Executive Summary

California's regulatory agencies are known nationwide as trailblazers that set benchmarks that the nation as a whole often follows. Over the years, such regulations have produced huge benefits for Californians in consumer safety, food security, worker protection, energy efficiency and air and water quality.

The state's large population and its dynamic and complex economy require a sophisticated, coordinated and thoughtful approach to developing the regulations our society needs to ensure fairness and protect California's quality of life.

It is unfortunate on several levels then, that California's approach to developing regulations is uneven, lacks coordination and, despite an independent agency to enforce the Administrative Procedure Act, lacks the kind of thorough oversight that ensures efficiency and accountability. The way California state departments develop regulations varies widely, particularly in their use of economic analysis to determine what burden a proposed regulation will have on a person or business affected by it.

California has been reluctant to adopt and use analytical tools employed in other states and at the federal level. This has produced a regulatory approach that can focus intensely on solving problems in a single arena without taking into consideration the broader context or consequences of the solution it imposes or developing regulations that maximize benefits in a systematic way.

In the course of the Commission's study, it saw examples of where these shortcomings either resulted in failed rulemaking efforts, the potential imposition of costly conditions that could force painful tradeoffs, or regulations undermined by an economic analysis that did not account for real-time changes in the economy.

An oversight system put in place to ensure that agencies weighed alternatives to solving a problem and used an economic impact assessment to choose the least burdensome solution simply does not work. The department checks a box on a form. The box is examined to see that it is checked. But no one checks to see if the department did its homework in assessing the impact or choosing the least burdensome alternative.

These shortcomings have costs to the state, in time and money, as well as in the state's reputation for fairness and the legitimacy of the regulatory process. These shortcomings also have costs to the state's economy.

During the course of the study, the Commission learned of examples of flawed rulemaking processes. In one instance, the department developing the regulations failed to account for economic impacts and created a duplicate and conflicting regulatory structure over an industry regulated by a different department. In another case, a department was developing regulations based on a law that was broad and opaque, which further complicated the rulemaking process. The department held extensive workshops with stakeholders who initially supported the work, but who ultimately withdrew their support near the end of the process, resulting in the department missing its deadline to file a final version of the regulation. This department did contract with outside researchers to conduct an economic impact assessment, though the analysis was not shared with the public or used in the public discussion of the proposed regulation. In each case, the results of the original process were tossed out and the processes started over, though lessons learned are now being applied by the state departments to avoid a repeat.

Economic Analysis Tools

Several types of economic methods can be employed to understand the potential impacts of a regulation. A more detailed description of analytical approaches is provided in the Background chapter of this report. Some of the most common types of tools are listed below in ascending order of rigor:

STD. Form 399 Economic Impact Statement. The most basic analysis a California agency can perform consists of completing the STD. Form 399 Economic Impact Statement. A copy of Form 399 is included in Appendix C. The form provides a method for organizing and reporting essential regulatory economic impact data (e.g., costs to business, number of businesses affected, estimated benefits to Californians).

Cost-Effectiveness Analysis. Cost-Effectiveness Analysis (CEA) offers a framework for identifying the most financially efficient policy choice. CEA examines various policy options for obtaining a desired result, and creates a ratio of cost to an effectiveness measure (e.g., tons of emissions eliminated). CEA allows analysts to avoid the need to put a dollar figure on benefits.

Cost-Benefit Analysis. Cost-Benefit Analysis (CBA) attempts to examine the costs and benefits of policies and identify the alternative that yields the largest net benefits for society. This approach is the most extensive, costly and susceptible to challenges, as it requires answering multiple hypothetical questions, conducting difficult monetization of intangible benefits and costs and relying on data or assumptions that may have inherent problems associated with the information.

The Commission also found that the rules for developing regulations do not apply to every department equally. The State Water Resources Control Board, for example, complies with the Administrative Procedure Act when it develops regulations such as its frost protection measures to prevent harm to endangered fish species, but is exempt from the act when developing conditions for water quality permits. The board currently is embroiled in a contentious set of permit renewals regarding storm water runoff, which threatens water quality. As a non-point source of water contamination, storm water runoff requires a different approach than used in the past for point-source water contamination. Industry, small cities, water treatment districts and the California Department of Transportation have expressed concern that the approach the board is proposing will be vastly expensive with little in the way of cleaner water to show for it. The permit process does not require the board to assess the economic impact of the new requirements.

