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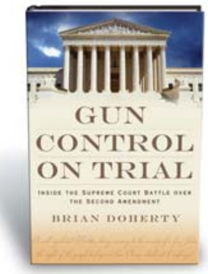

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Are We Ailing From Too Much Deregulation?

BY DAVID R. HENDERSON

"Americans May be Losing Faith in Free Markets" reads the title of a July 16 "news analysis" by *Los Angeles Times* reporter Peter G. Gosselin. "Wave Goodbye to the Invisible Hand" is the title of an August 1 article by Pulitzer Prize–winning *Washington Post* columnist Steven Pearlstein.

This recent trend in economic reporting actually began with an April 13 article by *New York Times* economics reporter Peter S. Goodman titled "A Fresh Look at the Apostle of Free Markets." Goodman's article, which I examined at length on the Cato@Liberty blog, was full of misinformation, not just about his subject, Milton Friedman, but also about economic thought and about the state of the U.S. economy. The newer articles continue the trend. And they're all wrong.

Many journalists claim that the U.S. economy since the late 1970s has been very free, with little regulation; that this absence of regulation has caused markets to fail; that there was a consensus in

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Gov. Mark Sanford (R-SC) was one of a number of distinguished speakers at the annual Cato Club 200 retreat, held in September at Kiawah Island, South Carolina. Sanford, one of the most small-government elected officials in the country, spoke on the continuing tension between the "Ted Stevens branch" and the "Tom Coburn branch" of the Republican party, and he urged the assembled Sponsors to continue to support candidates in favor of lower spending and greater personal choice.

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favor of little regulation; and that, now, this consensus is fading. On all these counts, the reports are false. Specifically, the U.S. economy has not been free since before the New Deal of the 1930s. Even before the 1930s, the U.S. economy was "mixed"—that is, a combination of economic freedom and government regulation—and Franklin Roosevelt's New Deal altered the "mix" substantially toward regulation and away from freedom. The deregulation of the late 1970s and 1980s reversed some of the regulations that came with the New Deal and some that preceded it, but the net amount of regulation has been much higher in the alleged era of deregulation than it was during the post–National Recovery Admnistration New Deal. Moreover, most of the apparent "market failures" that these articles refer to fall into one of two categories: Either they are not market failures at all, but market successes, or they are failures that are due to government regulation. Also, the consensus has not shifted from deregulation to regulation: there never was a consensus in favor of deregulation. There was a consensus in favor of deregulation among economists and a minority of politicians in the late 1970s and early 1980s, but never among the majority of politicians. Finally, most of the problems that have happened in the U.S. economy in the last few years strengthen the case for economic freedom and against government control.

Consider some specifics. Pearlstein writes:

> For the past 25 years, the United States has put its faith in open, unregulated and lightly taxed markets, and there's little doubt that, over time, that model has expanded economic output and improved economic efficiency. But what Americans have also come to realize is that the same model is less adept at providing other things that we value highly—things like safety, fairness, economic security and environmental sustainability.

There are two main problems with that two-sentence paragraph: the first sentence and the second sentence.

> "The U.S. economy has not been free since before the New Deal of the 1930s."

An Era of Deregulation?

Take the first sentence. "Unregulated markets" for the past 25 years? The Federal Register, which lists new regulations, averaged 72,844 pages annually during the Carter years from 1977 to 1980. These were presumably, by Pearlstein's 25-year standard, the last time before now that Americans didn't have "faith" in open, unregulated markets. Then the average fell to 54,335 during the Reagan years, rose to 59, 527 during the Bush I years, to 71,590 during the Clinton years, and, finally, to a record 75,526 during the administration of that great believer in laissez-faire, George W. Bush. It's true that when governments deregulate, they must announce those changes in the Federal Register, too, and so some of the pages represent genuine deregulation. But most of the pages were new regulations, no matter what president was in power at the time. So, far from moving away from regulation, the U.S. economy became even more regulated during Pearlstein's alleged 25-year era of light regulation.

