net impact of all regulations taken together. Generally speaking, the greater the volume of regulation that already exists when a new regulation is introduced, the greater will be the incremental, overall cost of adding the new regulation. Failure to take account of this is one of the most important factors contributing to the enormous growth in the overall regulatory burden. It also helps explain the decline in U.S. labor productivity and wage growth over the past two decades (see chart on following page), and the decline in employment during the last two years.

In light of the severe burden imposed by regulation on employment, President Clinton and Congress should reform the regulatory review process. Among the necessary reforms:

Reform #1: President Clinton should issue an executive order requiring explicit consideration of the employment effects of all new regulations.

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42 Nancy A. Bord, "Addressing Employment Effects in the Regulatory Review Process," draft final report prepared for the National Commission for Employment Policy, September 9, 1992, p. 33.

43 An analogous point applies in the area of taxation: Because different taxes often interact with each other in important ways, no individual tax can properly be evaluated in isolation. In fact, strictly speaking, taxes and regulations can only be analyzed in conjunction with each other. Each specific tax must be analyzed in light of every other tax and every regulation, and each specific regulation must be analyzed in light of every other regulation and every tax. See generally John R. Hicks, *Value and Capital*, 2nd ed. (Oxford: Oxford University Press, 1946); Arnold C. Harberger, *Taxation and Welfare* (Chicago: University of Chicago Press, 1974).

Reform #2: Congress should extend the same requirements to all of the "independent" regulatory agencies that lie outside the executive branch.

Reform #3: The President and Congress should establish a federal regulatory budget.

Under a regulatory budget, a limit would be placed on the total estimated cost imposed on the economy each year by all federal regulations. This limit would apply to new and existing regulations taken together. Thus, if the budget had been reached, an agency wishing to add a new regulation would have to repeal or modify an existing regulation. If an agency could not find a large enough offsetting reduction among the other regulations for which it was responsible, the government would have to agree to an offsetting reduction by another agency.

The introduction of a regulatory budget would have several virtues. First, it would place a limit on the total cost that can be imposed on the economy by federal regulation. This total burden would have to be a political decision, with ordinary Americans able to take part in the national discussion.

Note: *Federal Register* data represent a three-year moving average of total pages, omitting blank pages and number jumps from 1976-1992.
Sources: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Acounts of the U.S.*; Office of the Federal Register.

Second, it would force agencies to debate each other to justify the merits of proposed regulations, with the Office of Management and Budget (or any other body designated by the President, such as the newly created National Economic Council) making the final call. This in turn would compel the agencies, as they are not compelled at present, to think seriously about which regulations are most important to them and yield the greatest benefits.

And third, it would give agencies the incentive to review their existing regulations and find those which are not really worth retaining—or are causing greater job losses than expected—in order to make room for new regulations with a higher priority.

Reform #4: Congress should require the expected employment effects of all proposed regulations to be published in the *Federal Register* before the regulations take effect.

Present law allows but does not require publication of expected employment effects in the *Federal Register*. Congress should make such disclosure mandatory. In the meantime, executive and independent agencies should disclose expected job losses or wage reductions voluntarily. This would permit the public to know the expected magnitude of any job losses or net

wage reductions. Thus Americans could comment on this aspect of proposed regulations before they take effect. This also would enable the public to compare actual job losses with what was predicted at the time each regulation was issued.

CONCLUSION

The President and Congress must do something to get the problem of growing federal regulation under control. Regulation at the federal, state, and local levels is now costing the American people somewhere between $810 billion and $1.7 trillion per year, even after taking account of benefits, or between $8,400 and $17,100 per year per household. A major portion of this cost consists of the output that the American economy could have been producing today but is not because of over twenty years of excessive and inefficient regulation—somewhere between $450 billion and $1.1 trillion per year.

Another important cost of regulation is the failure to create more employment opportunities for Americans who would like to work. Many regulations directly increase the cost of employing workers and therefore act just like a hidden tax on job creation and employment. Unfortunately, regulation places especially heavy burdens on smaller and medium-sized businesses, which are the primary engines of job creation. As a consequence, there probably are at least three million fewer private-sector jobs in the American economy than could have existed today if the growth of regulation had been controlled and regulations had been more sensibly and efficiently designed.

While regulation has been taking a toll on employment throughout the last two decades, the toll has risen sharply in just the last four years. Moreover, two of the most significant and costly new regulations of the last four years—the 1990 Clean Air Act Amendments and Americans with Disabilities Act (ADA)—only started to take effect a few months ago; some of their provisions will not take effect until the middle of 1994. So the impact of these regulations on employment still lies in the future—the heavy job losses due to regulation in the last three years have been caused by existing rules. In other words, the employment loss due to regulation is almost certain to get worse if the President and Congress do not take action.

Many specific federal regulatory programs deserve a drastic overhaul. Even though repeal of such new regulatory programs as the Clean Air Act Amendments and the ADA is politically unlikely, the President and Congress could act to lighten the overall regulatory burden in other areas. Reform of deposit insurance and federal banking laws, for example, could help the entire economy and would do much to alleviate the credit crunch that has restrained job creation by small and medium-sized businesses over the past three years.[44]

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44 See William G. Laffer III, "How to Reform America's Banking System," Heritage Foundation *Backgrounder* No. 810, February 26, 1991; Victor A. Canto, "The Credit Crunch" (La Jolla, California: A.B. Laffer, V.A. Canto & Associates, April 20, 1990); Victor A. Canto, "The Credit Crunch Revisited" (La Jolla, California: A.B. Laffer, V.A. Canto & Associates, November 16, 1990); William C. Dunkelberg and William J. Dennis, Jr., "The Small Business Credit Crunch" (Washington, D.C.: NFIB Foundation, December 1992); Paul Craig Roberts, "Economic Dominoes," *National Review*, November 30, 1992, pp. 37-42. As predicted by Canto and confirmed by Dunkelberg and Dennis, the credit crunch has mainly affected medium-sized businesses and larger small businesses (that is, those small businesses with at least 40 employees).

But besides dealing with specific regulations, the regulatory process itself is badly in need of reform. What is needed is for the President and Congress to force agencies to inform Americans of the likely employment effects of proposed rules and to set priorities in rule-making. If these reforms are instituted, the federal government's regulation of the economy could be conducted with the fewest pink slips for American workers.

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