

Can STATE-LEVEL DEREGULATION AFFECT ECONOMIC WELL-BEING?

by Robert Krol and Shirley Svorny

What options are available to state policymakers interested in improving the economic conditions of individuals in their jurisdictions? A growing body of research suggests that lifting or modifying regulatory constraints is an important option.

Policymakers need not rely on faith that deregulation will have a positive impact on economic activity. Economists have studied the effects of state regulation in such areas as banking, trucking, the environment, and labor

markets. The evidence suggests that by reducing or modifying regulatory constraints, state and local governments can lower business costs, increase competition, increase employment, and improve such measures of aggregate well-being as per capita personal income and gross state product.

In this article we discuss what researchers have found, bringing together the evidence on the consequences of regulation at the state level. Readers interested in specific citations to the studies described here are referred to an article by the authors in the *Cato Journal* (Spring/Summer 1994).

BANKING REGULATION

Because credit availability is critical to investment and growth, state regulations that reduce credit availability have an adverse effect on economic activity. An increase in bank costs will discourage regional lending (credit), as will regulations that restrict competition among banks.

For example, some states have branching restrictions that prohibit banks from expanding. In 1970, more than three-quarters of the lower 48 states limited within-state branching. Although by 1994 the percent of states regulating branching had fallen, one-quarter of the states still retained such restrictions. Given this cross-state variation, researchers have been able to investigate the effects of this regulation. Not surprisingly, they have found that restrictions on branch banking raise the cost of doing business, in part by limiting opportunities for diversification.

Researchers have found also that branch banking restrictions limit competition in banking markets. Banking output (loans) in states that prohibit branching has been found to be below levels likely to occur in a competitive environment. In states that prohibit branching, deposit rates are lower, consumer access to banking services is more limited, and banks lend at higher interest rates.

Given that state branching restrictions raise bank

costs and reduce competition, one would expect that branching restrictions reduce economic activity. That is exactly what researchers have found. Interstate banking restrictions and limits on intrastate branching are associated with fewer jobs per capita and lower measures of personal income and gross state product per resident. Restrictions on branch banking have been found to reduce small business starts at the state level.

In the fall of 1994, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act. The law allows banks to branch across state lines beginning June 1, 1997. The law, however, allows substantial state discretion; states may choose not to participate. As of summer 1995, 18 states had passed legislation in response to the Riegle-Neal Act; 17 states chose to allow interstate branching and banking, while Texas chose to opt out. The evidence of the effects of intra- and interstate branching indicates that states that choose to be part of the interstate banking system should experience improved economic performance. This is a clear example of how state policymakers can influence economic activity.

LABOR MARKETS: MINIMUM-WAGE LEGISLATION

Individual states may set minimum wages that exceed the federal minimum. They also may allow exemptions to the minimum wage; for example, state governments may set a sub-minimum wage for certain groups of workers. During the 1980s, as the federal minimum wage remained constant and inflation reduced its purchasing power, some states decided to take independent action. Twelve states chose to set state minimum wages above the federal level.

Economic theory is clear on the expected effect of a minimum wage: Higher wages will reduce the amount of unskilled labor that firms choose to hire. Benefits accrue to those who obtain employment at the higher wage, but fewer unskilled workers will find employment opportunities open to them. Some argue that the minimum wage is an effective tool to reduce poverty. But only about one in seven minimum-wage workers is poor.

The general consensus from a variety of studies is that an increase in a state's minimum wage has a measurable effect on the employment of teenagers in a state. Estimates of the effect that a 10 percent increase in the minimum wage would have on teen employment range from a 3 percent reduction to a reduction of less than 1 percent. Because not all teenagers are employed at the minimum wage and not all industries are covered by the minimum wage, the negative effect on teenage workers actually employed at the minimum wage is even larger. A minimum wage that reduces legal teen employment will permanently reduce job market opportunities for some

youths; and unemployed teenagers do not develop marketable job skills. In this respect, the minimum wage conflicts directly with efforts to enhance the marketability of many inner-city teenagers through job training.

A few recent empirical studies, using establishment data, have received attention because they find little effect, either negative or positive, of an increase in the minimum wage on employment. Economists skilled in the analysis of labor market data argue that these studies are poorly done, and that they fail to control for factors other than changes in the minimum wage that influence employment; survey data used in at least one of the studies has been shown to be seriously flawed. The evidence is overwhelming that a state which increases the minimum wage reduces employment opportunities for its unskilled youths.