To the degree that California can increase confidence in the regulatory process by improving transparency and accountability of its regulatory processes, it must do so. The state must be able to demonstrate across departments that the way it develops regulations is fair and efficient in order to buttress the legitimacy of the regulations its departments produce.

One area critical to this goal is greater use of economic analysis in the development of regulations – already required by the state's Administrative Procedure Act – and greater oversight of the process to ensure adequate assessments and consistency across agencies. Though economic analysis should not be the determining factor in developing regulations, the work of building the analysis should force state agencies to engage with all interested parties early in the rulemaking process, develop and assess alternatives, and create a richer body of information to put before the board members and department directors who ultimately make the decision. Such analysis also can articulate and measure the benefits of a proposed regulation, providing greater context for the public as well as decision makers.

In recommending greater use of economic analysis, the Commission encourages a focus on prioritizing alternatives by their cost-effectiveness. This would tend to result in the selection of the alternative that best provides the benefit intended in the legislation but is least burdensome to regulated stakeholders and to the people of California. The emphasis on cost-effectiveness assessments is not to short shrift discussion, or assessment, of benefits. In most cases, however, the benefit, often with specific targets, is laid out in the legislation that the proposed regulations are to implement. All regulations should be required to show how a preferred approach would produce the desired benefits.

Non-regulated stakeholders, particularly environmental groups and labor advocates, have expressed concern about the potential abuse of economic analysis to undermine the goals of regulation, and its ability to create "analysis paralysis." In interviews and during a Commission advisory committee meeting, they reserved a specific wariness for cost-benefit analysis, which they said can understate the value of such benefits as clean water and air and human health, while allowing industry to overstate its costs.

The Commission recognizes that some parties within an industry have an incentive to game the process by withholding information or inflating estimates of the cost of compliance. It recognizes, too, the view that not all benefits, or costs, can be assigned an accurate dollar value and neatly fit into a cost-benefit model. It recommends the state focus more on cost-effectiveness assessments of alternatives that meet the goals of the legislation the regulation is trying to implement. A formal cost-benefit analysis is time-consuming and expensive and should be reserved for special cases or where required by legislation. For regulatory packages that have a significant impact on the economy, the state should have its economic impact assessments peer-reviewed by a panel of anonymous outside experts.

The Commission recommends that the state start the process of strengthening its rulemaking process by establishing a small Office of Economic and Regulatory Analysis, that would reestablish the regulatory analysis function which once existed in the now-defunct Trade and Commerce Agency. The primary duty of this small group would be the review of economic impact assessments for proposed regulations. This function could be assigned to the Department of Finance, which already has the task of assessing the fiscal impact of new regulations, or to the Office of the Governor or the Bureau of State Audits, which would provide independence from the executive branch entities overseen. In re-establishing this function, the state can learn from the example of the U.S. Office of Information and Regulatory Affairs, which is located in the White House's Office of Management and Budget. The small cost associated with re-establishing this function would be more than offset by reducing the costs of failed regulatory processes, by reducing lengthy challenges on methodology and the potential to improve confidence in the rulemaking process.

One of the first tasks of California's Office of Economic and Regulatory Analysis would be to set guidelines for economic impact assessments that would be used across departments to ensure consistency and fairness. The guidelines should be designed to accommodate a range of scales for regulatory involvement, with the most rigorous reserved for the most significant proposed regulations. The state should recruit an

advisory body of economists and experts from other disciplines with regulatory experience to help draft the guidelines. The guidelines should build on, but not be restricted by, work already done in California by the California Energy Commission and the California Air Resources Board, as well as the U.S. Office of Management and Budget's Circular A-4.

Separate from the Form 399 filing process, staff performing the regulatory review function should have the authority to check in with departments as they are drafting regulations to ensure that the agencies are following the appropriate guidelines for the level of economic impact analysis required, and that they are making every effort to engage with all interested parties inside and out of government before the rules are put out for public comment. As part of the review function, this staff should determine what level of economic impact assessment is needed on the front end. When the economic impact assessment is complete, as part of the Form 399 process, the regulatory review staff should make a determination whether the assessment is adequate.

The Office of Administrative Law, which ensures that agencies follow the Administrative Procedure Act through the rulemaking process, should be required to send back final versions of proposed recommendations that have not done the necessary economic impact assessment as determined by the Office of Economic and Regulatory Analysis.

