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Eric A. Posner

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# TRANSFER REGULATIONS AND COST-EFFECTIVENESS ANALYSIS

ERIC A. POSNER†

## ABSTRACT

*Recent scholarship on regulatory oversight has focused on cost-benefit analysis of prescriptive regulations—regulations that restrict behavior such as pollution—and their use to cure market failures, and has overlooked the vast number of transfer regulations. Transfer regulations are regulations that channel funds to beneficiaries. These regulations are authorized by statutes that establish entitlement programs like Medicare and Social Security, pay one-time distributions to victims of misfortunes such as natural disasters and the 9/11 terrorist attack, and fund pork barrel spending. Cost-benefit analysis cannot be used to evaluate transfer regulations because all transfer regulations fail cost-benefit analysis; cost-effectiveness analysis, however, can be used to evaluate transfer regulations. Although executive orders appear to require agencies to use cost-effectiveness analysis to evaluate transfer regulations that have a large economic impact, the agencies' record is dismal. Most agencies fail to perform cost-effectiveness analysis, and other agencies perform cost-effectiveness analysis incorrectly. More vigorous Office of Management and Budget and, possibly, judicial review could improve the quality of distributive regulations.*

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† Kirkland & Ellis Professor of Law, University of Chicago. Thanks to Matthew Adler, John Duffy, Beth Garrett, Tom Merrill, Arti Rai, Cass Sunstein, and Adrian Vermeule for their comments, and to J.T. Bloch for research assistance. The Sarah Scaife Foundation Fund and The Lynde and Harry Bradley Foundation Fund provided financial support.

## INTRODUCTION

Every year the Office of Management and Budget (OMB) sends a report to Congress that discusses federal regulations reviewed by OMB during the prior year.<sup>1</sup> These reports include a calculation of the aggregate costs and benefits of most major or significant regulations, so that Congress and the public may be given a sense of the welfare impact of regulatory policy. But excluded from this calculation is a class of regulations that OMB calls “agency transfer rules.”<sup>2</sup> The draft 2003 OMB report lists twenty-five such rules, issued by a diverse group of agencies, including Agriculture, Defense, Health and Human Services, and Transportation.<sup>3</sup> The 2002 OMB report lists seventy-two rules issued over an eighteen-month period.<sup>4</sup> Most of these rules implemented a congressional authorization or mandate to spend money. An appropriation statute would provide that a certain amount of money be given to farmers, or dairy producers, or victims of the 9/11 attack, and would direct an agency, in very general language, to give the money to the intended beneficiaries. Other transfer rules were issued pursuant to entitlement programs such as Medicare or Social Security. Agencies charged with the task of distributing money under these programs issued regulations that specified who would receive money, how much the person would receive, and how one should apply for it.

OMB has not explained why it excludes transfer regulations from the calculation of the aggregate net benefits of federal regulation, but the reason is clear. Ordinary regulations aim to correct market failures, and a regulation that successfully corrects a market failure generates social value. Cost-benefit analysis distinguishes regulations that generate social value and those that do not, and an aggregate cost-benefit analysis of all federal regulations reveals whether the

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1. The most recent published report is OFFICE OF MGMT. & BUDGET, STIMULATING SMARTER REGULATION (2002) [hereinafter 2002 OMB REPORT], available at [http://www.whitehouse.gov/omb/inforeg/2002\\_report\\_to\\_congress.pdf](http://www.whitehouse.gov/omb/inforeg/2002_report_to_congress.pdf). The draft report for 2003 can be found at Office of Mgmt. & Budget, Draft 2003 Report to Congress on the Costs and Benefits of Federal Regulations, 68 Fed. Reg. 5,492 (Feb. 3, 2003) [hereinafter Draft 2003 OMB Report]. The reports also discuss regulations issued by independent agencies, make proposals for regulatory reform, and discuss related matters. The 2002 OMB REPORT covers eighteen months. All of the reports can be downloaded from [http://www.whitehouse.gov/omb/inforeg/regpol-reports\\_congress.html](http://www.whitehouse.gov/omb/inforeg/regpol-reports_congress.html) (last visited Dec. 15, 2003).

2. See, e.g., 2002 OMB REPORT, *supra* note 1, at 36 n.30.

3. Draft 2003 OMB Report, *supra* note 1, at 5,479.

4. 2002 OMB REPORT, *supra* note 1, at 5,497.

regulations as a group increase or decrease efficiency. Transfer regulations, unlike ordinary market-correcting regulations, are not designed to generate value in the economic sense. A transfer regulation that pays \$100 to farmers also costs taxpayers \$100; the costs and benefits wash out, producing a social loss if administrative costs are greater than zero, as they always are. Thus, a conventional cost-benefit analysis of a transfer regulation will always yield a negative outcome. Treating every transfer regulation as a social cost, and subtracting the costs of transfer regulations from the net benefits of ordinary regulations, would not reveal anything about the quality of agency rulemaking. Rather it would indicate that Congress has decided to use agencies to implement transfers, something that is already known. The purpose of the OMB reports is not to tell Congress that agencies implement transfers; it is to tell Congress about the quality of agency rulemaking.

But this does not mean that transfer regulations cannot be evaluated. The difference between an ordinary regulation and a transfer regulation is, on a rough approximation (to be refined below), that the transfer regulation achieves a distributional goal or outcome mandated by Congress. Ordinary cost-benefit analysis cannot be used for evaluating a transfer regulation, but cost-benefit principles can be used. The term of art for a cost-benefit analysis that takes distributional goals as fixed and evaluates the means for achieving them is *cost-effectiveness analysis*, a decision procedure that is used widely by policy analysts outside the government.<sup>5</sup> Cost-effectiveness analysis is a procedure for comparing the different means for achieving a given regulatory end; it identifies the least costly means as the most cost-effective.

Cost-effectiveness analysis is the correct decision procedure for evaluating transfer regulations. The main reason for using cost-effectiveness analysis is that a cost-effective regulation will more cheaply achieve the regulatory goal than a cost-ineffective regulation. This point can be made in two ways: Given a regulatory goal like providing lunches to schoolchildren, a cost-effective regulation will cost less (say \$20 million) than a cost-ineffective regulation (say \$30 million) while providing the same lunches to the same children. Alternatively, given a fixed cost (say \$25 million), a cost-effective regulation will provide lunches to more schoolchildren than a cost-

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5. It is used frequently for evaluating regulations of medical practices; see *infra* Part II.A. for an example.

ineffective regulation. Although many alternative regulations will be difficult to compare because they affect different people in different ways, monetization of benefits, akin to the practice of cost-benefit analysis, can be used to make comparison possible.<sup>6</sup>

A subordinate but also important goal of cost-effectiveness analysis is regulatory transparency. Agencies have many advantages over their nominal overseers such as executive branch officials, members of Congress, and judges: agencies set the regulatory agenda within their domain and also have more information about the effects of different kinds of regulation. To the extent that agency officials have goals or values that differ from those of their superiors, or are especially vulnerable to interest group pressure, they may choose regulations that their principals would not choose. By requiring agencies to perform cost-effectiveness analysis of their regulations and report the results, the principals can force agencies to divulge information in a digestible form, thus reducing the agencies' ability to regulate in ways that the principals would not like.<sup>7</sup>

Executive Order 12,866<sup>8</sup> requires agencies to use cost-benefit analysis or cost-effectiveness analysis when evaluating regulations, whichever is appropriate.<sup>9</sup> Its reference to cost-effectiveness analysis is explicit: "When an agency determines that a regulation is the best available method of achieving the regulatory objective, it shall design its regulations in the most cost-effective manner to achieve the regulatory objective."<sup>10</sup> The same language can be found in the executive order's predecessor, Executive Order 12,291,<sup>11</sup> which was signed by President Reagan in 1981.<sup>12</sup> These executive orders, and some other related executive orders and statutes, have caused a significant shift in the practices of regulatory agencies, and over the last two decades it has become standard practice for agencies to perform and report cost-benefit analyses for important regulations

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6. For a discussion of cost-benefit analysis, see Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165 (1999).

7. In this way, cost-effectiveness analysis reduces agency costs (in the economic sense) in the same way that cost-benefit analysis does. See Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137, 1140-42 (2001) (arguing that cost-benefit analysis saves costs by "ensur[ing] that elected officials maintain power over agency regulation").

8. Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Oct. 4, 1993).

9. *Id.* at 51,735-36.

10. *Id.* at 51,736.

11. Exec. Order No. 12,291, 46 Fed. Reg. 13,193 (Feb. 19, 1981).

12. *Id.* at 13,193.

other than transfer regulations.<sup>13</sup> OMB reviews agencies' cost-benefit analyses and issues guidelines for good practice, as well as drafts the reports to Congress discussed above.<sup>14</sup> With the prodding of OMB, the agencies' cost-benefit analyses have gradually improved. These regulatory changes have in turn generated an enormous academic literature on cost-benefit analysis and its influence on regulatory outcomes.<sup>15</sup>

There has been no comparable activity with respect to transfer regulations. Agencies that implement transfer regulations recognize that Executive Order 12,866 applies, but they rarely provide the cost-effectiveness analysis that the executive order requires. Although agencies do, usually, say something about the costs of a regulation, their comments are rarely illuminating and often incoherent. Some agencies simply state that the regulation complies with the executive order without further elaboration.<sup>16</sup> Other agencies provide only the amount of the disbursement.<sup>17</sup> Still other agencies do perform, or claim to perform, a cost-effectiveness analysis, but in fact make claims inconsistent with cost-effectiveness principles.<sup>18</sup> OMB does not appear to engage in a strict review, as it does for cost-benefit analysis of ordinary, nontransfer regulations;<sup>19</sup> and, as noted above, its annual

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13. ROBERT W. HAHN & MARY BETH MUETHING, AM. ENTERPRISE INST.-BROOKINGS JOINT CTR. FOR REGULATORY STUDIES, *THE GRAND EXPERIMENT IN REGULATORY REPORTING* 3–5 (2003).

14. For information on OMB's activities, see its website at <http://www.whitehouse.gov/omb/inforeg/regpol.html> (last visited Dec. 15, 2003).

15. See, e.g., STEPHEN BREYER, *REGULATION AND ITS REFORM* 4–7, 111, 117 (1982) (creating a general framework for analyzing agencies and noting instances of cost-benefit analyses and how they are often prepared to support agency decisions already reached); CASS SUNSTEIN, *RISK AND REASON* 19–22 (2002) (describing the rise of cost-benefit analysis and its effect on agencies). Neither of these books mentions transfer regulations or says much about cost-effectiveness analysis. Nor can one find discussions in the major case books.

