

A Rational Perspective on the Importance of Reevaluating A Decade of Overregulation in the U.S.

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Government regulations are essential tools for ensuring that industry is accountable and acting responsibly. A company committed to a balanced risk framework would agree that reasonable regulatory tollgates are also necessary for guiding innovation. Innovation impacts micro and macroeconomics. Schumpeter distinguished innovation as, “[...] the commercially successful application of an idea, from invention, to the initial development of a new idea, and from diffusion, to the widespread adoption of the innovation” (Ashford and Heaton, 1981, p. 110 as cited by Stewart, 2010). Burdensome regulations cause corporations to “[...] divert time and money from innovation activities to compliance efforts” (Stewart, 2010).

INTRODUCTION

“Innovation and new goods are important forces driving economic growth and increasing the welfare of consumers” (Prieger, 2002). In regulated industries, firms across sectors, attempting to introduce new services or technologies, often must contend with burdensome, overregulation designed to protect special interests under the guise of consumer protection. Of notable concern is in measuring the cost versus benefit of, “Recent regulatory interventions—including regulatory costs associated with the recent health care and financial reform legislation [...]” which have unknown economic impact (Crews, 2016). Moreover, “Other long-recognized costs, such as indirect costs and the effects of lost innovation or productivity, remain stubbornly difficult to assess and can produce underestimates of the total regulatory burden” (Crews, 2016). This inability to assess the cost versus benefit of existing and new regulations is a catalyst for re-evaluating and delayering the current regulatory framework.

A significant increase in regulations are a direct response from the United States Federal Government to the 2008 Great Recession. The government saw fit to tighten existing and introduce new regulations across industries to more closely monitor financial solvency and adherence to post-recession protocols. The most affected by these layers of new regulations is the financial services industry, who is largely responsible for the events leading up to the Great Recession. Because of the financial sector’s involvement in the events leading up to the Great Recession, they have received the most corrective action and oversight focus from regulatory agencies, like the Consumer Financial Protection Bureau (CFPB).

Business leaders have expressed that policy makers on Capitol Hill have overreached and are now overregulating, which is affecting business advancement and competitive development. Recent research strongly suggests that the level of government oversight currently levied is diminishing the competitive edge of the U.S. in the Global Marketplace. “A study by the Information Technology and Innovation Foundation, a non-partisan research and educational institute, ranks the U.S. sixth out of 40 countries in overall innovation-based competitiveness” (Committee on Science, Space and Technology, 2012). If government regulators continue to arbitrarily layer regulations and over-process American business without reevaluating what already exists to determine if there is redundancy or excessive administrative cost, U.S. companies may likely retrench and continue to move overseas, inventing and growing elsewhere, which would have a “[...] chilling effect on our ability to grow, expand, and create jobs” (Committee on Science, Space and Technology, 2012).

THE GREAT RECESSION’S SLOW RECOVERY

“In 2008 the financial markets froze. Firms suddenly discovered that they could no longer roll over their corporate paper, a normally very liquid and easy-to issue security” (Spiegel, 2011). Banks stopped lending to remain solvent, prompting the American government to bail out troubled institutions, “[...] lending funds to fill in for the now absent credit markets. Congress complied, and thus was born the Troubled Asset Relief Program (TARP), an institution that lives on [...]” (Spiegel, 2011).

It's been roughly a decade since the recession of 2007-2009 ended. By all accounts, this severe downturn was followed by a historically disappointing recovery. Economic growth during the recovery has been far too slow to raise the employment-to-population ratio, from the low levels to which it fell during the recession. At present, the actual unemployment rate is at 9.2% (Gallup Organization, 2016). In addition, the recovery has not narrowed the gap much between real GDP and potential GDP, in stark contrast to the rapid recovery from the dark recession that took place in the early 1980s or from earlier severe recessions in U.S. history. When you include both the periods of the recession and the slow recovery, economic instability has more than tripled according to a common measure of performance used by macroeconomists: “[...] the standard deviation of the percentage gap between real GDP and potential GDP rose from 42 percent during 1984-2006 to 56 percent during 2007-2012” (Taylor, 2008).

