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The U.S. Needs A Supply Revolution

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Even though the US has gained 14.5M private sector jobs since the end of the Great Recession, many claim the recovery hasn't been brisk. Indeed, by measures of GDP growth, it hasn't been like a 'V-shaped' recovery.

This isn't unusual for the aftermath of a financial crisis, when the private sector is deleveraging, but some blame an increasing burden of regulation falling on US business slowing the recovery down.

Indeed, in theory, this could explain why business doesn't invest more, despite enjoying record profits, sitting on record cash levels, and facing record low interest rates.

We are not convinced about that. Even on the Heritage Economic Freedom Index, the US is still ranked 11th (out of 178 countries), while in 2011, it wasranked 17th.

The Cato Institute, another right-wing think tank, has this to say:

The United States, once considered a bastion of economic freedom, now ranks 16th in the world with a score of 7.73. Due to a weakening rule of law, increasing regulation, and the ramifications of wars on terrorism and drugs, the United States has seen its economic freedom score plummet in recent years, compared to 2000 when it ranked second globally.

So there could be something in the 'increased regulatory burden' argument for the slow growth; although the reasons for this are interesting, mentioned are not only an increase in regulatory burden, but also the 'ramifications' of the wars on drugs and terror, and a weakening rule of law.

Meanwhile, let's not lose sight of the fact that this started before the financial crisis and the US is still one of the most economically free countries on earth.

The regulatory burden might be increasing (Obamacare and Dodd Frank come to mind), but in a way this is something that is just a function of increased complexity of modern economies.

After all, consumers want to be assured of stuff like their fresh orange juice is really fresh, that when they buy a burger it's not laced with horse meat, when they go to a doctor he or she is qualified or when they consult company accounts in search of stocks to invest these accounts reflect reality.

So regulation is basically a last resort solution to a well known market failure, information asymmetries. This itself is a function of the increasing complexity of modern life, and basically unavoidable.

And while corporations often protest loudly against newly proposed regulation, and tend to paint a dark picture on the consequences of new regulation (in so called comment letters), they almost invariably say the opposite to shareholders. For instance:

In July 2015, Dennis Glass, the president and CEO of Lincoln National said in his comment letter that the proposed rule was "immensely burdensome" and "extremely intrusive," and would be "so burdensome and unworkable that financial advisors and firms will not be able to use it"; while two months earlier, Mr. Glass told investors that he didn't "see [the proposed rule] as a significant hurdle for continuing to grow that business." None of those are unconditional quantified falsifiable predictions; they are just adjectives. But the tone is different, sure.

Or: In July 2015, the president of Jackson National Life Insurance Company said in his DOL comment letter that the proposed rule would "be very difficult, if not impossible for financial professional and firms to comply" with; then, in August 2015, the president of Jackson's parent company told investors that a similar rule in the United Kingdom actually led to an increase in retail sales and that the company was positioned to "build whatever product is appropriate under that set and adapt faster and more effectively than competitors."

While starkly different, this does not necessarily amount to fraud, as both comments are essentially contingent predictions about an unknowable future. However, the contrast is often eye catching and, at the minimum, leaves a taste of dishonesty.

Here we come across another worry about regulations which can't be ignored, and this is the increasing input from corporations in shaping them. The amount of money spend on lobbying has doubled since 1997, according to the Economist.

That magazine also noted how profits are not only at record highs (or slightly off as a result of the oil crash and the high dollar), but noted several interesting features:

- Whilst American companies make 20% of their profits abroad, their return on capital within the US is 40% higher.
- The most troubling aspect of America's profit problem is its endurance.
- The rate of small-company creation in the US is close to its low in the 1970s.

Normally, high profits get competed away, but this process seems to be muted in the US. The Economist cites the results of a McKinsey study that show that the odds of maintaining high profitability have increased markedly.

All this seems to point to regulation as the culprit, but not so much regulation by overzealous politicians, but regulation on behest of big companies in order to protect their turf.

