The U.S. Regulatory Regime and the Global Economy

By Dr. Nancy Bord

The President of the United States, accompanied by executives of major corporations, travelled to Asia in January seeking trade concessions to improve America's competitive position. The President and his entourage were looking in the wrong place for the cure to America's declining global competitiveness. A major source of the problem is not to be found in Tokyo or Brussels, but rather right here in Washington and, to a somewhat lesser degree in places such as Sacramento, Albany, Austin, and Harrisburg. For it is from the nation's capital and state capitals that regulation hampering the efficient and effective functioning of our market economy emanates.

How can American corporations be competitive in the emerging global economy while struggling under the most elaborate and oppressive regulatory regime of any developed market economy in the world?

Government regulation operates as an "invisible foot" planted firmly on the back of American business and impeding its global competitiveness. In addition, consumers, whom regulation purports to benefit, pay higher prices as the costs of regulation to business are passed along to them. Finally, overall economic growth has slowed as resources are diverted to regulatory compliance rather than to investment, innovation, and productivity.

My purpose today is to describe how government regulations, often well meant but usually ill-conceived and erratically administered, have burdened American business to such an extent that our economic status in key global markets has been seriously impaired. This is not to imply that regulation affecting business activities is the only source of our economy's global problems, but that it is a significant and often overlooked causal factor in America's current economic malaise.

In my talk I will discuss the perverse economic effects of regulation in general, then focus on specific regulatory regimes, and finally provide some possible prescriptions.

Costs of Regulation. Regulatory regimes comprise a body of laws, executing rules and administrative practices, and judicial decisions accompanying them. They have effects which impose costs on the enterprises regulated. A dozen years ago, in his book *The Future of Business Regulation,* Murray Weidenbaum, who served as chairman of President Reagan's Council of Economic Advisors, outlined an analytical paradigm for assessing regulatory effects. He defined three types of effects of regulation:

- Direct effects;
- Indirect effects; and
- Induced effects.

He concluded that any analysis of regulatory costs and burdens on business enterprises should consider all three.

Direct effects are those related to or mandated by a piece of legislation and its implementation rules that immediately and obviously have an impact on production and operational costs. The Center for the Study of American Business at Washington University in St. Louis regularly estimates

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She spoke at The Heritage Foundation on January 16, 1992.
ISSN 0272-1155.

the costs of such regulation on individual manufactured items and the aggregate costs which are then passed on to consumers. One of the Center's studies shows that the retail price of an American automobile has been increased by over $3,000 due to direct costs associated with federal requirements. In light of this is there a mystery about why our autos are not competitive?

Other direct costs associated with regulation include the activities of the federal regulatory agencies which have been established to enforce and monitor regulatory compliance. In a detailed analysis of the 1992 budget, the Center found that federal spending on regulation will cost an estimated $13 billion for 1992 and employ 122,400 regulators at the federal level alone. More disturbing is the fact that despite a dramatic reduction-in-force during the first Reagan Administration, the number of federal regulators is greater today than in 1980.

These costs, of course, are borne by us as taxpayers, and the assets thus allocated to regulation are diverted from other potential, more productive uses. Recent studies reported in the *Journal of Regulation and Social Costs* and in The Heritage Foundation's *Policy Review* estimate the direct costs of regulation at $400 billion per year. The measures and cost categories may differ, but the overall conclusion is that the direct costs of regulation are formidable. They fall primarily on business enterprises who then pass them on to consumers.

In the electric utility industry, for example, environmental regulations imposed over the past decade have been largely responsible for the dramatic increases in utility rates during this period. Similarly, regulations such as the Jones Act, requiring shipping in American bottoms, add substantially to the direct cost of exporting our products. The list goes on and on. It is difficult to identify a single product or production process that escapes regulation's direct effects. Ironically at the same time the U.S. is held to be the model free market economy.

Indirect effects of regulation further contribute to the regulatory burden and are less visible. Compliance costs, particularly those involving paperwork and administrative activities necessary to demonstrate to regulators that an enterprise is properly carrying out regulatory requirements, responding to date requests, preparing filings and applications or requesting waivers are chief among these types of effects. Conservative estimates are that 150,000 man-years of effort which might be otherwise productively employed is spent by American firms each year simply responding to regulators' information requests. Regulation also introduces delays and impediments in day-to-day business operations as regulatory agencies must process and approve applications for permits, required filings, and licensing requests. The time required for new products and processes to pass through the regulatory maze is truly alarming and harmful to innovation.

