Is Overregulation Really Holding Back the U.S. Economy?

Ed Dolan

January 8, 2018

With tax cuts now a done deal, Republicans are turning to regulatory reform to give economic growth a further boost. There, they may find more bipartisan support. Past reforms of airlines, rail, and trucking regulation were, after all, set in motion by Democrats. Today there is significant Democratic support for reform of financial regulation, especially for smaller community banks. Overregulated small businesses can be found in every congressional district, red or blue.

But while regulatory reform could provide a big boost if it is done right, indiscriminate deregulation could do more harm than good.

Blanket Deregulation Won't Help

Many conservatives and libertarians seem to think the only good regulation is a dead regulation. If that were true, it should be possible to quantify regulation and measure the harm it does. However, attempts to do so have not been particularly successful.

Consider the regulatory freedom indexes published by the Heritage Foundation and the Cato Institute, which rank countries on a scale where a high score indicates greater freedom from regulation and a low score indicates a greater regulatory burden. Those scores correlate positively with GDP per capita and with broader measures of prosperity, such as the Social Progress Index and the Legatum Index of Prosperity. That tells us that countries with less regulation are, on average, richer and better off, but does it really support the notion that too much regulation is holding back the U.S. economy?

A closer look at the data shows that the United States already ranks high on the world scale of regulatory freedom. Its score is even better than would be expected, given its GDP. On the Heritage index, the United States ranks fourth out of 131 countries, behind only New Zealand, Denmark, and Australia. According to Cato, it ranks sixth out of 143 countries, with only one OECD country, New Zealand, doing better. Given how lightly regulated the U.S. already is by these measures, it is hard to think that one or two more steps up the regulatory freedom rankings would be transformational.

Furthermore, although prosperous countries do tend to have higher regulatory freedom scores, correlation is not causation. Other factors are at work that jointly influence both prosperity and regulatory freedom. In previous research, I have used some of those factors to compile a quality-of-government index, based on data regarding the rule of law, protection of property rights, judicial independence, procedural justice, and freedom from corruption.

I found that quality of government is a statistically significant predictor of GDP and of broader prosperity indexes. At the same time, when I controlled for quality of government, regulatory freedom lost its predictive power. I interpret this to mean that quality of government is the real cause of economic and social prosperity. Regulatory freedom, at least as it is measured by the Heritage and Cato indexes, is not an end in itself. Rather, it is an outcome of good government in the more general sense.

The Three R's of Effective Regulatory Reform

To get the good government they want, then, regulatory reformers must do more than cut, cut, cut. They must get their priorities right. Here are three R's that can help.

First, *retain* regulations that support the basic rules of a market economy. Those include regulations that protect property rights, ensure that contracts are honored, and protect against common law harms like fraud, negligence, and nuisance.

In principle, such rules can be enforced through the judicial system, but because courts can be slow and costly, regulations are a useful alternative. It is better to dispatch inspectors to ensure that nightclubs keep their fire exits unlocked than to wait for relatives of the deceased to sue a club's owners after a fire occurs. Similarly, it is more effective to regulate power plant emissions than to rely on downwind pollution victims to pursue damages or injunctions in court. Still, reformers should always be on the lookout for duplication, conflicting standards, and excessive reporting requirements that can be addressed without rendering the regulations ineffective.

Second, *replace* regulations that have legitimate aims but also have harmful unintended consequences. For example, in an effort to reduce CO2 emissions, CAFE standards set minimum gas mileage for new cars. Meeting the standards raises the price of cars, but better fuel economy lowers the cost per mile of driving. The unintended consequence is that people drive more, roads are more congested, and more accidents occur. Economists argue that a carbon tax would be a more efficient way to reduce emissions, since it would encourage people both to buy efficient cars and to drive them less.

Third, *repeal* regulations that are motivated primarily by the manipulation of public policy for private gain — that is, by what economists call *rent seeking*. Regulations that restrict competition or impose price controls rarely serve any purpose other than enriching special interests at the expense of the public. A new book by Brink Lindsey and Steven Teles, *The Captured Economy*, gives numerous examples of regulatory rent seeking. HBR has covered this as well, including noncompete clauses that limit workers' ability to change jobs.

The Lesson

Successful regulatory reform will require more of a scalpel than a meat-ax. Regulations need to be evaluated one by one to determine whether they should be retained, replaced, or repealed. An indiscriminate approach to deregulation risks being hijacked by rent seekers. In the name of cutting costs and creating jobs, bad actors will seek to dump their wastes in the air that the rest of us breathe, to destabilize financial markets in pursuit of short-term gains, and to defraud unwary consumers.

Apple farmer Laura Ten Eyck, a Democrat who serves on her town board, summed it up as well as anyone. Speaking to a New York Times reporter, in the wake of a disruptive mid-harvest regulatory visit, she said, “I’m not necessarily in favor of rolling back a lot of federal regulations. I’m in favor of applying them intelligently.”