Testimony 2/27/2012 on Temporary Restrictions on New Regulation

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I support the proposed Regulatory Freeze for Jobs Act of 2012 that restricts new regulation during the current recession until the unemployment rate falls to 6 percent of the labor force. The proposed legislation includes safeguards that permit the restriction to be set aside for reasons of national security, public safety, or for some other purposes. Some of the listed restrictions, such as public health and the environment can be abused to vitiate the act's purpose.

I have urged repeatedly that Congress limit new, costly regulation in the interests of increasing the speed and size of the economic recovery. The proposed legislation does not oppose regulation: As the short title suggests it sets recovery and reduced unemployment as priorities.

We all recognize that unemployment rates remain high, growth and investment slow. Forecasters expect slow growth to continue. One main reason is that investors and producers are uncertain about regulation and taxation. Investment and growth depend on estimates of the returns or earnings anticipated in future years. Current and prospective regulations make estimates of future returns highly uncertain. Who can predict with acceptable confidence what new or pending regulation will do to future costs for energy, healthcare, finance, and labor? Without confidence in estimates of predicted costs, returns to investment cannot be estimated adequately. Uncertainty increases. We all know that increased uncertainty restrains recovery.

Investors in capital equipment, in housing and other assets have responded to regulatory uncertainty in two main ways. They hold cash assets and wait for greater clarity, and they invest abroad in places where future costs are less uncertain. Cash assets are at record highs. A major reduction in regulation would release some of the cash hoards by reducing uncertainty about future costs and returns to investment. Reducing uncertainty acts as a stimulus.

A recent survey by Michael Porter and Jan Rivkin of the Harvard Business School asked thousands of HBS alumni about impediments to investment and job creation in the United States. The responses cited the U.S. tax code, regulatory burden and uncertainty, as well as the absence of job skills among the unemployed. Unless changes are made to reduce these costs and burdens, the alumni expected job-creating investment to decline over the near future.

The proposed legislation does not take a stand on the desirability of proposed regulations. It is about timing and priorities. It shifts policy to give more attention to jobs and economic recovery and away from regulation. I agree that employment and recovery should be our priority at the present time.

During the period when new regulations are restricted, Congress can and should improve regulatory processes and administration. Much current regulation is ineffective and does not accomplish the ends that the regulation was intended to achieve. Capture is one reason. The regulated become the regulators, or regulators have one eye focused on a career change to work for the firms or industry that they regulate. The Securities and Exchange Commission (SEC) is an often cited example. We know that the SEC did nothing to stop Bernard Madoff's

Ponzi scheme, despite several demonstrations by a financial professional directly warning the SEC that Madoff's claims could not be true.

Examples of regulatory "capture" are common in the academic and policy literature. The claims are supported in practice. Steve Linnick, Inspector General of the Federal Housing Finance Agency, issued a report stating that Fannie Mae knew about extensive foreclosure abuses by its outside law firms in 2003, four years before the crisis started. Regulators did not stop the bad practices when they could have prevented some of the costly failures that followed. Regulation failed in this case, as in many others.

Banks are regulated by several agencies. Prior to the housing and financial crisis that started in 2007, the Federal Reserve had hundreds of regulators working inside the largest banks in New York and Charlotte. They examined the loans made during this period. They did not prevent ANY bad loans. Regulation failed.

Prior to the crisis, an agreement by all the principal developed countries required commercial banks that lent on mortgages to increase their capital if they increased mortgage loans. The banks circumvented the regulation by setting up subsidiaries to hold the mortgages. Instead of more capital per dollar of mortgages, there was less. Regulators did not object. Regulation failed.

Currently, the Federal Housing Administration (FHA) is required to hold capital equal to 2 percent of the amount of insurance it issues. For the past three years, the FHA has not met that requirement. Currently, its capital ratio is near zero. Regulation is circumvented. Again, regulation failed.

The recent Dodd-Frank legislation imposed hundreds of new financial regulations, but left most of them to be specified by the regulators. An army of K Street lobbyists is at work to make the new rules less burdensome by circumvention. The so-called Volcker rule will almost certainly be circumvented along with many others.

Congress must devote more energy to assuring that regulatory practice is in the public interest—bringing private and social costs together.

In my recent book, Why Capitalism?, I offer three economic principles of regulation. The first says that lawyers and bureaucrats write regulations, but markets circumvent costly regulations. The second principle says that regulation is static but markets are dynamic. If a costly regulation is not circumvented at first, markets will learn to circumvent it over time. I can cite many examples.

I am not—repeat not—opposed to all regulation. Congress should work to develop effective regulation. My third principle will guide you toward more effective regulation. That principle says that regulation is effective if it changes the incentives of the regulated entity. I testified several times in favor of increased equity capital requirements for banks. I was gratified when one Senator introduced legislation that increased capital requirements relative to asset size as asset size rose.. It did not make it through the banking committees. Fortunately, an international agreement raised capital requirements. Unfortunately, it does not raise requirements for large banks relative to others.

Capital requirements change banker's incentives. They are difficult, even impossible, to avoid. And they put the cost of risky investments on the owners and managers, where they belong in a market economy. That's an effective way of reducing risk, one that does what proper regulation should do. It brings private and social costs together. In searching for regulatory rules, your guide should be to structure incentives to bring private costs as close as possible to social costs. The recent bailouts do the opposite; they relieve private costs by imposing large social and private costs on the taxpaying public.

We all recognize that full economic recovery requires recovery of the housing and mortgage markets. Ask yourself what you would do if you were a mortgage lender. One part of government urges you to speed foreclosures. At the same time, another agency sues you for alleged past practices. The conflicting actions create uncertainty and delay recovery by reducing bankers' incentives to write new mortgages. Regulators are undermining recovery.

Finally, I urge you to be concerned about the broader consequences of the large increase in regulation. Much of the regulation that we have replaces the rule of law with rule by regulators. The rule of law has been a pillar of successful capitalist development. Increased regulation erodes the rule of law. Under the rule of law, all citizens and companies are treated alike, or as nearly alike as possible. Under rule by regulators, that is not so. Some gain advantages over others, distorting resource allocation. One of many examples is familiar from recent practice. Too big to fail uses taxpayer money to prevent failure by large financial institutions. Smaller banks are allowed to fail. This is one of many examples of rule by regulators.

To repeat, I support the bill. If it becomes law, the economy would face lower uncertainty about future costs and returns. Investment, productivity and jobs would increase. This long recession and slow recovery would be shortened.