The regulatory reviewers also should be the key information hub for the Governor and cabinet members to ensure that they are aware of

Legislature Moves to Reform Regulatory Process

Senate Bill 617 (Calderon and Pavley) makes changes to California's regulatory development and oversight framework. Crafted with the support of the California Chamber of Commerce and the California Manufacturers and Technology Association, the bill passed both the Senate and Assembly with bipartisan support and was signed into law. The bill proposes amending the Administrative Procedure Act. These changes include:

- Requiring agencies to perform a standardized economic analysis for major proposed regulations. Agencies may use data derived from existing state, federal, or academic publications to conduct the analysis. The Department of Finance will develop the analytical methodology and evaluate impact assessments. Regulations qualify as major rules if the impact on California businesses and individuals is expected, by the agency, to exceed $50 million.
- Expanding on guidelines for the assessment of alternatives. Agencies must use analyses of possible rules to "*determine that the proposed action is the most effective, or equally effective and less burdensome, alternative in carrying out the purpose for which the action is proposed or the most cost-effective alternative to the economy and to affected private persons…*"
- Requiring agencies to describe the monetary and nonmonetary benefits (e.g., environmental, social equity, public health) of proposed regulations.
- Providing the Department of Finance with full access to the data used to perform economic analyses.
- Supplementing requirements to avoid nonduplication and inconsistency of rules.
- Requiring the Department of Finance to report to the Legislature on the performance of agencies in adhering to new analytical requirements.

The bill was announced at a press conference in conjunction with AB 29 (Pérez), which establishes the Governor's Office of Economic Development in statute.

Source: Chapter 496, California Statutes of 2011.

significant regulations in the works, and to point out where proposed regulations have the potential to conflict with existing regulations developed by other state agencies.

For significant regulations, those with the potential to incur annual costs of $25 million or more, the regulatory reviewers should work with the department developing the regulation to ensure that alternative approaches are considered and that those alternatives are assessed through a rigorous cost-effectiveness test.

For significant regulations where the science is new and technologies that will be used for remediation either do not exist or are not widely used and data is scarce, the regulatory reviewers should work with the department to make sure that the state is using the most appropriate methodology for its analysis. Where necessary, the reviewers and the department should form outside expert advisory panels for this process, as the California Air Resources Board did for the economic analysis of its 2010 revised scoping plan for implementing the Global Warming Solutions Act of 2006 (AB 32).

A cost-effectiveness test approach to evaluating alternatives should be emphasized especially where the desired social benefit and targeted goal is spelled out in statute. The guidelines also should include proper methodologies for a more formal cost-benefit analysis in the event such an analysis is required by legislation.

The Commission's recommendations are consistent with SB 617 (Calderon and Pavley), passed by the Legislature in September 2011 with bipartisan support and signed by the Governor, which calls for strengthening the Administrative Procedure Act and updating requirements for regulatory impact analysis.

In addition, the state should revisit regulations in the event of unintended consequences that create unexpected harm, the emergence of new technology that makes an existing regulation obsolete, or a fundamental change in the economy that, in a new context, creates an unforeseen regulatory burden.

To the extent regulatory reform can build confidence and enhance communication, transparency and accountability, such reform can improve the foundation for economic growth and bolster the legitimacy of the state's regulatory structure, protecting public health, consumers, workers and the environment. Done well, regulatory review should result in fewer failed rulemaking processes, saving state agencies and stakeholders alike time and money as departments implement the goals of the Legislature.

The Commission's goal is not to create less or more regulation, but rather better regulation – rules developed through a transparent and interactive process that meet the statutory purpose and that place the least burden necessary on Californians and the California economy.

Recommendations

Process:

Recommendation 1: The state should require departments promulgating regulations or rules that impose costs on individuals, businesses or government entities to perform an economic assessment that takes into account costs that will be incurred and benefits that will result.

- The economic assessment must be completed well before the proposed regulation is released for public comment.
- Departments must demonstrate how the proposed regulatory action will meet the statutory purpose of the regulation.
- Departments promulgating the regulation should be required to reach out to regulated and interested parties in the development of the economic assessment prior to the regulation's release for public comment.
- The Legislature should change statutes that exempt certain agencies from provisions in the Administrative Procedure Act that require an economic impact assessment of proposed regulations unless agencies can demonstrate why an exemption is justified.

Recommendation 2: The state should require departments proposing a major regulation to perform a high-quality, rigorous economic analysis.