16. See, e.g., Disaster Assistance; Cerro Grande Fire Assistance, 66 Fed. Reg. 15,948, 15,958 (Mar. 21, 2001).

17. See, e.g., New Markets Venture Capital Program, 66 Fed. Reg. 28,602, 28,608–09 (May 23, 2001) (describing the Small Business Association's and applicants' administrative costs for a loan guarantee program); Wool and Mohair Market Loss Assistance Program and Apple Market Loss Assistance Program, 66 Fed. Reg. 13,839, 13,840–41 (Mar. 8, 2001) (describing the amounts to be paid to various producers).

18. See *infra* Part III for examples.

19. There is some evidence that OMB has recently decided to pressure agencies to perform cost-effectiveness analysis on transfer regulations. See Letter from John D. Graham, Administrator, Office of Information and Regulatory Affairs, OMB, to Hon. Hector H. Barreto, Administrator, SBA, at [http://www.whitehouse.gov/omb/inforeg/sba\\_eidl-rtnltr.html](http://www.whitehouse.gov/omb/inforeg/sba_eidl-rtnltr.html) (Feb. 11, 2002) (on file with the *Duke Law Journal*) (sending a rule back to the SBA for cost-effectiveness analysis); Letter from John D. Graham, Administrator, Office of Information and

reports to Congress do not discuss the quality of the cost-effectiveness analyses performed by agencies during the prior year. The academic literature on transfer regulations is nil.

What explains the contrast between the intensity of interest in cost-benefit analysis of regulations designed to solve market failures, and cost-effectiveness analysis of transfer regulations? OMB says nothing about this topic in its reports to Congress: it lists the transfer regulations without explaining why their costs and benefits are not discussed. A separate document, the Best Practices Guidelines, implies without saying explicitly that transfer regulations are not susceptible to cost-benefit analysis because cost-benefit analysis is not designed to evaluate transfers.<sup>20</sup> But the obvious rejoinder, that cost-effectiveness analysis can be used to evaluate transfer regulations, is not discussed. In short, there has been virtually no discussion—not by OMB or the agencies, not by academics—about the use of cost-effectiveness analysis to evaluate transfer regulations that disburse money or other benefits to specified groups.

This Essay is a first effort to fill this gap. Part I defines transfer regulations and discusses their purposes and effects. Part II discusses cost-effectiveness analysis and explains how it can be used to evaluate both transfer regulations and the statutes that authorize transfer regulations. Part III provides some examples of how agencies evaluate transfer regulations. Agencies sometimes claim to perform cost-effectiveness analysis on transfer regulations, but they rarely perform it correctly. Throughout, it should be understood that there

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Regulatory Affairs, OMB, to Hon. Bill Hawks, Undersecretary for Marketing and Regulatory Programs, United States Department of Agriculture, at [http://www.whitehouse.gov/omb/inforeg/usda\\_ee\\_for\\_nonhuman\\_primates\\_rtltr012902.html](http://www.whitehouse.gov/omb/inforeg/usda_ee_for_nonhuman_primates_rtltr012902.html) (Jan. 29, 2002) (on file with the *Duke Law Journal*) (sending proposed policy back to USDA for cost-effectiveness analysis). The Draft 2003 OMB Report contains greater attention to cost-effectiveness analysis than in the past, see Draft 2003 OMB Report, *supra* note 1, at 5,499–503, but the context suggests that OMB has cost-effectiveness analysis of market-correcting regulations in mind, not of transfer regulations. In addition, the administrator of Medicare has recently decided to use cost-effectiveness analysis to evaluate Medicare coverage. See Robert Pear, *U.S. Limiting Costs of Drugs for Medicare*, N.Y. TIMES, Apr. 21, 2003, at A1 (describing how the Bush administration has begun to weigh cost as a factor in deciding whether Medicare should pay for new drugs and medical procedures).

20. See OFFICE OF MGMT. & BUDGET, ECONOMIC ANALYSIS OF FEDERAL REGULATIONS UNDER EXECUTIVE ORDER 12866 § III(c)(2), at <http://www.whitehouse.gov/omb/inforeg/print/riaguide.html> (1996) (on file with the *Duke Law Journal*) (“While transfers should not be included in the [executive order’s] estimates of the benefits and costs of a regulation, they may be important for describing the distributional effects of a regulation.”).

is no presumption that transfer regulations are undesirable; they can be used to good and bad ends, just like any other kind of regulation.

## I. WHAT ARE TRANSFER REGULATIONS?

### A. *A Typology of Regulations*

Regulations, as Table 1 shows, can be divided into two types: prescriptive regulations and transfer regulations. Prescriptive regulations are rules that place restrictions on behavior; examples include rules that restrict factory emissions, mandate safe workplaces, and require testing before drugs are marketed. Transfer regulations are rules that distribute money and other resources to firms or individuals. A regulation that distributes cash to victims of a natural disaster is a transfer regulation. However, transfer regulations do not always involve the disbursement of cash. Some transfer regulations distribute in-kind benefits such as food stamps, housing, or licenses to use the radio spectrum. The Appendix lists significant transfer regulations reviewed by OMB between April 1 and September 30, 2001.<sup>21</sup>

TABLE 1  
TYPES OF REGULATIONS

Type	Definition	Example
Prescriptive	A regulation that restricts behavior	Limitation on emission of a pollutant
Transfer	A regulation that transfers money or goods to beneficiaries	Distribution of funds to victims of a natural disaster

The regulations on OMB's list are diverse. They govern application procedures and eligibility criteria for cash relief for farmers whose crops have been destroyed by bad weather or driven from the market by foreign competition; the ingredients of the national school lunch and breakfast program; Medicare

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21. The list includes “[s]ignificant regulatory action[s]” under Exec. Order No. 12,866, 58 Fed. Reg. 51,735, 51,738 (Oct. 4, 1993), which are regulations that have an impact of at least \$100 million; “major” rules under the Congressional Review Act, 5 U.S.C. § 804(2) (2000); and rules above the threshold of the Unfunded Mandates Reform Act, 2 U.S.C. §§ 1531–1538 (2000).

reimbursement for the cost of self-management training for diabetics; prescription drug benefits for military personnel; disability criteria for children in the Social Security system; affirmative action reporting requirements for government contractors; disaster relief; and requirements for receiving certain small business loans.<sup>22</sup> The thread running through the regulations on OMB's list is that they are authorized by a congressional appropriation or budgetary statute, or a statute that establishes an entitlement program.

The purposes of regulation can be divided into two categories: correcting market failures and redistributing wealth. For example, a pollution regulation corrects a market failure, and a regulation that reimburses farmers who lost crops redistributes wealth. One might be tempted to generalize from these examples and conclude that all prescriptive regulations are designed to correct market failures and all transfer regulations are designed to redistribute resources to favored groups. But although this assumption is roughly true as an empirical matter, it is not an analytic truth. A transfer regulation can be designed to improve efficiency, and a prescriptive regulation can be designed to transfer resources to a group.

Consider, for example, a regulation that implements a congressional appropriation for monetary relief to victims of a natural disaster. This regulation looks like a straightforward transfer of money from the government to individuals, but it might be justified by a failure in the insurance market. If the insurance market fails to provide disaster insurance, the government might be justified in providing that insurance. One way to provide such insurance is to wait for a disaster to occur and then make payments to victims. If, as seems likely, people anticipate these transfers *ex ante*, then the regulation (in theory) enhances efficiency by enabling people to pool risk.

As for prescriptive regulations that serve distributional purposes, consider regulations that implement a congressional plan to support farm prices through a quota system. The regulations do not transfer money to farmers, but rather limit the amount of production. Yet through the limitation on production, prices are increased and farmers are benefited. Although the regulation prescribes behavior, it serves a distributional aim, not efficiency.

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22. See the Appendix, *infra*.

*B. The Appropriate Decision Procedure*

To bring order to this confusion, one needs to make a number of distinctions, as shown in Table 2.

TABLE 2  
PURPOSES OF REGULATIONS

Type of Regulation	Purpose of Regulation		
	Efficiency		distribution
	benefit specified by statute	benefit not specified by statute	
Prescriptive	cost-effectiveness	cost-benefit	cost-effectiveness
Transfer	cost-effectiveness	∅	cost-effectiveness

There are two types of regulations—prescriptive and transfer—and two broad types of statutory goals—to increase efficiency and to make distributions. Within the category of efficiency-oriented statutes, some statutes state that the regulations should achieve relatively abstract benefits—public health, for example—and other statutes specify a concrete benefit, such as reduction in the emission of a particular pollutant.

Cost-benefit analysis can be used only to evaluate prescriptive regulations authorized by statutes that do not specify the distribution in detail. A pollution statute that directs an agency to enhance public health gives the agency the discretion to choose among alternative regulations on the basis of their efficiency;<sup>23</sup> a pollution statute that directs an agency to limit pollution to a certain level does not give the agency the option to refrain from regulating when the statutory level is itself inefficient. Thus, cost-benefit analysis cannot be used in the latter case, though cost-effectiveness analysis can be used to distinguish among more or less costly ways to achieve the statutory level of pollution.

Cost-benefit analysis cannot be used to evaluate transfer regulations that are issued pursuant to a statute that is designed to

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23. Unless the statute mandates a minimum level of regulation when any amount of regulation is inefficient.

enhance efficiency. Consider a statute that funds general scientific research on the theory that the market undersupplies such research. An agency is directed to issue transfer regulations that provide the rules for applying for grants. The statute might or might not have the effect of enhancing efficiency through regulation, but the agency cannot veto the statute, so there is no point in doing a cost-benefit analysis of the entire statutory scheme. The agency can only do cost-effectiveness analysis, which will reveal whether a given regulation is less costly than alternative regulations for accomplishing the statutory goal of converting money into knowledge.

When one turns to statutes that have distributional aims, one sees that neither prescriptive regulations nor transfer regulations can be evaluated using cost-benefit analysis. Again, when a statute specifies a distribution, cost-benefit analysis cannot be used. But cost-effectiveness analysis is appropriate, as will be seen.

Statutory distributional schemes generally have two distinct purposes. The first purpose is to benefit a politically influential group, such as dairy producers or tobacco farmers. No serious scholar defends these transfers, and their unattractiveness might explain why the academic literature has ignored them. The implicit assumption seems to be that if these transfers are bad, then the regulations that implement them are bad, and there is no reason to discuss how to make them cost-effective. This response, however, is wrong. Even if politically motivated transfers are regrettable, they are a fact of life, and it is an important task to analyze how to implement them in a way that minimizes their disruptive impact on the economy.

The second purpose of transfer regulations is to benefit poor people, people who suffer from discrimination, and people who have suffered a misfortune. Social Security, Medicare, and Medicaid authorize transfer regulations that provide benefits to the poor and not-so-poor. Regulations implementing affirmative action programs for government contractors benefit victims of discrimination.<sup>24</sup> The regulations governing both the disbursements of 9/11 moneys and moneys for natural disasters benefit victims of a misfortune.<sup>25</sup>

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24. *See, e.g.*, Participation by Disadvantaged Business Enterprises in Procurement Under Environmental Protection Agency (EPA) Financial Assistance Agreements, 68 Fed. Reg. 43,823, 43,824 (proposed July 24, 2003) (to be codified at 40 C.F.R. pts. 30, 31, 33, 35, 40) (describing the EPA's efforts to ensure its affirmative action program is in line with decisions of the United States Supreme Court).