Of course, the number of pages in the Federal Register is a crude measure of regulation. But it's not the only measure we need rely on. Veronique de Rugy and Melinda Warren, in "Regulatory Agency Spending Reaches New Height," an August 2008 report by the Mercatus Center and the Weidenbaum Center, found that between 1980 and 2007, roughly the years that Pearlstein labels "unregulated," the number of full-time employees of U.S. government regulatory agencies increased 63 percent, from 146,139 to 238,351. During that same time, the U.S. population rose from 226.5 million to about 301 million, an increase of only 33 percent. Moreover, according to de Rugy and Warren, U.S. government spending on regulation alone (not including compliance costs, a much bigger number) tripled, from $13.5 billion to $40.8 billion (all in 2000-year dollars.) As a percent of GDP, spending on regulation rose from 0.26 percent to 0.35 percent, a 35-percent increase. Some deregulation.

One could argue that we need to distinguish here between different kinds of regulation. Often people refer to "economic regulation" when they mean restrictions on whether new firms can enter businesses or that require firms to get government permission before setting their prices. If this is what they mean, then there is a case to be made that, in substantial sectors of the economy, there is less government regulation now than before the late 1970s. There has been substantial deregulation at the federal level of airlines, trucking, railroads, oil, and natural gas, to name five large sectors. And indeed, as we shall see later, this deregulation has had, on net, good effects.

What was the nature of this new regulation? The biggest growth came in so-called "homeland security," where spending more than quintupled, from $2.9 billion in 1980 to $16.6 billion in 2007 (all in real 2000 dollars). The second-largest growth rate was in regulation of finance and banking, where spending almost tripled, rising from $725 million to $2.07 billion. Together, regulation of homeland security and of finance and banking now account for over half of federal regulatory spending.

Markets vs. Government

Also incorrect is Pearlstein's second sentence. Free markets have done much better than governments at providing safety, fairness, economic security, and environmental sustainability. The reason, for three out of the four, is simple. Economic freedom tends to lead to economic growth, as Pearlstein himself admits in the above quote, and economic growth leads to more safety, more economic security, and more demand for environmental quality. Safety and environmental quality are what economists call "normal goods." As our real incomes rise, we want more of them. Over the 20th century, as our real incomes rose, we workers demanded more safety. And we got it. As economist W. Kip Viscusi notes in "Job Safety," published in *The Concise Encyclopedia of Economics,* as U.S. per capita disposable income per year rose from $1,085 in 1933 to $3,376 in 1970 (all in 1970 prices), death rates on the job fell from 37 per 100,000 workers to 18 per 100,000. Note that all of this preceded the Occupational Safety and Health Administration, which began in 1970. This shouldn't be surprising. As workers, we show our demand for safety by the wage premium we insist on to take a given risk. As real incomes rose, this wage premium rose. Employers found it cheaper to avoid some of the risk premium by reducing risk—that is, by increasing safety. In short, there is and has been a "market for safety."

The case with environmental quality is similar. Past some income level, environmental quality is almost certainly a normal good, that is, a good that people demand more of as their income increases. But demand does not guarantee supply. Why not? One major factor is that so much of the environment is a "commons," a resource that everyone can use but no one owns. As Garrett Hardin pointed out in his classic 1968 article "The Tragedy of the Commons," when no one owns a resource, it will be overused because no one has much incentive not to overuse it. One obvious solution is to transform, to the extent possible, the commons into private property. This has been done with rivers, lakes, and land, but is hard to do with air and oceans. But certainly we could go much further toward private ownership than we have until now, turning rivers, for example, into private property, as is done in Scotland. Scotland, not coincidentally, has pristine rivers. So note the irony. Contra Pearlstein, one reason that we haven't had the environmental quality we have demanded is that overregulation has prevented private ownership.