- A major regulation is a regulation that would impose an annual cost of $25 million or more.
- At the minimum, the economic analysis should be a cost-effectiveness assessment of alternatives that meet the statutory purpose of the regulation to determine the lowest cost alternative to meeting this goal, prior to the release of the regulation for public comment (possibly the alternative that maximizes net social benefits).
- Proposed regulations that impose a substantially higher burden on an affected industry or industries, or have the potential to materially reshape the state's economy, should be subject to a cost-benefit analysis that includes an assessment of costs as well as social benefits.

- The department promulgating a major regulation should be required to make a substantial effort to engage all regulated and interested parties in the development of alternatives that would satisfy the statutory purpose of the proposed major regulation prior to its release for public comment. This should not prevent the department from developing additional alternatives, or refining its economic analysis, on the basis of information provided through the public comment process.
- The state should require a department that is promulgating a major regulation to demonstrate that its preferred alternative is the most cost-effective approach to meeting the major regulation's statutory purpose or explain why another alternative was chosen, or, in the case of a more substantial regulation that calls for a cost-benefit analysis, demonstrate that the chosen regulatory approach maximizes net social benefits.
- The department must respond to comments about its analysis of the alternatives, including the selected alternative, made during the public comment period.

Recommendation 3: The state should create guidelines that set out standards and the appropriate use of different types of economic assessment methodologies and data quality that can be used to properly describe and analyze the economic impact of new regulations. The use of these guidelines should be mandated by the Administrative Procedure Act.

- The guidelines should reflect the scale appropriate for the proposed regulation's impact, reserving the most rigorous and in-depth economic analysis for the most economically significant regulations.
- California's guidelines should be informed by:
  - ✓ Guidelines outlined in the U.S. Office of Management and Budget's Circular A-4.
  - ✓ Guidelines developed by the U.S. Environmental Protection Agency set out for this purpose.
  - ✓ Guidelines developed by the California Environmental Protection Agency and the California Energy Commission.
  - ✓ The experience and expertise of an expert economic advisory panel created for this purpose that can set such guidelines in the context of California's legislative and regulatory histories.
- The guidelines should be able to account for and integrate the development of new economic analysis tools and models and

should be updated to reflect new analytical approaches that meet the approval of an expert economic advisory panel.

- Cost-benefit analyses and cost-effectiveness assessments of alternatives for significant regulations must be subjected to a formal peer review by independent and anonymous experts, selected by the Office of Economic and Regulatory Analysis prior to the public comment period, and results of the reviews must be made available to the public.

Oversight:

Recommendation 4: To improve the quality of regulations promulgated by California agencies, and to ensure the process of developing regulations is consistent and transparent, the Governor should form an Office of Economic and Regulatory Analysis.

- This office should be responsible for:
  - ✓ Forming an expert economic advisory panel to develop the guidelines for economic assessments, and to serve as an independent arbiter in determining whether a regulation can be defined as a major regulation.
  - ✓ Ensuring that a high-quality, rigorous cost-effectiveness assessment of alternatives has been completed before a major regulation is released for public comment.
  - ✓ Requiring a department promulgating a major regulation to update or revise its economic analysis in the event it is determined that the assessment is materially flawed by data deficiencies, serious miscalculations, modeling deficits or other shortcomings; a material change in economic conditions, or the emergence of a new technology creates a better alternative to meeting the statutory purpose.
  - ✓ Monitoring whether unrelated regulations promulgated by different agencies cumulatively affect an industry sector and monitoring whether regulations from different agencies conflict, complicating compliance efforts.
  - ✓ Agencies should communicate through an Internet-based platform to promote public participation and transparency. Public comments should be filtered through the Web site and material relevant to the rulemaking process should be posted.
- The Office of Administrative Law should be required to send back a regulation that has not complied with regulatory or economic

assessment requirements, or in the case of a major regulation, the requirement for a cost-effectiveness analysis of alternatives, as determined by the Office of Economic and Regulatory Analysis.

Recommendation 5: The state should create a look-back mechanism to determine whether regulations are still needed and whether they work. The state should:

- Require new regulations to contain a sunset date for review for effectiveness and evaluation of unintended consequences.
- Give the Office of Economic and Regulatory Analysis the authority to revisit existing major regulations in the event of a fundamental change in conditions, such as the development of transformative technology, a substantial change in economic conditions, demonstration that the regulation is not having its intended effect, or the emergence of superseding regulations at the federal level that require linkage, integration or synchronization.