LABOR MARKETS: STATE FRINGE-BENEFIT MANDATES

Economists have pointed to state mandates of employee benefits as having a negative effect on employment and economic growth. Economic theory suggests that as firms' costs in terms of benefits per worker rise (due to mandated benefits such as health care or parental leave), they will hire fewer workers and rely more on overtime hours. Because such mandates raise firms' labor costs, they reduce the competitiveness of firms subject to mandates in national and international markets, reducing state employment and output.

Empirical work on the employment effects of mandated benefits is sparse but consistent with what we would expect to find. One study looked at the effect of mandated workers' compensation insurance on employment. The evidence, though relatively weak statistically, suggests that a 1 percent increase in workers' compensation rates causes employment to decline by approximately one-tenth of 1 percent. Another study looked at the employment effects of mandating maternity benefits. Such a mandate significantly increases the cost of insuring women of childbearing age. In three states where health insurance benefits for maternity were mandated, relative wages and employment of married women of childbearing age declined. This is a good example of how regulations can be deceptive, actually harming some of the individuals that they are designed to help.

LABOR MARKETS: WRONGFUL-TERMINATION PROTECTION

Changes in laws involving the relationship between workers and their firms affect job creation. An area of labor law that recently has received considerable attention is protection from wrongful termination. Many state

courts and state legislatures have moved away from the common law "employment-at-will" doctrine, historically interpreted to mean that employment is for an indefinite period and that there are few restrictions on the grounds for termination by the employer, the exceptions being a contract or a specific statute. Many states have reevaluated the employment-at-will doctrine and have expanded wrongful-termination doctrines. These changes have produced a significant increase in employer liability.

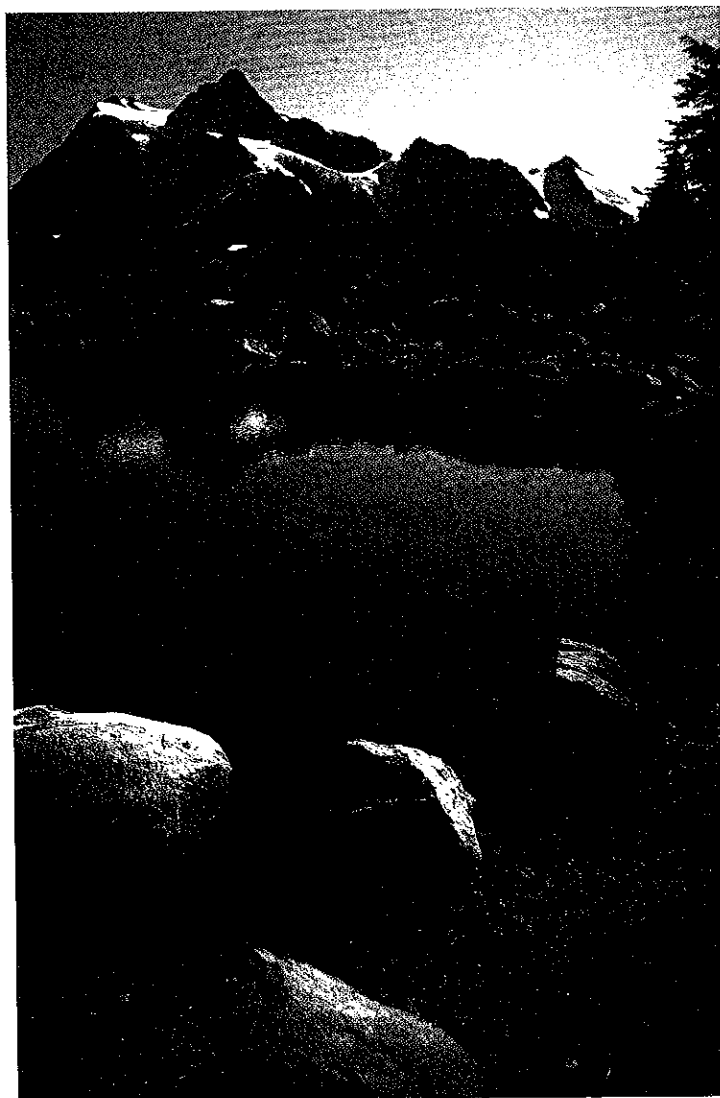
Economic theory suggests that such changes will affect state employment negatively. The reason is simple: Wrongful-termination protection raises the relative cost of labor. Firms will tend to spend more time and dollars screening potential employees, will be deterred from terminating lower-productivity workers, and will have greater legal expenses.

A recent study found that the adoption of wrongful-termination laws reduces state employment by between 2 and 5 percent. The impact appears to be smallest in manufacturing (where unions have already institutionalized many protections) and in small firms (perhaps because these firms' smaller net assets make the filing of wrongful-termination suits less profitable).