Role of Government Regulatory Policy in a Weak Economic Recovery

The slow recovery from the Great Recession appears to be an amalgamation of complex domestic and global instability; e.g., economic, geopolitical, organic market volatility, and overregulation across the private sector. In evaluating the role of government policy, it is important to consider actions taken before, during, and after the financial downturn in the 3rd and 4th quarters of 2008. An analysis of the five years before and five plus years after the Great Recession points to an abrupt and significant shift on the domestic policy front. Federal monetary policy that worked so well decades before, was no longer being deployed. Broadly speaking, monetary policy, regulatory policy, and fiscal policy each became more fluid, and less predictable in the years leading up to the crisis. “For this reason, policy should be factored into the list of possible causes of the crisis and severity of the recession. Ironically, the legacy of the crisis and the recession has been the catalyst for the government to double down the regulations even more on American businesses” (Taylor, 2011).

Federal Monetary Policy

“A significant shift in monetary policy started during the years from 2003 to 2005 when the Federal Reserve held interest rates unusually low compared to the previous two decades” (Taylor, 2014). There was a discretionary deviation from the Fed's monetary policy reaction function or status quo, which the Fed rationalized as part of their deflationary concerns. Evidence points to this deviation leading to the housing crisis and toxic assets on balance sheets, which were partially created by exotic, high-risk, unbalanced investment offerings. The demand for housing depends, on 30-year fixed mortgage rates, which can be held down by low short-term interest rates, or 3-5 year adjustable rate mortgages (ARMs).

But even if the effect on long-term rates is small, short-term rates have explicit effects on the demand for housing in part because low interest rates make low teaser rates on ARMs possible. “As demand for homes skyrocketed, housing price inflation jumped from around 7 percent per year from 2002-2003 to nearly 14 percent per year in 2004-2005 before plummeting in 2006-2007” (Taylor, 2013). Bordo and Landon-Lane (2013), found effects of such policies on housing over a longer span of US history, and similar effects have been found in other more developed countries: Ahrend (2010) demonstrated that the European Central Bank chose an interest rate which was much too low for Greece, Ireland, and Spain, causing extreme excesses in Europe. Furthermore, the low interest rate policy led to heavy “risk taking”, as noted by Bekaert, Hoerova, and La Duca (2013).

Ramping Up Regulations

There were also notable shifts in regulatory policy in the years preceding the crisis. While there were droves of regulators and auditors from the New York Fed on the premises of the large financial institutions, they obviously allowed these institutions to deviate from existing soundness rules and take on disproportionate risks, like no documentation, sub-prime, and alt-A home loans. “The main problem was not insufficient regulations, but a failure to enforce existing regulations” (Taylor, 2014). The regulators of Fannie Mae and Freddie Mac clearly permitted these large Wall Street firms to go well beyond prudent risk and sensible capital levels, as documented by Morgenson and Rosner (2011), who attribute the problem to regulatory oversight.

