The Right Kind of Nothing: Regulation and Finding the Balance Between Government and Market

Michael Munger, Director
Philosophy, Politics, & Economics Program
Duke University
WE MUST DO SOMETHING. "X" IS SOMETHING. WE MUST DO "X"! BAD STRUCTURE…

Analysts readily concede many of our regulations are badly designed or harmful.

But they believe the problem is one of structure, so all that is necessary is reform of the system. A better halter, a better saddle, better tack.

So, constant reforms to change the structure. New government agencies, new rules, ambitious new programs on top of old programs.
WE MUST DO SOMETHING. "X" IS SOMETHING. WE MUST DO "X"! BAD RIDER...

Others believe the problem is "bad people." Blame the rider! The solution is "good people." If we can just elect better leaders, and hire better bureaucrats, the (temporary) problem will be permanently solved.
WHY **SOMETHING** MAY BE WORSE THAN THE **RIGHT KIND OF NOTHING**: THE ANATOMY OF GOVERNMENT FAILURE

Market failure paradigm: Compare *actual* market performance to *hypothetical perfect* market performance. It will fall short.

Then propose implementation of *hypothetical perfect policy* to fix market failure.

Two problems:

1. *Market failure* defined with reference to an allocation that is, by definition, not only unattainable but actually unknown.

2. *Government failure* may cause actual policy to fall short even of what is possible, and knowable.
The Right Kind of Nothing
• Asymmetric Information
• Public Goods
• Externalities
• Natural Monopoly
• Equity

Market Failures
Market Failures

- Asymmetric Information (FDA, Health Inspectors, AMA)
- Public Goods
- Externalities
- Natural Monopoly
- Equity
• Asymmetric Information (FDA, Health Inspectors, AMA)
• Public Goods (National defense, Schools)
• Externalities
• Natural Monopoly
• Equity

Market Failures
Market Failures

- Asymmetric Information (FDA, Health Inspectors, AMA)
- Public Goods (National defense, Schools)
- Externalities (EPA, Pollution)
- Natural Monopoly
- Equity
Market Failures

- Asymmetric Information (FDA, Health Inspectors, AMA)
- Public Goods (National defense, Schools)
- Externalities (EPA, Pollution)
- Natural Monopoly (Utilities)
- Equity
Market Failures

- Asymmetric Information (FDA, Health Inspectors, AMA)
- Public Goods (National defense, Schools)
- Externalities (EPA, Pollution)
- Natural Monopoly (Utilities)
- Equity (Pensions, Health Care, Unemployment)
• Markets fail, in all these ways and more
• I can imagine that the state could solve each problem
• Therefore, market failure requires state action

*But…WILL "the state" actually do better?*

Logic
• **MUNGER TEST:** In the above model, remove the phrase "the state"
• Replace it with "Nancy Pelosi and Chuck Schumer." Do you still believe it?
• How about "Michelle Bachmann and Ted Cruz?" How about now?
• There is no "state." Only real politicians trying to get elected appealing to real voters

**Logic**
The Pretty Pig Contest
WHY SOMETHING MAY BE WORSE THAN THE RIGHT KIND OF NOTHING

• Collective action (Olson)
• Controlling Leviathan (Buchanan)
• Delegation (Niskanen and McNollGast)
• Democratic coherence (Arrow, Black, and McKelvey)
• Knowledge problem (Coase, Downs, Hayek, Tullock)
• Rent-seeking (Krueger and Tullock)
PROBLEM: POWER DOESN'T STAY WHERE WE PUT IT
Example: Clean Water Act 1972

Stream Water Quality Conditions (Miles)

- Good 34.7%
- Fair 54.0%
- Poor 11.3%

1972

- Good 54.3%
- Fair 44.8%
- Poor 0.9%

1996

Figure 13: Death rates for various water related diseases, 1900–1970

Source: Goklany (2007a), based on USBC (various years, 1975)
Power doesn't stay put; it metastasizes.

Clean Water Act 1972. What does it apply to? All waters with a "significant nexus" to "navigable waters."; however, the phrase "significant nexus" is unclear. The statute frequently uses the term "navigable waters," but also defines the term as "waters of the United States, including the territorial seas."
SCOPE PROBLEM

Power doesn't stay put; it metastasizes.


"Those areas that are inundated or saturated by surface or ground water at a frequency and duration sufficient to support, and that under normal circumstances do support, a prevalence of vegetation typically adapted for life in saturated soil conditions," and as such is subject to the Corps' permit authority because the lands were characterized by those conditions, and the property was adjacent to a body of navigable water."
These were puddles. They are not rivers; *puddles*. Clearly not navigable, not even permanent. No flow. But after 1985, they were regulated under the interstate commerce justification. Now, expanded from "Navigable waters" to "puddles." Covered under interstate commerce. Because water moves. And it might move across State boundaries.
SCOPE EXPANSION #2:

Larry Squires (veterinarian) owned land with alkaline sumps (holes catch appreciable rainwater less than once per century) in NM. Ideal for disposal of mining wastes because bed is red clay. Water evaporates, and wastes safely removed while in solid form. The sumps were so alkaline, naturally, that they were extremely poisonous and could not support any kind of life. Great Salt Lake life: not even those. (These facts not in dispute).