25. *See, e.g.*, September 11th Victim Compensation Fund of 2001, 28 C.F.R. § 104 (2003) (outlining the final rules regarding the disbursement of funds to victims of the attacks).

Although market-correcting rationales are sometimes given for these programs, their thrust seems to be redistributive. Regulations are needed because Congress does not want to determine every detail about how funds are allocated and disbursed; that is why Congress transfers these functions to an agency. Limited transfers to poor and unfortunate people are relatively uncontroversial, and it is thus a puzzle that the question of how to evaluate agency regulations that implement these transfers has been neglected by legal scholars.

Distributional statutes, then, are sometimes normatively defensible and sometimes not. But it is important to see that prescriptive regulations and transfer regulations authorized by distributional statutes all fail a standard cost-benefit analysis, that is, one that does not use a multiplier to adjust for the lower purchasing power of the poor.<sup>26</sup> When a regulation disburses cash, the benefits can be no greater than the costs, and will be lower as long as there is some administrative cost. Consider a payment of \$100 to a dairy producer. The benefit of the regulation is \$100, and the cost of the regulation is \$100 plus administrative expenses (and tax distortions if such is the case). This remains true for transfers to the poor. The benefit of a \$100 transfer to a poor person is \$100, and the cost is \$100 plus administrative expenses. It is true that a poor person is likely to value \$100 more than a rich person (or dairy producer) is, but such differences are excluded from cost-benefit analysis as it is usually performed.<sup>27</sup> Cost-benefit analysis does not take account of the fact that the poor person values \$100 more than the rich person does. Thus, cost-benefit analysis will also conclude that transfers to interest groups and poor people produce negative net benefits; it does not allow one to distinguish between these types of transfers, and it does not allow one to distinguish between better and worse regulations given a particular distributional goal.

In sum, cost-benefit analysis cannot be used to evaluate transfer or prescriptive regulations that have distributional aims, or to

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26. At one time economists believed that multipliers could be used to reflect variation in the valuation of marginal dollars by people of different wealth, but this project foundered on technical, empirical, and philosophical difficulties. For a brief discussion, see HARVEY S. ROSEN, *PUBLIC FINANCE* 259–60 (3d ed. 1992).

27. There are some limited exceptions. *See, e.g.*, Matthew D. Adler & Eric A. Posner, *Implementing Cost-Benefit Analysis When Preferences Are Distorted*, 29 *J. LEGAL STUD.* 1105, 1136–37 (2000) (analyzing cost-benefit analyses where the marginal utility of money based on wealth is factored in); Adler & Posner, *supra* note 6, at 194–97 (describing the need to factor in distorted preferences, such as those that arise from wealth differences, when performing cost-benefit analyses).

evaluate transfer regulations that implement statutes with efficiency goals that do not leave the benefit or distribution decision to agencies. For all these purposes, cost-effectiveness analysis is necessary. The next Part focuses on the simplest case—the use of cost-effectiveness analysis to evaluate transfer regulations authorized by statutes with distributional goals—though most of what is said will apply to the other cases as well.

## II. ANALYSIS OF TRANSFER REGULATIONS AND STATUTES

### A. *Analysis of Regulations*

A cost-effective transfer regulation distributes resources less wastefully than alternative transfer regulations do. To take a simple example, consider a statute that authorizes an agency to distribute \$10 million to victims of a natural disaster. The agency considers two transfer regulations. The first provides a lump sum payment of \$1,000 to each of the 10,000 people living in the affected area. The second requires individuals to apply for reimbursement of their losses and to provide evidence of the losses. The first regulation will overcompensate some people and undercompensate others, but it will save administrative costs. The second regulation will provide more accurate compensation, but will also generate sizable administrative costs. A cost-effectiveness analysis permits comparison of the two regulations. The more cost-effective regulation is the one that provides the fullest compensation to the most people—the first regulation if the natural disaster caused everyone about the same amount of harm greater than or equal to \$1,000; the second regulation if the disaster affected people unequally and proof is not too costly because records are complete and losses can be easily computed.

Cost-effectiveness analysis comes in many flavors. Some decisionmakers evaluate medical interventions by taking as fixed the goal of increasing “quality adjusted life years” (QALY), and comparing medical interventions on the basis of the ratio of QALYs saved to cost. A quality adjusted life year is a measure that represents the value to a person of living a year with a medical condition that degrades the quality of life. A government medical agency with a fixed budget and the mandate to increase QALYs will purchase medical devices with higher QALY/cost ratios until the budget is

exhausted.<sup>28</sup> The budgetary outlay and the mandate to maximize QALYs are fixed; cost-effectiveness analysis tells the agency which medical devices maximize QALYs given the budgetary constraint.

Another example of cost-effectiveness analysis comes from its use to evaluate environmental projects. Suppose that a certain environmental goal—a reduction of air pollution, for example—is provided by statute, but the agency is given the discretion to choose among means. The agency can mandate the washing of coal prior to its use in power plants, or the use of scrubbers attached to smokestacks, or some combination; or it can choose to put limits on the amount of pollution generated by factories while allowing factory owners to choose among different technologies; or it can create a system of tradable emission permits; or it can choose some other rule or framework for achieving the ends set by statute.<sup>29</sup> For a given reduction of air pollution, each regulatory instrument will have a different cost. Cost-effectiveness analysis compares the costs of the different means and identifies the least-cost means as the most cost-effective.<sup>30</sup>

A third example of cost-effectiveness analysis is its use to evaluate income redistribution programs. The goal is redistribution of wealth from rich to poor; the constraint is the willingness of taxpayers to pay for the redistribution. The policy analyst must evaluate different mechanisms, none of which is perfect. Tax and transfer systems, for example, require administratively costly determinations of need or else result in the inclusion of wealthy people with low income or the exclusion of poor people with higher incomes (for example, because they have many children or high medical costs). Minimum wage laws are less complex, but they exclude nonworkers and may hurt low-income workers. Tax and transfer systems distort

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28. See, e.g., Robert Fabian, *The Qaly Approach*, in VALUING HEALTH FOR POLICY: AN ECONOMIC APPROACH 118, 118–19 (George Tolley et al. eds., 1994); Arti K. Rai, *Rationing Through Choice: A New Approach to Cost-Effectiveness Analysis in Health Care*, 72 IND. L.J. 1015, 1048–52 (1997). For an example from the medical literature, see Daniel Polsky et al., *Economic Evaluation of Breast Cancer Treatment: Considering the Value of Patient Choice*, 21 J. CLINICAL ONCOLOGY 1139, 1139 (2003).

29. See LAWRENCE H. GOULDER ET AL., THE COST-EFFECTIVENESS OF ALTERNATIVE INSTRUMENTS FOR ENVIRONMENTAL PROTECTION IN A SECOND-BEST SETTING 1–3 (Nat'l Bureau of Econ. Research, Working Paper No. 6464, 1998) (analyzing the costs of various methods to reduce pollution).

30. For a well-known example, see BRUCE A. ACKERMAN & WILLIAM T. HASSLER, CLEAN COAL/DIRTY AIR 66–72 (1981) (arguing that the most cost-effective, short-term method for reducing air pollution from coal involves coal washing, not factory scrubbing).

labor-leisure choices; minimum wage laws impose deadweight costs on consumers or shareholders. A cost-effectiveness analysis cuts through these apparent incommensurables and shows that tax and transfer systems are likely to be superior: holding constant the payments to beneficiaries, they result in lower social cost.<sup>31</sup>

The basic idea behind cost-effectiveness analysis is that of comparing alternative regulations or projects when either the costs or the benefits are fixed.<sup>32</sup> The right form of cost-effectiveness analysis depends heavily on the statutory goal. Suppose, for example, that Congress appropriates \$100 million and authorizes the United States Department of Agriculture (USDA) to spend it on lunches for needy schoolchildren. Consider three alternative regulations: (1) give the money to schools in poor census districts; (2) give the money to schools in proportion to the number of needy students in each school; or (3) give school lunch vouchers to parents whose family income falls below the poverty line.<sup>33</sup>

Each alternative has different costs. Under (1), USDA must process applications from schools and monitor their behavior to ensure that the money is used to buy lunches, but this approach avoids the need to determine the poverty level of individual students. Under (2), USDA deals with a larger number of schools and engages in more intensive monitoring, but it will also deliver lunches to more poor students. Under regulation (3), USDA must print and distribute vouchers and ensure that they are used properly, but it will also reach children who are not at school, and children at schools that fail to apply for school lunch benefits. The regulations provide, respectively, increasing accuracy at increasing cost.

Cost-effectiveness analysis of these alternatives can be illustrated with a few numbers. If USDA itself paid all of the administrative costs (including those of the schools and parents) from the appropriation, the calculation would be simple. Just choose the regulation that gets the most lunches to needy children. If, as is more likely, USDA's administrative costs come from another appropriation, and schools and parents must absorb their own

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31. EDWARD M. GRAMLICH, *BENEFIT-COST ANALYSIS OF GOVERNMENT PROGRAMS* 123-33 (1981).

32. I follow the simple discussion in EDITH STOKEY & RICHARD ZECKHAUSER, *A PRIMER FOR POLICY ANALYSIS* 153-55 (1978).

33. This example is based loosely on the regulation discussed *infra* in Part III.B.

administrative costs, then a slightly more complex calculation is needed, as illustrated by Table 3.

TABLE 3  
SCHOOL LUNCH EXAMPLE—APPROPRIATION FIXED

Reg.	Lunches to Needy Children	Lunches to Other Children	Total Admin. Costs	Approp. + Admin. Costs	Cost per Lunch to Needy Child
<b>(1)</b>	15 million	5 m.	\$10 m.	\$110 m.	<b>\$7.33</b>
<b>(2)</b>	18 m.	2 m.	\$20 m.	\$120 m.	<b>\$6.67</b>
<b>(3)</b>	19 m.	1 m.	\$30 m.	\$130 m.	<b>\$6.84</b>

The cost of a regulation includes all its costs, not just the costs directly incurred by the agency. If beneficiaries, such as families, or intermediaries, such as schools, must incur costs in order to receive the benefits, then their costs must be included in the cost-effectiveness analysis. As such, the fifth column of Table 3 lists the combined cost of each regulation. Dividing the combined cost of each regulation by the number of beneficiaries under each regulation—the number of needy children listed in the second column—yields the average cost of delivering a lunch to a needy child (column six). According to this column, regulation (2) is the most cost-effective: it sends lunches to needy children at the least cost per child.