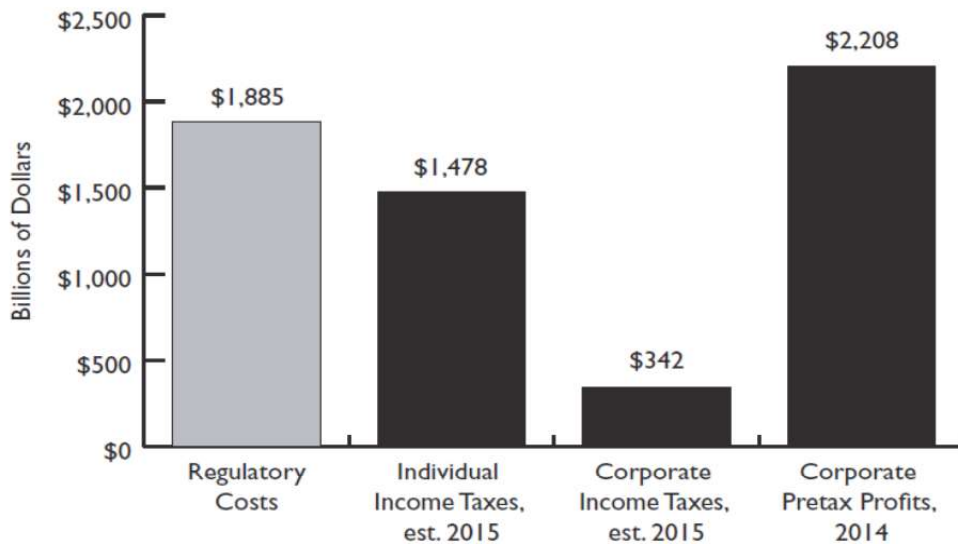
In the years since the crisis, there have been many changes on the regulatory front, including passage of the Dodd-Frank Consumer Protection Act. While this act did some good, including merging the Office of Thrift Supervision into the Office of the Comptroller of the Currency, it has created hundreds of new rules along with the newer Consumer Financial Protection Bureau (CFPB). The Dodd-Frank Act is not the only example of large regulatory intervention in recent years. The Affordable Care Act has also dramatically increased regulations across sectors (Taylor, 2014).

There seems to be a correlation between the poor economic performance in the past ten years and the shift toward government discretionary intervention that appears to be reactive and political, moving away from prudent, time-tested, predictable rule-like decision making. Macroeconomic theory that stresses the importance of time consistency, the Lucas critique, the predictability of policy, and the benefits of certain simple rules predicts that such a shift in policy would result in poorer performance. In a number of cases specific policy actions, such as holding rates too low for too long, had adverse consequences. (Taylor, 2014)

The Business and Scope of Government Regulatory Agencies

“Regulatory costs easily exceed the cost of individual income taxes and vastly exceed revenue from corporate taxes combined” (Crews, 2016). Based on the assessment that regulatory costs exceed benefits from those regulations and corporate taxes, it can be argued that regulatory costs and departments that are involved in law making are becoming a larger and larger part of the U.S. economy, 31.3%, which is concerning to those with aspirations on becoming a business owner (Crews, 2016). “The Office of Management and Budget’s (OMB) 2015 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates, which surveys regulatory costs and benefits, pegs the cumulative costs of 120 selected major regulations during the decade from 2004 to 2014 at between \$68.4 billion and \$102.9 billion (in 2010 dollars)” (Crews, 2016). As figure 1 below demonstrates, federal regulatory compliance costs are almost at the level of pretax corporate profits, which were \$2.208 trillion in 2014 (Crews, 2016).

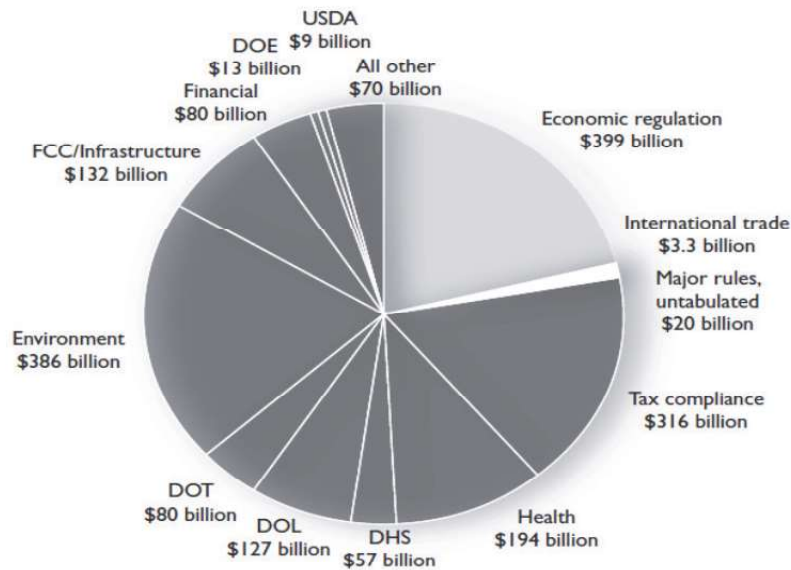
**FIGURE 1
REGULATORY COMPLIANCE COSTS**