Overall, loss of productivity is the most telling indirect result of the American regulatory regime. The productivity advantage the United States once enjoyed has long since disappeared into the regulatory morass as more and more resources are diverted to regulatory compliance.

Induced effects of regulation are the third area of impact. These effects of business regulation are probably the most insidious because they are largely hidden. These types of effects take the form of opportunities lost or forgone in investment, innovation and activities which stimulate economic growth over the long-term. There is no question that the capital formation process in this country has been brought nearly to a halt over the past twenty years and particularly after the 1986 tax reform act, which actually penalizes capital formation. This fact would not be so bad so long as the United States was perceived as a favorable environment for foreign direct investment. But, largely because of the onerous burden of regulation, at both state and local levels, this is no longer the case. The data show a marked decline in foreign direct investment in the United States over the past year as the regulatory burden on business has increased.

Thus, the negative consequences of the three types of regulatory effects reinforce each other in undermining America's competitive position. Increased costs of production and distribution from regulatory requirements, diminished productivity, the diversion of resources to regulatory compliance, and a more hostile environment for innovation, investment, and growth taken together represent a nearly insurmountable burden for American business. Further they have the most serious impact on small and moderate size enterprises, the driving force of economic growth.

Chart 1 shows our assessment of the proportion of those regulatory costs attributable to each category. *(See Appendix.)*

Types of Regulation. In the major project I am completing during my tenure as Bradley Resident Scholar here at The Heritage Foundation, I show how and why economic regulatory regimes in the United States have taken the form and direction they have and compare and contrast these regimes with regulation purportedly governing similar phenomena in Europe and industrialized Asia. I have chosen to focus on three specific areas of economic regulation for particular scrutiny. They deal respectively with regulation of 1) corporate dynamics, how business and commercial enterprises form, change and grow; 2) financial institutions and markets, how business enterprises obtain and maintain financial viability and the institutions such as banks and securities markets which are instrumental in these processes; 3) taxation, which many regard as a form of regulation, particularly in the United States, where taxation is used as a national economic policy surrogate.

Just as regulation in general burdens business enterprises and introduces a drag on economic activity and global competitiveness, so these three specific areas of economic regulation have particular dysfunctional effects for business.

As if these areas of economic regulation were not enough, the last twenty years have witnessed a tremendous increase in social and environmental regulation, particularly targeted to business. These types of regulation are not directly related to the functioning of economic enterprises. Rather they are motivated by political and social concerns. While many of these social objectives may have merit, one may question whether government regulation focusing on business activities is the best way to achieve them.

Regulation of corporate organization occurs at the state level in the United States. Regulation of corporate combinations through mergers, acquisitions, and joint ventures occurs at both state and national levels. This type of regulation not only hinders free market operations but can also preclude corporate formations and strategic alliances which can enhance global competitiveness. The United States regulatory regime in this area as it presently exists reflects an anti-market bias and limited perspectives on both market definition and time horizon.

Our principal global trading partners, outside the Western Hemisphere, in contrast, specifically encourage the development of business entities which are designed to be effective global competitors. Increasingly, competitive markets are being defined more broadly. Japan, as a small country oriented toward exports, has always defined its markets globally. Europe, as its regional economy has evolved under the European Community's institutions, defines its markets regionally for assessing competitiveness. Only in the United States of all major industrial nations is competitiveness defined locally. Of course this is not surprising if one examines the policy process from which regulatory regimes emanate. The American policy process is essentially local politics acted out in Washington, reinforced institutionally by the frequent election of House members, who tend to be locally oriented.

Financial Markets. A second area of economic regulation whose impacts serve to impede the competitiveness of American business enterprises in the global marketplace involves financial institutions and markets. The regulatory regimes governing commercial banks and other financial intermediaries such as securities markets virtually assure that American institutions will be at a disadvantage in the international marketplace.