Congress might alternatively pass a statute that directs USDA to provide lunches for, say, 20 million needy children, to be paid out of a general appropriation. Again, USDA would come up with various alternative regulations, and then it would compare them, as in Table 4.

TABLE 4  
SCHOOL LUNCH EXAMPLE—BENEFIT FIXED

Reg.	Lunches to Needy Children	Lunches to Other Children	Total Admin. Costs	Cost of Lunches (\$5 per lunch)	Cost per Lunch to Needy Child
(1)	20 million	8 m.	\$13 m.	\$140 m.	<b>\$7.65</b>
(2)	20 m.	4 m.	\$23 m.	\$120 m.	<b>\$7.15</b>
(3)	20 m.	1.5 m.	\$33 m.	\$107.5 m.	<b>\$7.03</b>

All three of the regulations provide the same benefits (second column). The most cost-effective regulation is regulation (3) because it costs least per lunch to deliver these benefits (last column).

I have simplified in order to convey the basic principles of cost-effectiveness analysis. A few observations are now necessary. First, note the difference between cost-benefit analysis and cost-effectiveness analysis. All of these regulations would fail a standard cost-benefit analysis, because a transfer to needy children is not a “benefit” in the conventional economic sense—it’s just a transfer. The cost to the taxpayer offsets the benefit to the needy child, and the administrative costs are a deadweight loss. To fulfill the congressional mandate to transfer resources to needy children, USDA could not use cost-benefit analysis.

Second, the cost-effectiveness analysis, as I have performed it, assumes that the value of getting a lunch to a non-needy child is zero. This might be a reasonable assumption, but it also might not be true. Congress could worry that non-needy children do not always have nutritional lunches and want to remedy this situation. Thus, a more accurate cost-effectiveness analysis might attach some weight to a lunch received by a non-needy child—say, 10 percent of the value of a lunch to a needy child—and the agency could use this weighting in the cost-effectiveness analysis; it should also make the weighting explicit, so that elected officials would know the basis of the decision. In some situations, this might produce different results—regulation (1) might be better than regulation (2) or regulation (3)—but it also seems reasonable for the agency to take its lead from Congress, and not attach value to the receipt of lunches by non-needy children unless Congress says otherwise.

Third, one might argue in the first example that the choice of regulation (2) defeats Congress's purpose: Congress wants to get as many lunches to needy children as possible, and for that purpose regulation (3) is better, even if more costly per lunch. But it would be better for USDA to return to Congress and ask for a larger appropriation, so that 19 million needy children would be benefited using regulation (2), explaining that the extra budgetary expense is less than the administrative costs under regulation (3).

Fourth, one should note that Congress could choose different ends—at a higher or lower level of abstraction. Congress could ask USDA to ensure that all children have adequate nutrition, understanding that poorer children need more aid. Congress could give USDA the option to provide school breakfasts as well as lunches, or more food stamps, or cash assistance, or educational programs about good eating habits, and so forth. Congress might also stipulate the nutritional content of the lunches, or leave that decision up to USDA. The more discretion that USDA has, the more complex the cost-effectiveness analysis will be. As the level of abstraction increases, cost-effectiveness analysis becomes the same as cost-benefit analysis.

One problem with using cost-effectiveness analysis to evaluate transfer regulations is that if the underlying transfer statute itself is bad, then one is firmly in the world of the second best, and cost-effectiveness analysis might have perverse effects. Consider a statute that appropriates \$100 million for dairy producers because of their political influence and not because of any legitimate need. A highly cost-effective statute will result in more money in the pockets of the dairy producers and less squandered on administrative expenses, but that just means more slops in the political trough, and more lobbyists sidling up to it.<sup>34</sup> (This problem is not as severe for regulations that survive cost-benefit analysis.<sup>35</sup>) Cost-effectiveness is not an ultimate moral value; the social value of even a highly cost-effective regulation depends on the social value of the statutory program that it implements. For that reason, it might be desirable for agencies to

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34. Cf. Gary Becker & Casey Mulligan, *Deadweight Costs and the Size of Government*, 46 J. LAW & ECON 293 (1998).

35. Though there are some potential similar problems. See Posner, *supra* note 7, at 1163–65 (describing problems with cost-benefit analysis where, for example, the president transfers money to special interest groups simply to get elected).

evaluate the authorizing statute as well as the regulations. This is the topic of the next Section.

*B. Analysis of the Authorizing Statute*

When Congress authorizes a distribution to a particular group, agencies cannot usually prevent the distribution from occurring as intended.<sup>36</sup> But there are actions short of interference that might improve distributional outcomes and the political process that leads to them. Of special interest are reporting requirements, such as those created by the National Environmental Policy Act (NEPA),<sup>37</sup> which requires agencies to issue environmental impact statements.<sup>38</sup> Rather than banning activity that harms the environment, NEPA requires agencies to estimate and report the environmental impact of projects such as the construction of highways.<sup>39</sup> Opponents of the regulation cannot seek relief from a court unless an agency fails to issue an adequate environmental impact statement. If the environmental impact statement is adequate, opponents must take their case to elected officials and seek a political remedy.

Agencies that issue transfer regulations could similarly be required to report the welfare costs and distributional effects of these regulations—that is, to issue “welfare impact statements.” If the welfare impact is objectionable, then critics can bring this information

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36. I put aside the controversy over whether the president or agencies have the authority to refuse to spend appropriated moneys. Regarding presidential impoundment, see *Train v. City of New York*, 420 U.S. 35, 49 (1975). See also Ralph S. Abascal & John R. Kramer, *Presidential Impoundment Part I: Historical Genesis and Constitutional Framework*, 62 GEO. L.J. 1549, 1549 (1974) (describing the history of the federal budgetary system and concluding that the executive cannot derive impoundment authority from statutes); Ralph S. Abascal & John R. Kramer, *Presidential Impoundment Part II: Judicial and Legislative Responses*, 63 GEO. L.J. 149, 149 (1974) (describing the courts' undue deference to the executive and the probable impact of the Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (codified as amended at 2 U.S.C. §§ 681–688 (2000))). Regarding the line item veto, see Elizabeth Garrett, *Accountability and Restraint: The Federal Budget Process and the Line Item Veto Act*, 20 CARDOZO L. REV. 871, 872–74 (1999) (arguing that the Act was inappropriately analyzed by the Supreme Court, and that the Act should be constitutionally viewed as a congressional delegation to the president of the power to withhold all spending, regardless of the form of the spending). See also J. Gregory Sidak, *The President's Power of the Purse*, 1989 DUKE L.J. 1162, 1162 (1989) (arguing that the president has implied powers to get money from the treasury, even without congressional appropriation).

37. National Environmental Policy Act of 1969, Pub. L. No. 91-190, 83 Stat. 852 (1970) (codified as amended in scattered sections of 42 U.S.C.).

38. 42 U.S.C. § 4332(c) (2000).

39. There is no substantive review under NEPA.

to politicians and lobby for reform. The welfare impact statement would include the following information.

1. *Distribution of Benefits.* In 1999 Congress passed an appropriations bill that provided relief to dairy producers who had incurred large losses after the collapse of dairy prices. The bill directed USDA to give money to dairy producers, but did not say (a) which dairy producers would receive money, or (b) how much money each would receive.<sup>40</sup> USDA promulgated a transfer regulation that, among other things, distributed moneys to dairy producers on the basis of their production in 1997 and 1998. As I discuss in Part III.C, USDA used both years in order to avoid the cost of collecting new information from producers who had provided 1997 production figures when enrolled in the program the year before, but as a result, some firms, including firms that had stopped production, would receive payments even though they did not lose money in 1998 as a result of the market collapse.

The statement that accompanied the USDA's transfer regulation did not explicitly describe the distributive consequences, though they could have been inferred from the formula in the regulation by someone who had data about the structure of the industry. The agency had information about the industry and could have provided more detailed information about the distributional effects of the regulation. It could, for example, have broken down producers by size, and described the average level of compensation for each group of producers—both in absolute terms and as a percentage of each producer's loss. The agency could also have provided correlations between compensation level and other attributes, such as location, number of employees, and so forth.

The reason for requiring the agency to provide this information is that it facilitates monitoring of the agency by Congress, affected parties, and the public.<sup>41</sup> To the extent that agencies can provide a concise, numerical account of the distribution of benefits, Congress, relevant staffers, or committees can relatively easily check that the agency is acting consistently with statutory goals. If the agency is not,

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40. See *infra* Part III.C.

41. Regarding the effects of informational regulations, see SUNSTEIN, *supra* note 15, at 191–228.

Congress can in the future exercise greater oversight or enact more precise statutes.<sup>42</sup>

2. *Deadweight Costs.* It is possible that these distributional effects of the dairy market regulation, though not intended by Congress, could have been justified by a cost-effectiveness analysis, which would show that a more accurate distribution of benefits would have entailed excessive administrative costs. But even if this is the case, there is the further question whether the basic statutory goal of compensating dairy producers is desirable, given the inevitable welfare losses that accompany any distributional scheme. One might think that Congress took these costs into account when it enacted the statute, or that the agency has no basis for questioning Congress's decision in any event. But NEPA suggests a different view: Congress both authorizes agencies to approve projects that have harmful environmental impacts and requires agencies to issue a report describing these impacts. The reason is presumably to provide a check on agencies that focus too much on their mission and discount environmental concerns. Similarly, Congress could ask agencies both to redistribute wealth and to report the welfare distortions caused by redistribution.

In welfare economics, it is often said that a transfer does not have any efficiency effects, but this statement is a simplification that does not take account of so-called indirect costs. Every transfer requires taxation, and all taxation causes distortions. The \$200 million appropriated for dairy producers comes from the pockets of taxpayers, and will distort their choices between labor and leisure as well as other activities. There are standard, albeit rough, ways to measure this welfare loss, and the welfare loss could be reported by the agency.<sup>43</sup> Prescriptive regulations that redistribute wealth through market restrictions cause even greater distortions, which can also be calculated and reported.<sup>44</sup> In addition, the behavior of recipients of transfers can also be distorted as long as the transfer is not a surprise. The dairy industry knows that it will receive transfers from Congress when dairy prices collapse; as a result, producers do not allocate

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42. Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Oct. 4, 1993), already requires a discussion of distribution, *see id.* at 51,735–36, but agencies usually respond with boilerplate.

43. *See* ROSEN, *supra* note 26, at 305–22 (describing the concept of welfare loss and methods for measurement).

44. *See* GRAMLICH, *supra* note 31, at 123–33 (providing an analytical model for the distorting effects of wealth redistribution programs).

resources efficiently. Some should not be in business in the first place; others should diversify or take other steps to protect themselves against downturns. Every transfer reinforces the expectation that Congress will intervene in the future, and thus results in distortions. These distortions can be calculated and reported.