In 1987 EPA ruled (under US v. Riverside Bayview) that the lake not regulated by Clean Water Act, so brinewater disposal was allowed. Squires created firm "Laguna Gatuna, Inc.," invested in pipelines from the lake to nearby oil and gas wells.
In 1992, the EPA monitored the sumps for water quality. Saturated with salts and heavy metals. Noticed dead birds in the area of the lake: EPA claimed Laguna Gatuna, Inc., had violated Clean Water Act by "discharging" pollutants without the EPA's permission. The EPA claimed the lake "provides a significant nesting, feeding and loafing area for migrating birds, including shorebirds, ducks, coots, grebes and raptors."

Natural rainwater accumulates in the sinkholes about once per 150 years, but bottom of holes impermeable. EPA claimed the sump could be regulated by the Clean Water Act because…. 

Birds landing on these puddles "are engaged in interstate commerce."

The EPA issued a cease and desist order to Laguna Gatuna, Inc., and threatened to impose a $125,000-a-day fine should the company continue to dispose of production water on the land. This was "pre-enforcement," pending an "actual" regulatory decision.

But it was not "pre-enforcement" from the perspective of the company, which had to shut down. It asked for compensation for loss of property value, but U.S. Federal District Court in NM / U.S. Court of Appeals said EPA orders under the Clean Water Act are not open to judicial review.
So, Squires could not recover damages for loss of the use of the land for its business purpose. No compensable taking, under the 5th Amendment, given the regulatory public interest. Squires tried continuously to get compensation.

Then, in 2001, the Supreme Court struck down the Migratory Bird Rule under the Clean Water Act in SWANCC v. U.S. Army Corps of Engineers. Squires was certain that he could get compensation now. The response of the EPA is breath-taking. Guess?
Remember, it was a *pre-enforcement* ruling. It turned out, on review, that the limits on operating the business were *ultra vires* (beyond the power of the law.) Therefore, the EPA could not possibly have taken the use of the land, because the law didn't allow it. It was all "pre-enforcement."

Thus, according to the EPA, Squires had a remedy: he could have continued to operate the business, and pay the $125,000 per day, for nine years. Just to be clear, that would have been cumulative fines of more than $400 million dollars. The EPA said that they would have refunded the fines in full, once the pre-enforcement process had been completed. But since Squires had "voluntarily" settled, they had not proceeded, and never discovered the action was *ultra vires*. So there was no loss to Squires, and no compensable "taking" at all. It was not a real decision, because it was all a pre-enforcement settlement. Caused THIS reaction from the federal judge...
SETTLED

In September 2001, the U.S. Court of Federal Claims ruled in his favor. The court found that the Laguna Gatuna's numerous investments made in anticipation of future company progress had been destroyed by the EPA's regulatory order. Consequently, the agency's action constituted a "taking" that warranted compensation.

Squires received $2 million in compensation. Almost all went to pay legal fees. He died a few months later.
Sackett family bought a lot near Priest Lake in northern Idaho in 2005 for $23,000, to build a home. Many other houses nearby. Homes and a road existed between their lot and the lake, which is 500 feet away. Steep, not swampy. They rounded up needed permits and began work in the subdivision.

The EPA in 2007 declared their lot was a wetland. The Sacketts were ordered to cease construction, and to remove the gravel that had been dumped on the lot (at a cost of $27,000), to restore the vegetation to what existed previously, to fence off the property, and to file annual reports about the condition of the property. The Sacketts were threatened with fines up to $32,500 (doubled if EPA "prevailed") per day until they were in compliance.

The Sacketts sued, seeking declaration that property not a wetland (except when it rains). The district court and Ninth Circuit Court held that Sacketts not "ripe" until EPA requested a federal court to enforce their order. Courts could not review compliance orders because no order of enforcement had been filed. Pre-settlement!

Supreme Court unanimously (!) reversed decision from the Ninth Circuit, held for the Sacketts. The Court did not address the wetland issue. The point of the case is one of administrative procedure: March 2012.

The Sacketts had the right to contest EPA orders as “arbitrary” and “capricious” under the Admin Procedure Act. Since EPA order was a “final agency action” the Sacketts could challenge; there was no other remedy. Courts can review the actions of agencies under the Administrative Procedure Act to ensure that its requirements have been followed properly by the agency. The agency cannot simply declare victory, impose fines, and the party subject to the ruling have no chance to appeal to the courts.
DEEPWATER HORIZON

- Liability Cap: $75 million
- MMS takes over safety inspections: Budget based on new wells
Properly, dispense with this continuum. A *mechanism design* problem, not "more" or "less" regulation.
HOW TO DESIGN THE BEST GAME?

Too little government

Too much government, always arguing over the rules
How to design the best game?

1. The referee is not a player, but the referee is powerful and in charge. Prevent metastasis.

2. Choose good rules, for an interesting game that creates value for everyone. So problem is NOT “is the referee too powerful?,” but rather “are the rules the correct rules?”

3. “Rule of Law”: treat everyone equally, so that they practice skills (invest in productive assets) rather than arguing and lobbying for favorable judgments from the referee.

4. Actively cultivate doing "the right kind of nothing." It's not easy. But doing the wrong kind of something is often much worse.