A Proposal to Encourage States to Rationalize Occupational Licensing Practices

A *Proposal to the Brookings Institution Hamilton Project*

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Our proposal is to encourage states to rationalize occupational licensing practices and make them more efficient and fair.

Occupational licensing refers to mechanisms to impose minimum standards (often educational standards) for entry and the ability to continue working in an occupation. These regulations range from less restrictive (eg. requirements to register their names, addresses, and qualifications with a government agency), having an exclusive right to a title, known as certification, to very restrictive (eg. licensure, whereby it is illegal to practice for pay without meeting government standards).

Occupational licensing is extensive and growing. In 2006, nearly 30 percent of the workforce was required to hold a license (Kleiner and Krueger 2010), up from around 10 percent in 1970.

It is well understood that occupational licensing can serve as a barrier to occupational entry resulting in reduced employment, monopoly rents for workers in the occupation, and higher prices for consumers (Friedman, 1962).

Kleiner and Krueger (2010) show that after controlling for education, labor market experience, occupation, and other controls, licensing is associated with a 15 percent wage premium in the labor market. This estimate may partially reflect a premium for higher unmeasured human capital, but it is also consistent and likely in large part due to rents.

There is little empirical work on the effects of licensing on employment levels or growth rates, but the existing estimates suggest that they could be large. Kleiner (2006) examined employment growth rates in states and occupations with stronger versus weaker occupational licensing requirements. Specifically, he compares employment growth between 1990 and 2000 of occupations that are licensed in some states to the same occupations that are not licensed in other states. In order to account for differential growth rates between states, he also compared the growth rate of occupations that are either fully licensed or fully unlicensed in both sets of states.[1] Using a "difference-in-difference" regression analysis, Kleiner found that partially licensed occupations had a 20% lower growth rate in states with licensing relative to states without licensing and relative to the difference in growth rates between these sets of states of fully licensed and fully unlicensed occupations. This estimate implies that a licensed occupation that grew at a 10 percent rate between 1990 and 2000 would have grown at a 12 percent rate if it were unregulated.[2]

Because occupational licensing varies by state, another channel through which licensing can effect employment is through reduced mobility. The patchwork of regulations raises the cost of cross-state mobility for workers in these occupations. This will result in slower adjustment costs to regional economic shocks which can result in higher unemployment.

Because it restricts employment, licensing can also lead to higher prices for services faced by consumers. This has been documented in a number of studies including Shepard (1978), Bond, Kwoka, Phelan, and Whitten (1980) Cox and Foster (1990), and Kleiner and Todd (2009).

While it is not possible to precisely estimate the effects of substantially reducing occupational licensing at the present time, both theory and the available evidence suggest that such a reduction could translate into significantly higher employment, better job matches and improved customer satisfaction. Low-income consumers, in particular, would benefit because

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[1] The partially licensed occupations he considers are librarians, respiratory therapists and dieticians and nutritionists. The fully licensed occupations are lawyers, dentists and cosmetologists. The fully unlicensed occupations are economists, computer programmers and glaziers.

[2] Note that this estimate only reflects the differential growth rate between licensed and unlicensed occupations, not levels.

reduced barriers to entry would reduce the prices of services provided (Shapiro, 1986 and Cox and Foster, 1990) .To get a sense of magnitudes of the effect of licensing on employment and consumers, consider the following ("back-of-the-envelope") calculation. Suppose that the entire 15 percent wage premium for licensing is from rents (as opposed to human capital), labor supply is perfectly elastic and the labor demand elasticity is 0.5. There are approximately 38 million licensed workers in the US with average annual earnings of $41,000. Under these assumptions, licensing results in 2.8 million fewer jobs with an annual cost to consumers of $203 billion.[3]

Of course, these estimates do not take into account possible benefits from licensing. Licensing may result in higher quality outcomes for those who obtain services, for example, because it requires a certain amount of education and training. It may also encourage greater investment in human capital because individuals will be able to recoup a higher return for their investment if they are not competing against lower-quality substitutes.