The reason for reporting this information is that Congress and the public might not know the economic cost of the transfers that have been authorized. The report of deadweight costs makes it explicit that the transfer of money to dairy producers and other interest groups has effects beyond the obvious distributional changes. People who are willing to tolerate the distributional changes might change their minds when they learn the accompanying deadweight cost. In many circumstances, there will not be the political will to repeal statutory transfers or resist enacting them in the first place, but greater public awareness of their costs might have a desirable effect on the margin.

3. *Pareto Superior Regulations.* As a supplement to the information on deadweight costs, an agency could propose a statutory scheme that is Pareto superior to the authorizing statute.<sup>45</sup> Frequently, this will be impractical or pointless, but in many cases the proposal would make clear the problems with the statute. For example, it is often the case that giving cash to beneficiaries is Pareto superior to using price controls or quantity limits. Consider a statutory program that benefits farmers by increasing prices and revenues through restrictions on production. If, instead, the quotas were eliminated and farmers were given cash equal to the implicit subsidy created by the quotas, there would be money left over for taxpayers or other beneficiaries.

One might imagine that when an agency proposes a quota regulation pursuant to a statute that provides for quotas, it will also report the Pareto superior statutory scheme. The report could be sent to Congress, which might then decide to stop the regulation and

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45. Cf. IVAN LITTLE, A CRITIQUE OF WELFARE ECONOMICS 86–88 (1950) (describing the rise of the Pareto approach and its relevance to social welfare analysis in the first half of the twentieth century); Stephen Coate, *An Efficiency Approach to the Evaluation of Policy Changes*, 110 *ECON. J.* 437, 437 (2000) (proposing an approach whereby different policy changes are compared for Pareto superiority).

appropriate money for the proposed transfer.<sup>46</sup> Although Congress might often refuse to enact the Pareto superior appropriation because of inertia, time constraints, or a desire to retain the disguise on the transfer, in some cases it might well prefer the Pareto superior appropriation, and act accordingly.

I have argued that regulatory oversight of transfer regulations would be improved if agencies reported three kinds of information: (1) the distributive effects of the regulation, (2) its welfare costs, and (3) any Pareto superior alternatives. As Part IV discusses, Executive Order 12,866 already authorizes the first type of reporting, and probably the other two as well, but a statute modeled on NEPA might also be desirable. Just as NEPA requires agencies to report the environmental impact of regulations without directly banning environmentally unsound regulations, the proposed statute would require agencies to report the welfare impact of regulations without directly banning distributively unjust regulations. The agency would, in effect, route opponents of the regulation to the political process.<sup>47</sup> The benefits to the political process could be expected to be similar to those that NEPA has produced.

There is, however, an important objection to reporting requirements. NEPA has, in practice, imposed considerable administrative and litigation costs on agencies. Environmentalists have used NEPA to delay and block regulations: Agencies frequently have decided that the administrative and litigation costs, and perhaps the political costs as well, are so high that an otherwise legal regulation is not worth defending.<sup>48</sup> The NEPA experience suggests that reporting requirements for transfer regulations might involve high administrative costs, and be used as a weapon against transfer regulations. Whether this is good or bad depends on how high the costs will be, and on what kinds of regulations are likely to be blocked. It is possible that reporting requirements can, in the

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46. A legislative veto is illegal, *INS v. Chadha*, 462 U.S. 919, 959 (1983), but informal pressure on the agency might be sufficient, or else a statutory injunction against the regulation would be necessary.

47. There are other programs designed to regulate through information disclosure; one prominent example is the toxics release inventory. See Madhu Khanna et al., *Toxics Release Information: A Policy Tool for Environmental Protection*, 36 J. ENVTL. ECON. & MGMT. 243, 243–45 (1998) (detailing the regulatory effect the disclosure of environmental information can have on firms and how firm behavior changes after such disclosures).

48. For a discussion of the high cost and low quality of lengthy NEPA reports, see Bradley C. Karkkainen, *Toward a Smarter NEPA: Monitoring and Managing Government's Environmental Performance*, 102 COLUM. L. REV. 903, 917–23 (2002).

American legal and political system, only generate either boilerplate (if the legal standard is low) or excessive litigation (if the legal standard is high), in which case reporting requirements for transfer regulations would be inadvisable. Much depends on whether there are groups that will monitor welfare impact statements and take agencies to court when they fail to issue adequate welfare impact statements, as environmental groups have done for environmental impact statements. Too much enthusiasm for litigation might lead to interference with normal agency functions; however, too little enthusiasm might again lead to statements containing nothing but boilerplate.

### *C. Mixed Regulations and Distributional Questions*

Many statutes authorize agencies to issue prescriptive regulations that both cure market failures and effect transfers to particular groups. A statute designed to restrict pollution might provide that factories in one region cut emissions more than factories in another region, or that all factories use a technology that is cheaper for some factories than for others. If Congress could have achieved its goals equally well or better without making these distinctions, then the statute self-consciously redistributes wealth compared to a statute whose distributional effects follow naturally from the primary goal of correcting a market failure. The agency must accept statutory constraints, and when it performs cost-benefit analysis, it must exclude alternative regulations that have a higher benefit-cost ratio but do not have the prescribed distributional effects.<sup>49</sup>

More interesting, when agencies have a broad mandate to solve market failures, they will face two possible situations: (1) a single optimal regulation that might or might not have desirable distributional effects, and (2) multiple regulations with equal benefit-cost ratios and different distributional effects.

In the first case, cost-benefit analysis supports one outcome. If the agency promulgates a different regulation with a more attractive distributive effect, that regulation is a mixed regulation. There is reason to think that agencies do this. When agencies justify regulations, they often explain how they designed the regulation so that the burden is not concentrated on the poor, or on a particular

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49. One might prefer to say that the decision procedure is cost-effectiveness analysis, but this is just a matter of labeling.

segment of the population, or on residents of a particular geographical area; or they note that the regulation favors small businesses at the expense of big businesses. For example, in 1982, the EPA promulgated regulations governing the lead content limits for gasoline that imposed stricter standards on larger refineries than on small refineries.<sup>50</sup> And agencies are directed to do this, in part by executive orders, and perhaps also in part by a political sense of the groups that Congress or oversight committee members care about.<sup>51</sup> In all these cases, the agency's decision procedure is most accurately described not as cost-benefit analysis, but as cost-effectiveness analysis of various routes to some distributional goal.

In the second case, cost-benefit analysis does not distinguish among multiple regulations with different distributional effects, and for that reason the agency must issue a mixed regulation that reflects an implicit or explicit decision about distribution. In the absence of legislative guidance, the agency might rely on any of the factors described in the previous paragraph, or on its own beliefs about distributional equities. In this case, the agency's decision procedure is cost-benefit analysis, but supplemented with (not constrained by) a distributive judgment.

A related question—but one that can only be mentioned and not answered here—is why there is no distributional analogy to Executive Order 12,866's mandate to use cost-benefit analysis. In theory, an executive order could require agencies that are given vague statutory direction to promulgate prescriptive or transfer regulations that meet certain distributional criteria. Indeed, it appears that agencies already do this, albeit in an ad hoc way.<sup>52</sup> The question is why OMB does not demand more consistent and specific distributional results—for example, regulations that improve the Gini coefficient, or some other measure of equality.<sup>53</sup> No doubt the answer has to do with the difficulty of specifying distributional criteria that are as clear as the

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50. Regulation of Fuels and Fuel Additives, 40 C.F.R. pt. 80 (1982) (amended 1996).

51. See Draft 2003 OMB Report, *supra* note 1, at 5,514 (general requirements); Exec. Order No. 13,132, 64 Fed. Reg. 43,255, 43,255 (Aug. 4, 1999) (federalism); Exec. Order No. 12,898, 59 Fed. Reg. 7,629, 7,629–30 (Feb. 11, 1994) (environmental justice); Exec. Order No. 12,866, 58 Fed. Reg. 51,735, 51,736 (Oct. 4, 1993) (distributive impact).

52. See the farm relief regulation discussed *infra* in Part III.A; the agency imposed a cap on the size of the transfer without any statutory authority, thus favoring smaller producers relative to larger producers (though not necessarily wealthier producers relative to poorer producers).

53. For a discussion of the Gini coefficient, the Poverty Index, and other measures of distributional inequality, see JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 230–35 (1986).

cost-benefit standard, but this difficulty itself is something of a mystery.<sup>54</sup>

#### *D. The Opportunities and Limits of OMB Review*

The OMB has been the chief force behind the spread of cost-benefit principles among agencies, and it could serve a similar role for cost-effectiveness analysis. How cost-effectiveness analysis of transfer regulations might improve the political process depends on the goals and incentives of the relevant political actors. One can distinguish two broad possibilities—both are caricatures intended only to make clear the forces at work.

1. *Congress Is Honest but Agencies Are Not.* Suppose that Congress honestly legislates in the public interest, but that agencies have specific goals or missions that deviate from congressional goals. Congress has diverse methods for disciplining agencies, but with agenda setting power and superior information about their regulatory domain, agencies can issue regulations that differ from Congress's ideal. However, if agencies were required to perform cost-effectiveness analyses on transfer regulations, and faced sanctions if they did not, they would be forced to divulge some of their private information, which would facilitate monitoring by Congress or the relevant committees. Here, cost-effectiveness analysis, like cost-benefit analysis of prescriptive market-correcting regulations, is a device for solving a principal-agent problem.<sup>55</sup>

2. *Congress Is Dishonest but the President Is Not.* Suppose that Congress seeks to pay off interest groups, while the president, with his broad national mandate, prefers to regulate in the public interest. Transfer statutes, then, do not distribute wealth to deserving beneficiaries, but to interest groups. However, because Congress enacts vague statutes that delegate a great deal of discretion to agencies, the president can use his authority over the agencies to counter Congress's efforts. Consider a tax credit law that has the overt aim of creating jobs but is in fact intended to, or partly intended to, benefit firms that fill out the forms for companies that claim the

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54. See LARRY TEMKIN, *INEQUALITY* 91, 118 (1996) (discussing various possibilities for the correct criteria of equality).

55. Cf. Posner, *supra* note 7, at 1140 (discussing “cost-benefit analysis as a method by which the President, Congress, or the judiciary controls agency behavior”).

tax credit.<sup>56</sup> If the statute is vague enough, and does not explicitly require contracting with members of the interest group, then a regulation that does involve that group is likely to fail a cost-effectiveness analysis. Thus, the president, through OMB, can use the cost-effectiveness obligation to resist congressional efforts to disguise transfers, forcing Congress either to make the transfers explicit—which entails political costs—or to abandon them.