The existing regulatory regime perpetuates a system which has penalized expansion and innovation and artificially supported an illogical superfluity of banking institutions. Is there any evidence that consumers and corporations in Canada with barely a dozen full service banking institutions are less well served than those in the United States with more than fifteen thousand banking institutions with limited specialized functions?

Shifting Management Concerns. American businesses also have more onerous, short-term oriented reporting requirements imposed by government agencies. This tends to shift management's concerns from longer term strategic considerations to short-term financial results. Such a focus generally results in more frequent financings which are more sensitive to near-term market fluctuations and a higher weighted average cost of capital for American businesses. This is particularly true for smaller and medium sized enterprises which are most dependent on traditional domestic financing sources.

As for the American corporate tax structure, we know there is absolutely no economic rationale behind it (even Keynesian economists agree on that). It has long since ceased to be merely a means of revenue production and has become the principal economic policy tool of the federal government. Its pernicious effects on corporate behavior both domestically and internationally have been amply documented. On the one hand, the tax code is so broad and sweeping in scope and its exceptions so narrowly drawn that small and medium-sized businesses, the real engines of economic growth, are penalized. On the other hand, the code as presently interpreted also deters large corporate entities from undertaking new ventures, advanced research and development and capital investment.

The double taxation of dividends and inherent debt-bias of the U.S. tax code provide incentives and disincentives for corporate strategic decisions which are often not in the best interest of shareholders, consumers, other corporate constituencies or of the corporation itself. A corporate tax code which inhibits growth and innovation is not likely to lead to the type of business and investment decisions which would be made in a market less distorted by such a code. In addition, given the complexity and internal contradictions with which the U.S. corporate tax code is replete, the level of uncertainty on the tax implications of a corporate decision is very high even for businessmen with a low risk threshold.

Taken together the implications of just these three regulatory regimes can be seen to have a serious and substantial negative effect on the ability of American companies' products and services to be internationally competitive. When the added burdens of health, safety, "social," and environmental regulation (now accounting for more than half of all regulatory costs) are included, the real impact of regulatory drag on both productivity and competitiveness is truly formidable.

Proving Counter-Productive. Social and environmental regulations have no rationale in economic theory. They have been enacted in the interests of attaining what legislatures believe is a social good enhancing the general welfare. Granted that the objectives of clean air and water and equal opportunity are noble goals. However, the heavy-handed, non cost-beneficial manner in which U.S. policy makers have sought to fulfill them are already proving counterproductive to both domestic economic growth and global competitiveness.

As an example, the Center for the Study of American Business estimates that the 1990 Clean Air Act will add costs of $25 billion to $35 billion per year to the $100 billion already being spent on pollution control. This legislation represented a compromise of the concerns of special interests and has resulted in elaborate, confusing, and often conflicting compliance rules. Even the attempt to introduce economic incentives to the regulatory process through the mechanism of "tradable emission permits" was greatly diluted by congressional action.

Legislation such as the Occupational Safety and Health Act (OSHA) and the Mine Safety and Health Act (MSHA) have been perverted from their initial worthy purpose to become principally revenue generating devices for the federal treasury. An elaborate set of mandated fines covering even the most insignificant and trivial "offenses" has been established. Naturally, compliance is most onerous and sometimes disastrously destructive to small and medium-sized businesses. These businesses, in many instances unintentionally in violation of complicated and obscure rules, are often operating on slim profit margins. They are unable to insure against heavy fines and penalties as larger enterprises can. New legislation such as the Americans With Disabilities Act and the most recent Civil Rights Act further burden businesses of all sizes but again are especially onerous for small and medium-sized enterprises.

One may wonder whether these health, social, and environmental regulatory regimes represent a concerted, deliberate effort to make the private sector pay for policies which policy makers would like to endorse but that government simply cannot afford. One may also question the form and substance of these regulatory regimes. My experience has shown that whenever government has intruded unnecessarily into day-to-day operations of business enterprises the results are usually unproductive for the enterprises themselves, for their customers and for the overall economy. Now added to the unfortunate results of our onerous regulatory regimes is the added factor of diminished global competitiveness.

In Chart 2, major categories of regulation have been rated according to their relative impact on U.S. economic growth and global competitiveness. *(See Appendix.)* Direct and indirect monetary costs were considered in these ratings as well as the substantial, less easily measurable induced costs of regulation.