On the issue of economic security, the wealthier we are, the more secure we are. And because, as Pearlstein himself admits, economic freedom creates wealth, it necessarily creates security. Virtually no one in America ever needs to worry any more about starving. That is in part due to the welfare state but is mainly due to the riches created by relatively free markets. Of course, if, by "economic security," Pearlstein means confidence that one's income will never fall, then he's right that markets don't lead to that. Nor does government regulation. Government regulation of the economy's money supply, high tariffs, high taxes, and regulations that kept wage rates high all caused the Great Depression or contributed to its length.

> "Free markets have done much better than governments at providing safety, fairness, economic security, and environmental sustainability."

Freedom and Fairness

Pearlstein objects that economic freedom does not lead to fairness, but it does. One of the fairest things in life is that people reap what they sow, getting the benefits when they make good decisions and bearing the costs when they make bad ones. Markets create that fairness every day. And what makes Pearlstein's argument ironic is that elsewhere in his article he writes that "government has had to step in to rescue the markets from their excesses and prevent a meltdown of the financial system." If he really believes that these are excesses and if he really wants fairness, why does he think that the government should bail people out from their mistakes? Some of the people whom the government is bailing out are very wealthy people who will retain more of that wealth because of the bailouts. Many of the people paying taxes for the bailouts are middle-income people who acted responsibly. Just what is Pearlstein's view of fairness, anyway?

In his article, Gosselin details three factors that are "pushing people to favor more regulation"—the high price of gasoline, the fall in house prices, and the dismal performance of the stock market for most of the current decade. If Gosselin were simply stating that these factors have made people more favorable to regulation, he might have a point. But that's not all he does. He seems to take the side of those who see these three factors as market failures. On gasoline prices, although he points out that most economists think these prices are due to "booming global demand meeting limited global supply," he dismisses this reasoning, arguing that "the price run-ups seem out of whack with demand, which has increased only about 1% worldwide." But Gosselin is confusing demand and consumption. It's consumption of oil that has increased a little. Demand has increased much more than consumption. That's why the price rose. A standard exercise in introductory economics classes is to show students that when supply is fairly inelastic and demand increases a lot, the price will rise a lot, and the actual amount produced and consumed will rise just a little. That's what has happened in the world oil market. Moreover, why has global oil supply been so limited? There are three main factors, all of which are entirely due to regulation. The first factor is OPEC, an organization of governments that regulates the supply of oil. OPEC was formed, incidentally, in response to President Eisenhower's regulations on oil imports, which discriminated against imports from the countries that formed OPEC. The second factor is that almost all oil-producing countries in the world have government-run oil industries. The third factor is the U.S. government's restrictions on offshore drilling for oil and on oil development in the Arctic National Wildlife Refuge. Whether one favors or opposes these restrictions on drilling, the point is that they do constrain the supply of oil and do, therefore, cause the price of oil to be higher than otherwise.

Interestingly, Gosselin leaves out the major price declines that have occurred in some of the most unregulated or newly deregulated parts of the economy: computing power (there is little regulation of the computer industry) and clothing (there has been a major shift toward free trade in clothing.)

Fannie, Freddie, and the Housing Crunch

On housing prices, Gosselin claims that "the rise in house prices and the recent plunge grew out of an almost unregulated corner of the mortgage market—the one for riskier loans." But in fact much of this problem arose from regulation. Jeffrey Hummel and I detailed how in *Investors' Business Daily* ("Blame the Feds, Not the Fed, For Subprime Mortgages," March 23, 2008). Federal government regulation contributed in three ways. First, the federal government helped cause the boom in housing prices by helping cause moral hazard: people taking risks because they know that if things turn out badly, someone else will bear some of the cost. The federal government's semiautonomous mortgage agencies—Fannie Mae, Freddie Mac, and Ginnie Mae—all buy and resell mortgages. Of the more than $15 trillion in mortgages in existence in early 2008, about one third were owned by, or were securitized by, Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Housing and Veterans Administration and other government agencies that subsidize mortgages.