Without doing a detailed analysis at the occupation-by-occupation and state level, we cannot say which occupations can be justified based on quality-consideration, though we note that when studies have been conducted they have found at least in a number of cases licensing reduces employment, increases prices, but does not result in better services. For example, Kleiner and Kudrle (2000) find that occupational licensing of dentists does not lead to improved measured dental outcomes of patients, but is associated with higher prices of certain services, likely because there are fewer dentists.[4]

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[3] Note that this is a transfer from consumers to workers. There will also be deadweight losses.
[4] For additional examples see Carroll and Gaston (1981).

Proposal

The existing body of work completed on occupational licensing offers just a sample of the possible reforms that could be done. For example, a sensible reform that has been identified is to allow dental hygienists to operate a practice without the supervision of a dentist. But rather than taking a piecemeal approach, we propose a number of general reforms that states and localities could take that would rationalize future and existing regulations:

(i) Prospective Evaluations: State and local governments should require benefit cost analysis prior to the new occupational licensing requirements. The burden should be on the government together with the interest groups representing the occupation to demonstrate that the social benefits of these requirements exceed the economic costs. If the benefits to the public exceed the costs, governments and the interest groups should also demonstrate that the proposed regulations are the least restrictive means of furthering the goals of the regulations.[5]

(ii) Retrospective evaluations: State and local governments should develop and execute a plan to evaluate existing occupational licensing requirements. The evaluations could be based on existing studies or new analyses. When the costs of the evaluations are shown to exceed the benefits, the requirements should be modified or dropped.

(iii) Reciprocity: When licensing is deemed to be in the interest of the public, weighed against the economic costs, states and localities should accept, as much as possible, licenses granted in other states.

Proposal (iii) would facilitate cross-state mobility and would make it more difficult for special-interests to tighten regulations in order to increase their monopoly power in a given state. Under

[5] This proposal was recently introduced in the Minnesota state legislature.

this proposal, targeting the ten states with the most mobility between them would go a long way towards solving the problem.[6]

If state and local governments were to seriously undertake proposals (i)-(iii), the available evidence suggests that employment in these occupations would grow, monopoly rents would fall. The main fiscal cost on states would be from the loss of fees for occupational licenses.

There are ways for governments to raise revenues while at the same time curtailing the use of occupational licensing and increasing employment:

(iv) Impose a surcharge or tax on workers in licensed occupations where there is evidence that the licensing leads to barriers to entry perhaps as much as the rents within the occupation.

Proposal (iv) is more unorthodox, but is based on sound principals. When there is occupational licensing leading to entry barriers, workers in those occupations enjoy monopoly rents. This surcharge would draw from those rents without adverse employment consequences. Moreover, as has been well documented, when there are employment restrictions, even if they can be justified based on their benefit to the public, special interest groups have incentives to tighten the restrictions beyond what is optimal. Taxing rents would reduce the incentive for these groups to engage in this kind of lobbying.

[6] Between 1995-2000, the ten state pairs with the most gross mobility between them were (New York, Florida) , (New York, New Jersey), (California, Nevada), (California, Texas), (California, Arizona), (Florida, Georgia), (California, Washington), (California, Oregon), (California, Colorado), and (New Jersey, Pennsylvania).

The Federal Role:

While there are occupational licensing requirements at the Federal level, it is state and local rules which, by far, have the broadest reach. Research has also found that licensing has the most pronounced effects when it is subject to multiple layers of jurisdiction. Local requirements tend to have less bite. For these reasons, we think that the Federal government is best suited to promote a set of best practices, for example those listed above. This could be achieved through a combination of the bully pulpit and monetary incentives.

Under this plan states would be encouraged to submit a proposal that outlines specific steps they plan to take to reduce unnecessary licenses. The proposals should describe steps they plan to take to reduce barriers to entry in specific occupations (eg. dental hygienists and nurse practitioners) as well as broader "process" reforms they would undertake, such as (i)-(iii) above. The plans would be reviewed by a panel of experts in the area and a partial award would be distributed to the most meritorious plans with the remaining amount withheld until certain benchmarks have been met.

Because these practices do not impose a substantial fiscal burden on states, the incentives do not have to be large for this to have an effect on state take-up. The incentives from the successful "Race to the Top" fund were $4.3 billion, which is smaller than even conservative estimates of the costs of licensing. The monetary incentives are scalable, but importantly on a dollar for dollar basis their economic benefits are likely to exceed costs.

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