Sources: Crews, *Tip of the Costberg*, 2016 ed. Estimated 2014 tax figures from OMB, Historical Tables, Table 2.1, "Receipts by Source: 1934–2019;" <http://www.whitehouse.gov/omb/budget/Historicals>. 2014 corporate pretax profits (domestic and international) from Bureau of Economic Analysis, National Income and Product Accounts Tables, Table 6.17D, "Corporate Profits before Tax by Industry," <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=243>.

What the U.S. government spends on regulatory enforcement is more than some developing countries entire GDPs. Funding regulatory agencies has become one of the largest pieces of the U.S. budget (31.3%). To put this into perspective, the U.S. government spends more on regulatory agencies than defense, which is around 3-5% of GDP (US Government Spending, 2017). Based on the aforementioned statistics it would not be difficult to believe that, "More is "spent" on embedded or hidden regulation in society than on health care, food, transportation, entertainment, apparel and services, and savings" (Crews, 2016). The point is that the more regulatory agencies grow, the tougher it will be to re-evaluate and delayer or determine which regulations are beneficial and which are not. As further example of the enormity of government regulatory involvement, "The number of estimated full-time-equivalent administrative and enforcement staff stood at 277, 266 in FY 2015, up from 276,576 in 2014, According to the joint re-port by the Weidenbaum Center and Regu-latory Studies Center" (as cited by Crews, 2016). Figure 2 (below) outlines 2016 estimate for regulatory budget by regulatory agency.

FIGURE 2
FEDERAL REGULATORY INTERVENTION 2016 ESTIMATE \$1.885 TRILLION



Source: Wayne Crews, *Tip of the Costberg: On the Invalidity of All Cost of Regulation Estimates and the Need to Compile Them Anyway*, 2016 ed., <http://ssrn.com/abstract=2502883>.

Note: DHS = Department of Homeland Security; DOE = Department of Education; DOL = Department of Labor; DOT = Department of Transportation; FCC = Federal Communications Commission; USDA = U.S. Department of Agriculture.

OVERREGULATING ACROSS INDUSTRIES IN A FREE MARKET

Innovation can lead to a higher level of productivity, infusing the type of mass capital that has the potential to increase economic growth and improve social welfare (Lumpkin, 2009). Regulatory interventions that affect the innovation of new ideas and products for consumers, and that generate excessive administrative costs, do have a downstream effect on the economy and on consumers in that the cost of excessive regulation will likely be passed on to customers of the product, pricing certain consumer segments out of the market for the new innovation. Some of these innovations that people are being priced out of are medical and pharmaceutical, which is detrimental to our health system. In the U.S., we pay some of the highest prices for drugs and healthcare because we absorb a large amount of regulatory cost, which is part of research and development (Mohamed, 2015). The U.S. pays retail for drugs and other countries negotiate because the government believes that regulating pharmaceutical pricing would undermine our free market, which seems to contrast what is currently taking place between the government and U.S.-based businesses (Mohamed, 2015).

Aside from the U.S. pharmaceutical industry, two glaring examples of government regulatory overreach are in the manufacturing and financial services industries. As far as manufacturing is concerned, “Regulations on issues such as contractor blacklisting, employee overtime, silica, union elections and injury and illness reporting will not only result in hundreds of millions of hours of paperwork, but will also come at a price tag of more than \$80 billion in compliance costs over the next 10 years” (Micetich, 2016). These regulations make it harder for manufacturers to stay state-side where heavy taxes are levied, create new jobs for Americans and innovate (Micetich, 2016).