The Economist estimates that about a third of the profits are due to this kind of rent seeking behavior, but this isn't the whole picture, as in some industries, like banking, these practices do not show up as higher profits but are captured by an employee elite.

And while the slowdown in new company formation probably has more reasons, it's difficult to assess the economic cost of this.

The practice has even produced a conference of economists trying to answer questions like whether this changes the theory of the firm, and if maximizing shareholder value as the sole goal of the company allows for this kind of regulatory capture.

Basically, all participants argued that these practices are ongoing, but opinions differed on whether this was harmful. A notable dissenter was Chicago Booth professor Steven N. Kaplan:

If companies were changing the rules of the game, it should have helped incumbents, but there has been a huge turnover among top corporations in the U.S. in the last 50 years.

But he might want to consult with the Economist article we cited above. Or he might have read Bloomberg columnist Barry Ritholtz about the US Chamber of Commerce, by far the largest business lobby group in the country (Bloomberg):

According to Open Secrets, a site that tracks political lobbying and spending, during the past 18 years, the Chamber has spent three times more than any other organization on behalf of industry ($1.2 billion versus $351 million by the No. 2 lobbying group, the National Association of Realtors).

But it's not just its size that caught Ritholtz's attention:

This is of great interest in the context of the Chamber's opposition to thenew fiduciary rules for retirement accounts, requiring brokers to put savers' interests ahead of their own. Opposing the fiduciary standard may be pro-Wall Street, but it's anti-small business.

Ritholtz describes other fields where the Chamber is at odds with the interests of some, if not most, of its membership, and seems mostly driven by the priorities of a few big donors.

So while business is complaining about ever more rules and regulations, it increasingly influences these rules and these increasingly tend to favor big established corporations, rather than small and new ones.

We would say that the quality of rules matter as much, if not more than the quantity, and it is therefore hugely important how they come about and what interests they reflect. Here is Robert Kuttner, describing the new book by Robert Reich (Saving Capitalism: For the Many, Not the Few), former Labor Secretary under Bill Clinton:

Reich's new work is the best statement since Karl Polanyi's 1944 masterwork, The Great Transformation, of how markets are creatures of government and politics rather than a default state of nature... Reich's latest book is a compendium of all the ways that political power by economic elites rigs the rules of how markets work - in favor not of efficiency, but of the rich and the powerful - increasing both inefficiency and inequality.

Indeed, Reich's book is full of examples (from an interview with the author inthe WSJ):

Americans pay more for Internet service than citizens of any other advanced country, and we get the slowest service. That's directly related to the fact that almost 80% of Americans have no

choice of Internet service provider. And why is that? Because the Internet service providers have a lot of political clout, both locally and nationally, and the cable companies know how to keep their monopolies.

Another example would be the pharmaceutical industry. Americans pay more for pharmaceuticals than do the citizens of any other advanced country. Why? It's not simply because U.S. companies do the most research, and in fact lately U.S. companies have been doing very little research. Rather, it's because the rules and laws governing pharmaceuticals here allow companies to do things they're not allowed to do in most other countries, like pay the manufacturers of generics to delay the introduction of generic equivalents beyond the point where the patents have run out.

The increasing market power as a result of regulatory capture can explain many of the phenomena cited above in the Economist article, like the rising profits, rising concentration, the return on capital differentiation between the US and overseas operations, the persistence of above normal returns, and the like.

Conclusion

There has been an increase in regulation, but in and by itself that isn't necessarily a big problem as most of it could simply be a reflection of the increased complexity of modern economies.

The US still seems to be far away from more heavily regulated places like France or Italy, countries which could indeed benefit from a mild assault on the regulatory burden.

Where it is a problem in the US is when the regulatory process is being captured by established economic interests and used to protect these interests at the expense of new competition and economic dynamism, and there are increasing signs that this has become a serious problem.

In that sense, the US could indeed do with a supply side revolution, but one that safeguards that markets are indeed competitive and doesn't favor established big players to keep the competition at bay.