TRUCKING REGULATION

The Motor Carrier Act of 1980 passed by Congress significantly weakened the regulation of interstate trucking. In effect, it gave firms increased freedom to enter and exit interstate trucking markets. In addition, it substantially altered the administration of rate-setting. As a result, rates on interstate trucking decreased, without any noticeable deterioration in service quality. Despite concerns, neither highway safety nor service to small towns has deteriorated since deregulation.

The predictions of economic theory regarding trucking deregulation are straightforward: A reduction in transportation costs should increase economic activity.



Researchers estimate the gain from deregulation of interstate trucking to be about \$10-11 billion dollars per year. This translates into a 14 percent decrease in shipping rates (adjusted for inflation).

Following interstate deregulation, a number of states deregulated *intrastate* trucking; Florida did so in 1980, Arizona and Maine in 1982, Alaska, Vermont, Delaware, New Jersey, and Wisconsin more recently.

The current regulation of intrastate trucking in most states is costly. With intrastate regulation, it is, in some instances, actually cheaper to ship an item out of state and back than to ship it directly within the state. This creates an incentive to shift warehousing of goods across state lines, adversely affecting employment within the state.

Two studies found that carrier rates fell in Florida as a result of the 1980 deregulation of intrastate trucking. Prior to deregulation, Florida imposed state-level controls on areas served, back hauls, types of vehicles, commodities hauled, and customer service coverage. Observations on ten carriers for two years following deregulation showed a decline in rates of almost 15 percent. Prices in large mar-

kets declined more than in small markets, suggesting that regulators may have been setting rates in a manner that subsidized small markets at the expense of larger ones.

Other researchers, using data from the deregulated interstate trucking market, have attempted to forecast what intrastate rates would be in California and Nebraska if deregulation were to occur. For shipments below 10,000 pounds, they concluded that deregulation of intrastate trucking would result in a 30 percent reduction in shipping rates.

ENVIRONMENTAL REGULATION

Environmental regulation is a direct response to the negative side effects ("externalities") that result from pollution. Government efforts to restrict emissions, by

definition, diminish other economic activity. Efforts to restrict emissions force firms to bear the costs associated with reducing emissions, thus discouraging production in industries where pollution is a significant factor.

Three studies attempting to quantify the effect of pollution-control requirements on economic activity have found modest or no effects. At least one researcher argues that these results reflect the lack of a good measure of the strictness of state environmental regulation. Using total state expenditures on pollution abatement presents a problem because federal law requires stricter controls for new firms; this means that empirical tests are biased toward finding a positive association between high abatement costs and job growth. Complexities in state environmental regulations prevent use of a single rule to measure the strictness of state environmental regulations. Even when regulations are comparable, variations in enforcement across states make it difficult to assess the actual severity of state environmental laws.

In any case, the elimination of pollution-control regulation is not desirable. Given that environmental quality is desirable, regulators can enhance economic activity in their states by choosing regulations that minimize the costs of emissions control. Mathematical simulations can be used to identify low-cost regulations. For example, there is some evidence of cost savings associated with revising regulatory arrangements to permit firms to buy required emissions reductions from other firms. Emissions trading encourages innovation in emission control and shifts pollution abatement to those firms for which the costs of abatement are lowest. Allowing trading is one of several potentially cost-saving policies that may minimize total pollution-abatement costs and encourage economic growth.

REGULATION OF THE PROFESSIONS

There is evidence that state regulation of such professions as medical doctors, dentists, lawyers, electricians, and plumbers raises the cost of services to consumers. Although the effect of any particular restriction on aggregate state economic activity is hard to measure, state-imposed barriers to entry necessarily increase prices and reduce competition in the given market. Contrast a market in which low prices and widely available services facilitate economic growth.

It has been shown that local and state licensing laws that limit the number of electricians and plumbers (through entry restrictions) insulate wages of these groups from general movements in wages. This prevents the equalization of wages between these groups and similar workers, and so precludes the efficient use of labor. In addition, there is evidence that licensure limits the mobility of workers and professionals across states.

Medical markets also are affected by regulation at the state level. States using superfluous medical licensure restrictions in the mid-1960s (such as requiring U.S. citizenship) had relatively fewer physicians per capita. There is evidence that, where state restrictions prohibit optometrists from advertising, prices of eyeglasses are significantly higher. One study found that state restrictions on the use of parodontal professionals have resulted in dentist/parodontal ratios higher than in states without such restrictions; this is evidence that such restrictions limit the efficient combination of labor. Finally, it has been found that in states that do not automatically license dentists licensed in other states, fewer dentists are employed and dental fees are significantly higher.

CONCLUSION

We hope that this summary of the available empirical findings makes readers aware of the potential for improving living standards by changing or eliminating regulations at the state level.

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