### *E. Judicial Review*

Judicial deference to agency action is justified by division of labor: agencies are specialists, judges are generalists. The problem with judicial deference is that agencies can use their discretion in ways that are inconsistent with social welfare and congressional policy, as the case may be. Agencies might transfer resources to politically powerful interest groups or indulge ideological passions not shared by the public. The virtue of cost-benefit analysis (as a statutory mandate) is that it harnesses the power of quantification, permitting courts to scrutinize an agency's decision without reproducing it. When monetization of costs and benefits does not otherwise distort the agency's mission too much, judicial enforcement of cost-benefit analysis will produce better regulations, regulations that do not reflect the internal biases of the agency or its chief.<sup>57</sup>

As has been seen, cost-benefit analysis is not suitable for evaluating transfer regulations. If judges enforced cost-benefit analysis, all transfer regulations would be struck down. However, with legislative authorization—or through aggressive interpretation of the arbitrary and capricious standard<sup>58</sup>—courts could use cost-effectiveness analysis to review transfer regulations. This review could take many forms. At the lowest level, courts would remand regulations when the accompanying statement in the Federal Register does not include cost-effectiveness ratios for the regulation itself and

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56. Compare to the Targeted Jobs Tax Credit, 26 U.S.C. § 51 (2000) (now the Work Opportunity Tax Credit), discussed in Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 521–22 (1998) (arguing that “the most vociferous supporters of the targeted jobs tax credit were not the disadvantaged groups covered by the provision nor the businesses that claimed the credit,” but rather the “firms that helped employers determine which employees qualified for the tax credit and complete the necessary tax forms”).

57. This is Sunstein's view, see SUNSTEIN, *supra* note 15, at 191–228, although he thinks judges should be highly deferential because of their lack of expertise, *id.* at 225.

58. See the discussion *infra* in Part III.C.

for a range of plausible alternative regulations. In addition, a transfer regulation that is less cost-effective than an alternative within the agency's authority would be vacated on judicial review, and on remand the agency would be required to issue the cost-effective transfer regulation. There would still be a place for judicial deference, as in the case for cost-benefit analysis; determining the distributional goals of a statute would need to be discretionary within a broad range. But this would not mean that the agency is unconstrained. At a minimum, agencies would be required to act consistently across regulations. In a similar way, if agencies have some discretion to choose discount factors and valuations of life for cost-benefit analysis, a consistency requirement across regulations and agencies would constrain their behavior in useful ways.<sup>59</sup>

My suggestion is not radical. Courts already review agencies' cost-effectiveness analyses when transfer regulations are the subject of litigation. Part III discusses some examples.<sup>60</sup> But, as will be seen, the judicial efforts are dispiriting. Although courts focus on the right issues—whether inaccurate distributions should be tolerated in order to reduce administrative costs—courts rarely demand that agencies provide data that support their cost-effectiveness analyses, so it is always hard to see why courts approve some transfer regulations while rejecting others. One senses that courts rely on a rough sense of the ideal distributional outcome intended by the statute and are impatient with arguments that administrative cost savings justify reliance on crude proxies or bright-line rules that result in distributions that deviate from the ideal. If courts think it proper to defer to agency judgments, then they should not reject these arguments; if they think it proper to scrutinize the agency's claims, they should demand data and base their own judgment on an assessment of the facts. Currently, they do neither.

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59. See Posner, *supra* note 7, at 1191–92 (arguing that agencies, when performing cost-benefit analyses, should be forced to be consistent with all kinds of valuations, including valuations of life and discount factors).

60. Here are two others: *McDaniels v. United States*, 300 F.3d 407, 411 (4th Cir. 2002), where the court defended the agency's decision to use gross revenues as a proxy for net income on grounds of administrative cost, and *Michigan Head Start Directors Ass'n v. Butz*, 397 F. Supp. 1124, 1140 (W.D. Mich. 1975), where the court rejected a similar proxy on the ground that the administrative cost savings (nowhere specified) were insufficient.

## III. SOME EXAMPLES

According to OMB reports to Congress, agencies have promulgated several hundred transfer regulations, counting only those regulations that have had an impact of at least \$100 million or are otherwise considered “major” under OMB’s conventions. Each one of these regulations was published in the Federal Register along with a statement that the regulation complied with Executive Order 12,866. Many of the statements contain boilerplate, but a significant number contain a cost-effectiveness analysis, or at least a gesture in that direction.

No scholar has tried to determine whether these regulations are, as a group, cost-effective. At first sight, this gap in the literature seems odd, for there is a large literature on the related question of whether prescriptive regulations issued under market-correcting statutes are cost-justified.<sup>61</sup> But the reason for the different levels of attention devoted to these questions is probably that agencies’ cost-benefit analyses supply much more data than agencies’ cost-effectiveness analyses, making scholarly review of the cost-benefit analyses easier.

In the absence of agency supplied data about cost-effectiveness, the best way to determine whether agencies issue cost-effective transfer regulations would be through an empirical study that collected all the regulations and determined whether their cost-effectiveness ratios were superior to plausible alternatives. Such a study, however, would be nearly impossible. One cannot know whether a regulation that provides school lunches at \$5 per lunch is cost-effective unless one knows what alternatives are available, and if the agency does not provide a thorough and credible discussion of the alternatives (and they never do, as far as I have found), one could not know what these alternatives would be without becoming an expert in every field of regulation.<sup>62</sup> As a result, one cannot evaluate transfer

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61. *See, e.g.*

regulations on the basis of their cost-effectiveness in the same systematic way that John Morrall evaluated health and safety regulations on the basis of their implicit valuations of life.<sup>63</sup>

For these reasons, I will take the less ambitious route and evaluate the quality of the cost-effectiveness analysis in a small sample of regulations. The point here is not to defend or criticize the regulations themselves, but to evaluate the reasoning of the agency.

#### A. *Farm Relief*

After the collapse of farm prices in 1998, Congress appropriated \$3 billion for farm relief, of which \$200 million was directed to dairy producers “in a manner determined by the Secretary” of USDA.<sup>64</sup> The Secretary thus had to develop a formula for distributing the \$200 million among the many dairy producers who lost money. This is not as easy as it sounds: the problem is determining how much a particular producer lost as a result of the price decline. One idea would be to look at how much milk the producer manufactured in the year prior to the market collapse, and give the producer an amount of money equal to the industry-wide average level of profits per unit of milk that the affected producer manufactured in the prior year. This formula, however, would overcompensate unprofitable producers: if these producers would have made no profits in 1998 even if prices had not declined, any payment would overcompensate them. On the other hand, it would have been very difficult to determine the lost income of each producer on the basis of a projection to 1998. Apparently for this reason, the Secretary chose a bright-line rule that awarded a fixed amount per unit of milk produced in the earlier year. She also capped compensation at 2.6 million pounds of milk.<sup>65</sup> This cap favored smaller producers.

In 2000, Congress appropriated another \$325 million for dairy producers (and livestock producers as well), directing the Secretary to use the money “to compensate producers for economic losses

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David M. Cutler, *Health Care and the Public Sector*, in 4 HANDBOOK OF PUBLIC ECONOMICS 2145 (Alan J. Auerbach & Martin Feldstein eds., 2002).

63. Morrall, *supra* note 61, at 29–34.

64. Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, Pub. L. No. 105-277, sec. 101(a), tit. XI, § 1111(d), 112 Stat. 2681, 2681–744 (1998).

65. 7 C.F.R. §§ 1430.502–.506 (2003).

incurred during 1999.”<sup>66</sup> The Secretary maintained the cap issued under the prior regulation, and also provided that producers signed up in the first year of the program would be automatically enrolled in the second year of the program. Payments would be based on production in 1997 and 1998.<sup>67</sup> As a result, producers who had gone out of business in 1999, or even 1998, would nonetheless obtain compensation as though they had been in business but had lost money. Milk Train, a consortium of large milk producers, brought suit against the Secretary, arguing that the cap and the automatic enrollment provisions favored smaller dairy producers.<sup>68</sup> The cap clearly prevented larger producers from obtaining compensation for their losses beyond the cap, and the automatic enrollment provisions extended this preferential treatment to producers (presumably, smaller producers) who were no longer in the dairy business.

The Secretary argued that the rule complied with Executive Order 12,866 (the most recent cost-benefit executive order) and passed a cost-benefit test,<sup>69</sup> a claim that was apparently accepted by the D.C. Circuit Court.<sup>70</sup> Although the agency’s description of the cost-benefit analysis is hard to follow, the Secretary seemed to believe that a payment of \$173 million to dairy producers could create benefits of \$400 to \$600 million. “The differences between outlays, which are virtually all direct transfers to program participants, and income, are made up of increased dairy prices . . . .”<sup>71</sup> This explanation is incoherent. Cash transfers to dairy producers would not normally increase dairy prices, but even if they did, the loss to consumers—not mentioned anywhere—would offset the gain in income.

The Crop and Market Loss Assistance rule fails a cost-benefit analysis, as indeed does any rule that determines how money appropriated by Congress would be distributed to beneficiaries. But it does not follow that any rule that the Secretary might promulgate

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66. Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2000, Pub. L. No. 106-78, §§ 805, 822, 825, 113 Stat. 1135, 1179, 1186-87 (1999) (codified as amended in scattered sections of 7 U.S.C.).

67. 7 C.F.R. §§ 1430.502-506.

68. *Milk Train, Inc. v. Veneman*, 310 F.3d 747, 750 (D.C. Cir. 2002).

69. 1999 Crop and Market Loss Assistance, 65 Fed. Reg. 7,942, 7,948 (Feb. 16, 2000).

70. See *Milk Train*, 310 F.3d at 754, 756 (relying on the existence of the cost-benefit analysis in holding that the cap and automatic enrollment provisions were proper). Executive Order 12,866 cannot be enforced by a court; the argument probably was made because a cost-justified regulation would not seem arbitrary and capricious under the APA.

71. 1999 Crop and Market Loss Assistance, 65 Fed. Reg. at 7,948.

would be equally bad or good. The Milk Train case centered on just this question. Milk Train complained that the rule violated the statute by favoring smaller producers, and the Secretary argued that deviations from the statutory goal were justified by administrative cost savings.

It is possible that the automatic enrollment portion of the rule was more cost-effective than an alternative procedure, such as a requirement that dairy producers fill out new applications and provide supporting evidence. The automatic enrollment provision was intended to avoid the cost of applying for compensation and the cost of processing applications, the first borne by the producers and the second borne by USDA. The provision, however, would also result in the transfer of moneys to producers who had gone out of business, leaving less in the treasury for the intended beneficiaries of the statute. The question, then, is whether the administrative cost savings justified these error costs. Answering this question requires some numbers. USDA could have estimated the application and processing costs by extrapolating from its past experiences with administering transfer programs, and USDA could have estimated the error costs from industry data on liquidations of producers. It seems likely that these estimates would have been relatively easy to make and would not involve vast administrative expenses. But because USDA did not make these estimates, and provide the relevant data, it is impossible to know whether the automatic enrollment provision was cost-effective.

It is less likely that the cap was cost-effective.<sup>72</sup> It is hard to see how it could have saved administrative costs, while it clearly deprived large producers of their entitlements under the statute.