Innovation in the financial services industry “[...] should be seen as a natural aspect of the workings of a competitive system. Thus, the ideal policy approach is to find an appropriate balance between preserving safety and soundness of the system and allowing financial institutions and markets to perform their intended functions” (Lumpkin, 2009). Innovations in the financial services industry bring consumers better products for balancing and allocating assets, which has the potential to positively impact the economy the clientele of these institutions and funds. The three core policy objectives featured in most financial regulatory frameworks are: mitigating risk, managing reputational risk; i.e., through sound business practices, and ensuring adequate protection for stakeholders. However, since the financial services industry is among the most heavily regulated of all, impact to innovation and operations is staggering.

“Businesses depend on a healthy, well-regulated financial system to spur economic growth. However, the past decade has been turbulent—from the financial crisis to its legislative response. While many of these reforms have improved the resilience of our financial system, a number of policy responses have gone too far and are negatively influencing Main Street companies and their customers” (Center for Capital Markets, 2016). Because of intensive regulations, it has become difficult for banks to lend money to customers with varying or non-traditional needs. Product innovation in the industry is stifled by the heavy regulatory requirements, which stagnates growth in the sector, trickling down to the entire U.S. economy. Further, more than three-quarters of American companies estimate that the effect of the Dodd-Frank Wall Street Reform other financial regulatory rules adopted over the past six years is making it hardly scalable for them to access the financial services they need (Center for Capital Markets, 2016). Without a strong financial services supply chain, the country cannot finance the type of growth required to re-start the economic and job growth. “Regulatory efforts to ensure financial stability must be accompanied by equally vigorous, data-driven analysis to make certain that Main Street companies continue to have access to the financial services they need” (Center for Capital Markets, 2016).

According to Thompson Reuters (2016), financial services “[...] compliance professionals continue to express regulatory fatigue and overload, with no perceived let-up in the volume of regulatory change. Like last year’s survey results, 69 percent of firms expect regulators to publish even more information in the next year, with 26 percent expecting significantly more”. As of July 2014, it was estimated that the top six financial services firms spent over \$70.2 billion dollars per year in regulatory expenses, which does not include productivity lost to compliance staffing and in-house regulatory oversight.

How Much Regulation is too Much Regulation

Manufacturers and financial services institutions alike understand the need for reasonable regulation and take pride in creating sound workplaces with opportunities for all, but this seemingly endless stream of regulatory burden is not a balanced approach that creates success or a forward-moving marketplace. “Manufacturers want to spend their time and resources hiring new workers or investing in life-improving products, but the billions being spent complying with burdensome regulations makes that goal increasingly difficult to achieve” (Micetich, 2016). Scott Tipton, Colorado Congressman has been particularly critical of overregulation and has noted that the regulations in place across industries are not sustainable and are damaging his small local economy as well as the national economic landscape. According to Tipton (2016), business owners in his district report that “[...] overregulation is one of the top challenges they face in creating jobs and growing their businesses.” Furthermore, Tipton posits that it is time excessive regulation is reined in so that our economy can begin to grow again and lawmakers can stop layering regulations to grow their agencies, which only increases and the reach of government over our free market system (Scott Tipton U.S. Representative for Colorado: Constitutional Issues, 2016).

There is no doubt a responsible balance must be stricken as far as regulations are concerned. Too much of anything is never good, including regulations supposedly designed to protect the consumer. Overregulation causes an evident paralysis in business that stagnates growth and innovation across all sectors of the U.S. economy, while the government flourishes as a result, which may just be an unintended consequence. However, unintended, it is alarming to arrive at the realization that the government spends more on regulatory agencies than any other service that promotes social welfare. The

lack of balance in government spending toward regulation should be examined more closely (but by whom is the question). As Luke 12:48 KJV asserts, “From everyone who has been given much, much will be demanded; and from the one who has been entrusted with much, much more will be asked. For unto whomsoever much is given, of him shall be much required [...]” (Luke, n.d.). It is up to the government and businesses to work together to strike that delicate, skillful balance between what is both right for the consumer and fair to the marketplace, while maintaining an adequate separation between American businesses and American government.