Although Fannie Mae and Freddie Mac were no longer government agencies during the time period at issue, they were government-sponsored enterprises. Many buyers of their repackaged loans, therefore, assumed an implicit federal-government guarantee. That assumption, as we now know, was all too true. This implicit guarantee caused less scrutiny by lenders than otherwise, which helped drive up housing prices.

The federal government's second contribution to the increase in housing prices was the Community Reinvestment Act. This act, first passed in 1977 and beefed up in 1995, requires banks to lend in high-risk areas that they otherwise would avoid. Banks that fail to comply pay fines and have more difficulty getting approval for mergers and branch expansions. As Stan Liebowitz, a University of Texas economist, has pointed out, a Fannie Mae Foundation report enthusiastically singled out one mortgage lender that followed "the most flexible underwriting criteria permitted." That lender's loans to low-income people had grown to $600 billion by 2003. Its name? Countrywide, the largest U.S. mortgage lender and one of the lenders in the most trouble for its lax lending practices.

> "The three overriding facts are: (1) we have not had a period of light regulation, (2) deregulation didn't fail, and (3) regulation makes things worse."

Finally, a little-noted change in regulations by the comptroller of the currency in December 2005 acted as the trigger. The comptroller made it mandatory for banks to require minimum payments on credit card balances, causing increases of at least 50 percent for most cards and as much as 100 percent on others. Many people who hold subprime mortgages are people for whom a higher monthly payment on a credit card would be a problem. Whereas before this regulation, many people's priorities would have been mortgage first, credit card second, the new regulation caused many borrowers to reverse the order. Thus the comptroller's seemingly small increase in regulation had the unintended effect of causing some mortgage borrowers to default.

This is not to say, of course, that private businesses never do anything stupid unless it is caused by bad government policy. Certainly, many actors in the private sector put their and other people's money at risk in absurd way. It is safe to say, though, that in the case of the subprime mess, regulation and government subsidies deserve much of the blame.

Why Regulation Fails

Moreover, notably absent from all four earlier-mentioned articles is an argument for why regulation would work or how deregulation fails. I have already provided evidence of how badly regulation has worked in oil and in the housing market. But there's more to say. There are two main reasons that regulation generally works out badly. One is that the regulators have little incentive to get things right. Indeed, when their regulations fail, they often use this fact to argue for more power and more regulation. Astonishingly, the argument often works. The second reason is that regulatory agencies are often captured by the politically powerful and used to stomp out competition. The recent regulations on housing finance, for example, require mortgage brokers to be licensed. That will reduce competition in mortgage brokering and enhance the incomes of existing mortgage brokers.

And we have powerful evidence of the beneficial effects of deregulation. Air fares, for example, according to Brookings Institution economists Clifford Winston and Steven Morrison, are 22-percent lower than they would have been had regulation continued. Brookings economist Robert Crandall and Mercatus economist Jerry Ellig estimated in the late 1990s that when the lower air fares are adjusted for the decline in quality and amenities, passengers saved a cool $19 billion a year. In other words, the majority of us prefer lower fares to higher fares, more meals, and emptier airplanes. According to Hoover Institution economist Thomas G. Moore, between 1977, the year before deregulation of trucking began, and 1982, inflation-adjusted rates for truckload-size shipments fell by 25 percent and service quality improved. And, of course, because of decontrol of oil and gasoline prices under presidents Carter and Reagan, increases in world oil prices have been passed on to consumers rather than suppressed, so that the time-killing line-ups for gasoline in the 1970s have not been repeated.

It's possible that I'm being uncharitable in interpreting Gosselin. Perhaps his tone simply reflects the tone of Americans whom he sees as souring on economic freedom. But shouldn't economic journalists, whatever else they do, get the facts right? And the three overriding facts are: (1) we have not had a period of light regulation, (2) deregulation didn't fail, and (3) regulation makes things worse. ■