### *B. School Breakfasts and Lunches*

The School Breakfast Program, National School Lunch Act, and Child Nutrition Act established the School Breakfast Program, which provided funds for eligible schools that offer free breakfasts to their students.<sup>73</sup> School districts and state educational agencies apply for funds from the USDA, which issues regulations describing the criteria for eligibility. The statute provides that one goal of the program,

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72. The court held that it did not have subject matter jurisdiction over the Secretary's decision to impose the cap, which, in the court's view, was discretionary under 5 U.S.C. § 701(a)(2) (2000) of the APA. *Milk Train*, 310 F.3d at 751–52.

73. 42 U.S.C. § 1773 (2000) (school breakfast program authorization).

although not the only goal, is to ensure that funds for breakfasts “to the maximum extent practicable . . . reach needy children.”<sup>74</sup> The plaintiffs, a class of needy children, argued that USDA violated the statute by failing to demand from school districts enough information to determine that needy children were being helped, and for refusing to withhold funds from schools in districts that failed to provide such information.<sup>75</sup>

The challenged regulations required that applicants provide information about how they planned to distribute funds and how many schools with needy students would not be served, but the requirements were minimal.<sup>76</sup> The states themselves defined “needy” in an inconsistent way, and many states did not reveal how they defined need, so that a school with a fair number of needy students might be defined as a non-needy school. Further, USDA did not have in place any process for verifying that the states provided accurate information; did not try to encourage states to bring more needy children within the program; and did not encourage compliance by threatening uncooperative school districts with sanctions at its disposal, such as a cutoff of federal aid.<sup>77</sup> The court did not quarrel with all of these practices, but it ordered USDA to issue regulations that required schools to provide more information about the effect of their plans on needy children.<sup>78</sup>

The case reflects the tradeoff between decision and error costs. USDA emphasized decision costs. It did not demand much information from states and did not verify that information, because doing so would have been too costly—both for the schools and for USDA. As a result, many schools would obtain funds even though they did not serve needy children, and many schools that served needy children would not obtain funds. The court’s holding implicitly assumed that more stringent information requirements would not burden the schools or USDA too much, but rather would reduce the amount of error. But the court was not willing to demand a great deal of extra work from USDA, presumably because it thought that that excessive decision costs would interfere with the operation of the

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74. 42 U.S.C. § 1759a(e)(1)(C) (2000).

75. *Charette v. Bergland*, 457 F. Supp. 1197, 1199 (D.R.I. 1978).

76. 7 C.F.R. § 220.7 (2003).

77. *Charette*, 457 F. Supp. at 1205–06.

78. *Id.* at 1207.

program, burden schools, or have a similar perverse effect on the distribution of funds.

The court, however, did not explain why it thought that demanding more information from states was cost-justified but that verifying the accuracy of this information was not necessarily cost-justified (an issue left for remand). These claims are susceptible to empirical analysis. For the states, determining the numbers and locations of needy students in the school system is expensive: surveys must be conducted, answers must be verified, and data must be compiled. For USDA, verifying the information provided by the states may or may not be costly: spot checks along with the threat of funds cutoff might be sufficient to ensure the states' honesty. USDA should have estimated and reported the administrative costs of both the regulation in question and the alternative regulations that imposed more rigorous and less rigorous application and verification procedures.

On the error cost side, the statutory language indicates that Congress wanted to ensure that needy children received lunches, but also did not mind if non-needy children received lunches. At a minimum, USDA should have discussed alternative regulations, and in particular reported how many needy children each regulation would have likely helped. The estimates of the number of children who would be helped by the regulation could have been based on widely available demographic information concerning the distribution of needy and non-needy children in school districts. If USDA was charged with exhausting an appropriation, then the cost-effective regulation would most likely have been that regulation that provided lunches to the most needy children. If the appropriation was not determined or budgeted in advance, then the cost-effective regulation would be the one that provided lunches to needy children at the least cost per lunch.<sup>79</sup> The one complication is Congress's apparent ambivalence about funding lunches for non-needy children. A regulation that saved on administrative costs but resulted in the funding of lunches for a number of non-needy children, as well as needy children, would arguably be more cost-effective than a regulation that resulted in substantial administrative costs but aided only needy children. Here, USDA would seem to be given discretion, but it should have reported how it used its discretion by revealing the implicit or explicit weight that it put on receipt of a lunch by a non-

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79. See *supra* Part II.A.

needy child. Because USDA failed to provide the necessary information, it is impossible to evaluate USDA's actual regulation on cost-effectiveness grounds.

### C. Food Stamps

The Food Stamp Program, like the School Breakfast Program, gives the Secretary of USDA a great deal of discretion to issue regulations, in this case as he "deems necessary or appropriate for the effective and efficient administration" of the program.<sup>80</sup> Under the program, USDA issued regulations providing that, among other things, food stamps would be sent by mail and the federal government would replace food stamps that were lost in the mail. Subsequently, Congress enacted a statute that authorized USDA to share the costs with the states, and USDA issued a new regulation that required states to pay for lost food stamps above a threshold—0.5 percent of the value of the coupons sent through the mail.<sup>81</sup> The purpose of the regulation was to give states the "incentive to reduce [mail] losses"<sup>82</sup>—presumably by cracking down on food stamp thieves. The state of New Mexico brought suit challenging the cost-sharing regulation.<sup>83</sup>

New Mexico argued that the regulation assumed that lost coupons were inevitably redeemed—that is, they were not really lost but stolen and used by the thieves or customers of the thieves—when many coupons really were just lost.<sup>84</sup> If the coupons were really lost, then USDA did not lose any money, aside from the trivial printing costs when it replaced the coupons, and thus should not have been entitled to reimbursement from the state. USDA argued, and the court agreed, that

it would have been irrational for the Department of Agriculture to adopt a tracking system for food stamp issuances and redemptions as the State of New Mexico suggests. Such a system likely would cost more than the savings expected from the mail loss reduction

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80. 7 U.S.C. § 2013(c) (2000).

81. 7 C.F.R. § 276.2 (2002).

82. Food Stamp Program; Mail Issuance Loss Tolerance Levels, 47 Fed. Reg. 50,681, 50,682 (Nov. 9, 1982).

83. *Gallegos v. Lyng*, 891 F.2d 788, 789 (10th Cir. 1989).

84. *Id.* at 791–93.

program; thus it was not arbitrary or capricious for FNS to reject this proposal.<sup>85</sup>

The court agreed that decision costs associated with the tracking regulation would have outweighed the error costs, and therefore held that the agency's decision was not illegal.<sup>86</sup>

As far as the opinion indicates, the court took the agency's word that the tracking system would have cost more than it saved. But this claim was an empirical claim, susceptible to cost-effectiveness analysis. The cost of a tracking system included staff time and other expenses; the benefit of a tracking system was, in this case, the cost savings for the state, but, more broadly, the reduction of resources that would go to criminals rather than to the intended beneficiaries of the food stamp program. The cost-effectiveness inquiry is whether the tracking system would cost less in dollar terms than the extra appropriations needed to replace coupons that would not have been lost if a tracking system had been in effect. An adequate cost-effectiveness analysis would contain estimates of these costs. It would also have considered alternative regulations.

There is a further interesting federalism dimension to the regulation. The question was not whether USDA would have saved Congress money by using the tracking system; the question rather was whether USDA would have saved states and Congress money by using the tracking system. Recall that the idea of loss sharing was to give states an incentive to crack down on food stamp thieves and save Congress money. Even if the tracking system would not have been cost-effective, there was a separate question whether the 0.5 percent threshold gave states the optimal incentive to invest in greater policing. A low threshold would cause states to externalize the costs on the federal government; but a high threshold would cause states to overinvest (and redundantly invest) in food stamp policing when it would be better for the federal government to use a centralized monitoring system. Indeed, this was New Mexico's claim. USDA should have estimated the effects of different thresholds on the incentives of states to invest in policing.

Thus an adequate cost-effectiveness analysis would determine (1) how much different investments in policing would reduce mail thefts of food stamps, and (2) how sensitive states are to different

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85. *Id.* at 792.

86. *Id.* at 795.

cost-sharing rules. An empirical study could determine (roughly) the level of police investment where the marginal cost of the investment equals the marginal benefit in food stamp savings; and then a separate study could determine the cost-sharing arrangement that would cause states to engage in the optimal level of investment. Although USDA understood this basic logic, it did not provide the relevant information for determining whether it performed a valid cost-effectiveness analysis.

*D. Medicare: Outpatient Diabetes Self-Management Training*

The Balanced Budget Act of 1997 expanded Medicare coverage of self-management training programs for diabetics.<sup>87</sup> In 2000, the Department of Health and Human Services (HHS) published a final rule that, among other things, limited coverage to training ordered by a physician or other qualified practitioner, required that the physician provide a plan of care, described the elements of a valid training program, and identified the medical conditions that would qualify for the coverage.<sup>88</sup> The statute provided for the transfer of resources to beneficiaries; therefore, the regulation that implemented the statute was a transfer regulation.

Of special interest is HHS's discussion of Executive Order 12,866, which it said applied to the regulation because the regulation would have an impact of greater than \$100 million per year. HHS then proceeded to discuss the costs and benefits of the regulation. On the cost side, HHS started out promisingly. There were 4.5 million Medicare beneficiaries with diabetes, but because many of them already had training or would not qualify for it under the proposed regulation, about 2.25 million would receive benefits under the regulation. Each of these individuals would receive ten to twelve hours of training. Multiplying the number of beneficiaries by the number of hours and by a training cost (not specified), and taking account of the capacity of accredited programs and the time lag before a sufficient number would be in operation, HHS estimated budgetary costs of \$150 million in fiscal year 2001, increasing to \$280 million in fiscal year 2005.<sup>89</sup> But then HHS faltered. It mentioned that

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87. 42 U.S.C. § 1395w-21 (2000).

88. Department of Health and Human Services, Health Care Financing Administration, Medicare Program; Expanded Coverage for Outpatient Diabetes Self-Management Training and Diabetes Outcome Measurements, Part II, 65 Fed. Reg. 83,130 (Dec. 29, 2000).

89. *Id.* at 83,146-47.

diabetes can cause death, heart disease, blindness, and many other medical problems, and that self-management can reduce these problems, but it did not monetize these factors.<sup>90</sup> It should have calculated the net cost of the program by subtracting the medical costs averted from the cost of self-management training. Having done that, HHS should next have calculated the cost-effectiveness ratio by dividing the net cost of the program by the stipulated benefit, such as QALYs gained.