THE PURPOSEFUL ASPECTS OF REGULATION

It would be remiss not to address the fact that not all regulation is over-burdensome and costly. Some regulation, especially technical and environmental, can result in new innovation that yields financial gains. We will discuss both circumventive and compliance innovation within the scope of regulation. “Circumventive innovation occurs when the scope of the regulation is narrow and the resulting innovation allows the firms to escape the regulatory constraints” (Stewart, 2010). For example, the regulation of a financial product, such as a credit card product, may cause a retail bank to invent new financial products that elude the scope of a credit card product, creating an alternative lending vehicle with revolving credit. “Compliance innovation occurs when the scope of the regulation is broad and the resulting product or process innovations remain within the scope of the regulation. For any regulation that requires at least some innovation for compliance, there are these two opposing forces, and, in general, whichever one is stronger will in large part determine whether the regulation stifles or stimulates innovation” (Stewart, 2010). It is important to note, however, that simply “[...] requiring innovation for compliance is no guarantee that the resulting innovative activity will meet the Schumpeterian definition of innovation by creating a commercial success. The innovative activity can result in “dud” products or processes, and thus, even when it demands compliance innovation, regulation can still stifle innovation in the end” (Stewart, 2010). From a financial perspective, the most effective innovations will require compliance innovation and, at the same time, “[...] will minimize the compliance burden and manage the risks of producing “dud” inventions” (Stewart, 2010).

Furthermore, new innovations can affect public interest and health. While many innovations prove beneficial, others can result in adverse outcomes...some innovations can be a health hazard if not properly vetted. “Examples of the latter include products that are misrepresented or simply inappropriate for end-users and as a result [...]” cause dramatic issues that are interconnected, creating a domino effect of negative consequences (Lumpkin, 2009). Therefore, at their best, and when moderate, most regulatory frameworks are designed to protect the consumer, the economy and the structure of our social welfare system. Regulations can provide enormous protection if thoughtfully designed, with the entire system of its effects in mind.

CONCLUSION

Regulatory reform faces a fundamental challenge: How do we foster innovation that deepens financial growth, while mitigating instability in the interconnectedness of the American economy. We also face the challenge of reevaluating the role of government in our businesses. There is currently a bill in the House of Representatives called the Separation of Powers Restoration Act of 2016 (H.R. 4768) to stop excessive regulation and restore the separation of powers between the three branches of the federal government. If this bill passes, it will be a long road ahead to delayer regulations across business sectors as they exist today.

American Constitutional textualists would posit, “One of the complaints that the Founding Fathers leveled against King George III in the Declaration of Independence was that “He has erected a Multitude of New Offices, and sent hither Swarms of Officers to harass our people, and eat out their Substance” (Tanner, 2016). This nation was founded on the principle that government would be limited and serve a more supportive role where their main interest would be national security, focused on foreign threats.

Questions come to mind about the absence of the core value or precept of limited governmental power when ruminating on regulatory issues of the day. As Ronald Reagan once said, “Government exists to protect us from each other. Where government has gone beyond its limits is in deciding to protect us from ourselves” (Tanner, 2016). Therefore, our ability to arrive at a more reasonable regulatory framework would have to be a social welfare movement undertaken by a bi-partisan committee of U.S. business leaders, economists and U.S. legislators. The goal of this effort would be to repeal the reactionary posture the government took in response to the 2008 financial crisis by peeling back existing regulations to make room for a more practical design that can be accurately measured for cost/benefit analysis, which is difficult to measure in the current regulatory environment.

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