One cannot know whether the regulation is cost-effective without knowing the effectiveness of the training program. If the effectiveness is high enough, and the benefits are high enough, then the regulation would be cost-effective; otherwise, it would not be. If it is cost-effective, what this means is that given the goal of providing aid to a class of people who have illnesses, it is cheaper for the government to achieve this goal by paying for self-management training than by paying for medical care for symptoms that could have been avoided through self-management. (Alternatively, cost-effectiveness analysis might have revealed that giving more intensive training to fewer people, or less intensive training to more people, would have produced a greater ratio of benefits to costs.) As is always the case, the cost-effectiveness analysis would not show that Medicare coverage is welfare maximizing; it shows that given the goals of Medicare coverage, one kind of transfer is superior to another.

To sum up, HHS recognized that Executive Order 12,866 applied to the diabetes self-management regulation, and it performed a regulatory impact analysis. But its regulatory impact analysis was inadequate. It identified the budgetary costs of the regulation, but did not reduce them to a present value. More important, it failed to provide an estimate of the probability that self-management would result in cost savings and QALY gains; it failed to monetize the cost savings and subtract them from the cost of the program; and it failed to compare the cost-benefit ratio of the regulation in question with the cost-benefit ratios of alternative regulations. As a result, one cannot determine from the regulatory impact analysis whether the regulation is cost-effective.

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90. *Id.*

#### IV. LEGAL AUTHORITY FOR ECONOMIC ANALYSIS OF TRANSFER REGULATIONS

Executive Order 12,866 requires agencies to perform cost-effectiveness analysis on transfer regulations. Several clauses of this order are pertinent:

When an agency determines that a regulation is the best available method of achieving the regulatory objective, it shall design its regulations in the most cost-effective manner to achieve the regulatory objective. In doing so, each agency shall consider incentives for innovation, consistency, predictability, the costs of enforcement and compliance (to the government, regulated entities, and the public), flexibility, distributive impacts, and equity.<sup>91</sup>

This provision appears to apply to transfer regulations. Other provisions of the executive order direct agencies to conduct cost-benefit analysis; this provision seems to acknowledge that a cost-benefit analysis might not be consistent with the “regulatory objective.” If the regulatory objective is not efficiency, it must be redistribution.<sup>92</sup> Because the regulatory objective is set by statute, the president cannot override it through an executive order. But the president can, given standard views of presidential power, guide the means that agencies use to obtain the objective, and this surely includes requiring agencies to use less expensive rather than more expensive methods for achieving the objective. The agency must choose the most “cost-effective manner” for achieving this distribution, one that accounts for “the costs of enforcement and compliance”—what I call decisions costs—and distributive impacts—what I call error costs.

An additional provision requires agencies to provide information about these costs and benefits. The provision says that the agency should provide

an assessment, including the underlying analysis, of costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable

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91. Exec. Order No. 12,866, 58 Fed. Reg. 51,735, 51,736 (Oct. 4, 1993).

92. Or some other nonefficiency moral goal such as changing preferences, but this is not the case in the transfer regulations that I have examined.

nonregulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.<sup>93</sup>

This is a reporting requirement, and it could be used to force agencies to reveal the results of a cost-effectiveness analysis.

Agencies have not (with a few exceptions) accepted these invitations to perform cost-effectiveness analysis on transfer regulations, but OMB could prod them to do so, as OMB has prodded agencies to perform cost-benefit analysis on regulations designed to solve market failures. Following the cost-benefit model, OMB could announce that agencies should conduct cost-effectiveness analysis of transfer regulations and that OMB will send back to agencies any transfer regulations that are not accompanied by a satisfactory assessment of their cost-effectiveness.

Executive Order 12,866 does not direct agencies to report the economic distortions caused by the transfer statute, as implemented in regulations, or to report Pareto superior distributions that are outside the authority of the agency.<sup>94</sup> To achieve this end, either the president would need to amend the executive order, OMB would need to issue new guidelines, or Congress would need to enact a statute modeled on NEPA. The new language might say:

All major transfer regulations must be accompanied by a report of (1) alternative rules or transfers of money, if any, that would obtain the same distributive goals at a lower cost; and (2) a calculation of the economic distortions caused by the transfer regulations.

For example, a major regulation that implements price supports would identify potential tax-and-transfer regimes for obtaining the same distributional goals at lower cost, and would calculate the economic cost of the price supports.

#### CONCLUSION

Executive Order 12,866 already requires regulatory agencies to perform cost-benefit or cost-effectiveness analysis for major regulations, and agencies have correctly concluded that transfer regulations are not exempt. But they have rarely performed cost-

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93. Exec. Order No. 12,866, 58 Fed. Reg. at 51,741.

94. One could possibly find some authority in the executive order itself. *Id.* at 51,735–36.

effectiveness analysis, and their occasional efforts have been inadequate.

Given the current low level of activity, agencies could improve regulatory performance dramatically by following some simple precepts. Agencies should always report several alternative regulations, not just the regulation that they propose. These alternatives could be generated by staff or by outsiders, including regulated entities. Agencies should describe the distributional effects and administrative costs of each regulation and provide cost-effectiveness ratios under alternative assumptions. Agencies should discount costs and benefits as they do when performing cost-benefit analysis. And agencies should calculate and report the welfare costs of their regulations.

Courts frequently review cost-effectiveness analyses performed by agencies when litigants challenge transfer regulations under the Administrative Procedure Act, but their judgments do not inspire confidence. Judicial review would be more valuable if courts demanded that agencies supply the data used in the cost-effectiveness analyses, and courts had a more adequate understanding of cost-effectiveness principles. Although many courts understand that administrative cost savings justify reliance on transfer regulations that are rough rather than specific, they also need to understand that one cannot evaluate transfer regulations properly without information about the cost savings and the expected distribution of benefits.

## APPENDIX

Transfer Regulations Reviewed by OMB Between April 1, 2000 and September 30, 2001<sup>95</sup>

**Department of Agriculture**

Agricultural Disaster and Market Assistance

2000 Crop Agricultural Disaster and Market Assistance

Market Assistance for Cottonseed, Tobacco, and Wool and Mohair

Bioenergy Program

Farm Storage Facility Loan Program

Wool, Mohair, and Apple Market Loss Assistance Programs

Dairy, Honey, and Cranberry Market Loss Assistance and Sugar Programs

Livestock Assistance, American Indian Livestock Feed, Pasture Recovery, and Dairy Price Support Programs

2000 Crop Disaster Program

Catastrophic Risk Protection Endorsement

Food Stamp Program: Recipient Claim Establishment and Collection Standards

National School Lunch and School Breakfast Program: Additional Menu Planning Approaches

Requirements for and Evaluation of WIC Program Bid Solicitations for Infant Formula Rebate Contracts

Non-Discretionary Provisions of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996

Non-Citizen Eligibility and Certification Provisions of Public Law 104-193

Food Stamp Program: Personal Responsibility Provisions of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996

**Department of Defense**

Tricare: Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), NDAA for Fiscal Year 2001 and Pharmacy Benefits Program

**Department of Health and Human Services**

Medicare Program: Medicare + Choice

Prospective Payment System for Home Health Agencies

Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities

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95. These regulations are drawn from 2002 OMB REPORT, *supra* note 2, at 58-61.

Medicare Program: Hospital Inpatient Payments and Rates and Costs for Graduate Medical Education (1999)  
Medicare Program: Changes to the Hospital Inpatient Prospective Payment Systems and Fiscal Year 2001 Rates  
Medicare Program: Revisions to Payment Policies Under the Physician Fee Schedule for Calendar Year 2001  
Medicare Program: Expanded Coverage for Outpatient Diabetes Prospective Payment System for Hospital Outpatient Services  
Revision to Medicaid Upper Payment Limit Requirements for Inpatient Hospital Services  
Medicaid Program: Medicaid Managed Care  
Medicaid Program: Change in Application of Federal Financial Participation Limits  
Medicare Program: Inpatient Payments and Rates and Costs for Graduate Medical Education (2000)  
Medicare Program: Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities—Update  
Medicare Program: Prospective Payment System for Inpatient Rehabilitation Hospital Services  
Medicare Program: Changes to the Hospital Inpatient Prospective Payment Systems and Rates and Costs of Graduate Medical Education for Fiscal Year 2002  
Modification of the Medicaid Upper Payment Limit Transition Period for Hospitals, Nursing Facilities, and Clinic Services  
State Child Health; Implementing Regulations for the State Children's Health Insurance Programs

#### **Social Security Administration**

Supplemental Security Income: Determining Disability for a Child Under Age 18  
Revised Medical Criteria for Determination of Disability, Musculoskeletal System and Related Criteria  
Collection of the Title XVI Cross-Program Recovery  
Office of Federal Housing Enterprise Oversight  
Risk-based Capital

#### **Department of Labor**

Government Contractors, Affirmative Action Requirements  
Claims for Compensation Under the Energy Employees Occupational Illness Compensation Program Act

Procedures for Predetermination of Wage Rates; Labor Standards Provisions Applicable to Contracts Covering Federally Financed and Assisted Construction and to Certain Nonconstruction Contracts (“Helpers”)

Birth and Adoption Unemployment Compensation

**Department of Transportation**

Safety Incentive Grants for the Use of Seatbelts

Amendment of Regulations Governing Railroad Rehabilitation and Improvement Financing Program

**Veterans Administration**

Disease Associated with Exposure to Certain Herbicide Agents:  
Type 2 Diabetes

**Federal Emergency Management Administration**

Supplemental Property Acquisition and Elevation Assistance

Disaster Assistance: Cerro Grande Fire Assistance

Supplemental Property Acquisition and Elevation Assistance

**Small Business Administration**

Small Business Size Standards: General Building Contractors, etc.

New Market Venture Capital Program

**Office of Personnel Management**

Health Insurance Premium Conversion

**Federal Acquisition Regulation**

Electronic Commerce in Federal Procurement: FAR Case 1997-304

Electronic Commerce and Information Technology Accessibility:  
FAR Case 1999-607

**Securities and Exchange Commission**

Disclosure of Mutual Fund After-Tax Returns

Privacy of Consumer Financial Information

Selective Disclosure and Insider Trading

Unlisted Trading Privileges

Disclosure of Order Execution and Routing Practices

Revision of the Commission’s Auditor Independence Requirements

**Federal Trade Commission**

Privacy of Consumer Financial Information

**Federal Communications Commission**

Promotion of Competitive Networks in Local Telecommunications Markets

Competitive Bidding Procedures

Installment Payment Financing for Personal Communications Services Licensees

Assessment and Collection of Regulatory Fees for Fiscal Year 2000

Narrowband Personal Communications Services; Competitive Bidding

24 GHz. Service; Licensing and Operation

Extending Wireless Telecommunications Services to Tribal Lands

Assessment and Collection of Regulatory Fees for Fiscal Year 2001

### **Nuclear Regulatory Commission**

Revision of Fee Schedules; 100% Fee Recovery

Emergency Core Cooling System Evaluation Models

Revision of Fee Schedules; Fee Recovery for fiscal year 2001

### **Federal Reserve System**

Privacy of Consumer Financial Information