What is to be Done. For the past sixty years, exponents of interventionist economic theories have dominated the economics profession in both academia and government. They have legitimized expansion of regulatory regimes. In the past thirty years they have been joined by lawyers who draft and then implement and administer regulations. Thus, two key professions (in which I claim membership) have had a vested interest in stimulating and perpetuating regulatory regimes which seriously disadvantage American businesses, particularly in the global marketplace. This is a situation which makes me both sad and angry. Sad because I see an economy with unique advantages and outstanding resources squandering them, losing productivity and world-wide market status, in short heading in the direction of overall economic decline. Angry because this is happening unnecessarily. Except for a few zealots who really do wish to punish "big bad business" no matter what, most policy makers really seem to believe regulation is in the best interests if not of something amorphous called "the public," at least of a special interest group purporting to speak for a larger social good. I spent the first half of my professional career in the corporate world. I have great faith in free markets and private enterprise. It is a pity my faith is not shared by more policy makers, lawyers, and government officials in the United States. But, one may protest, markets are not always fair. Of course not, markets any more complicated than Marlborogh Fair are by definition inherently unfair. However, aside from the barest minimum health and safety standards subject to genuine, rigorous cost/benefit analysis and broad-gauged assessment, intervening in market processes through regulation improves neither equity nor efficiency.

Although sad and angry about the regulatory morass which has already dampened economic growth and investment and reduced our global competitiveness, I cannot end on a totally negative note. The first glimmer of hope is of course that you are all here listening to me and mostly I expect agreeing with me. Some of you are directly or indirectly involved in the policy process. Secondly, there will in due course be a book dealing with all of the points I have made, in greater detail with more substantiation. I hope the book will be read and discussed by policy makers, their professional advisors, and members of the business community. Perhaps it can increase their understanding of the relationships, between three key economic policy areas: regulation, trade, and investment.

Thirdly, this is an election year, and regulation and trade policy are already emerging as important issues. Now is the time for us to play a role in framing the debate and in tying together the related strands of regulation, competitiveness, and trade.

The fourth and final factor which gives some cause for hope comes from the newly liberated economies of Central and Eastern Europe, who are seeking to emulate our high standards of material well being. They are embracing free market processes and abandoning, albeit somewhat more slowly than they might wish, totally regulated and totally uncompetitive economies. If they are to flourish, however, they should not seek to emulate our regulatory regimes.

A favorite story of my youth was *Gulliver's Travels*. The edition I owned showed an illustration of Gulliver completely immobile on the ground, swathed in ropes and chains. This image might have some relevance to an economic giant so emersed in regulation he can barely move. We have not yet reached this sorry state, so there is still time to act.

Ample Scope for Action. The direct approach of repealing regulation is most difficult for there are now vested interests in the bureaucracy and the economic and social structure supporting various types of regulations. Less direct approaches such as those employed during the Reagan Administration concentrate on shrinking government enforcement budgets. Since more than fifty agencies of the federal government and countless state and local agencies are charged with some aspects of regulatory enforcement, there is ample scope for action here. Beleaguered, resource-constrained state and local governments could realize substantial cost savings from these measures.

A third approach, which I am loath to advocate except in very special circumstances, is to invoke the judicial process to challenge the most flagrant interference in business operations. There is some evidence that federal courts are rediscovering the contract, takings, and commerce clauses of the Constitution. Perhaps these can be utilized to relieve some of the regulatory burden from American business and consumers and permit free market forces to function with fewer regulatory impediments.

However, even if all existing regulation were to disappear tomorrow, Congress and state legislatures are still producing legislation requiring new regulation and greater government interference on business and economic operations. Legislators say they are only responding to public concerns. But if the American voters, who are also consumers and taxpayers, fully realized the hidden taxes and higher prices they pay because of unnecessary and inefficient regulatory regimes, fully recognized the degree to which special interests and entrenched regulatory constituencies influenced the shape and scope of regulation, fully understood the burdens on economic growth and global competitiveness inflicted on the economy by regulation, the alleged consensus favoring more regulation would be revealed as a lawmaker's fantasy.

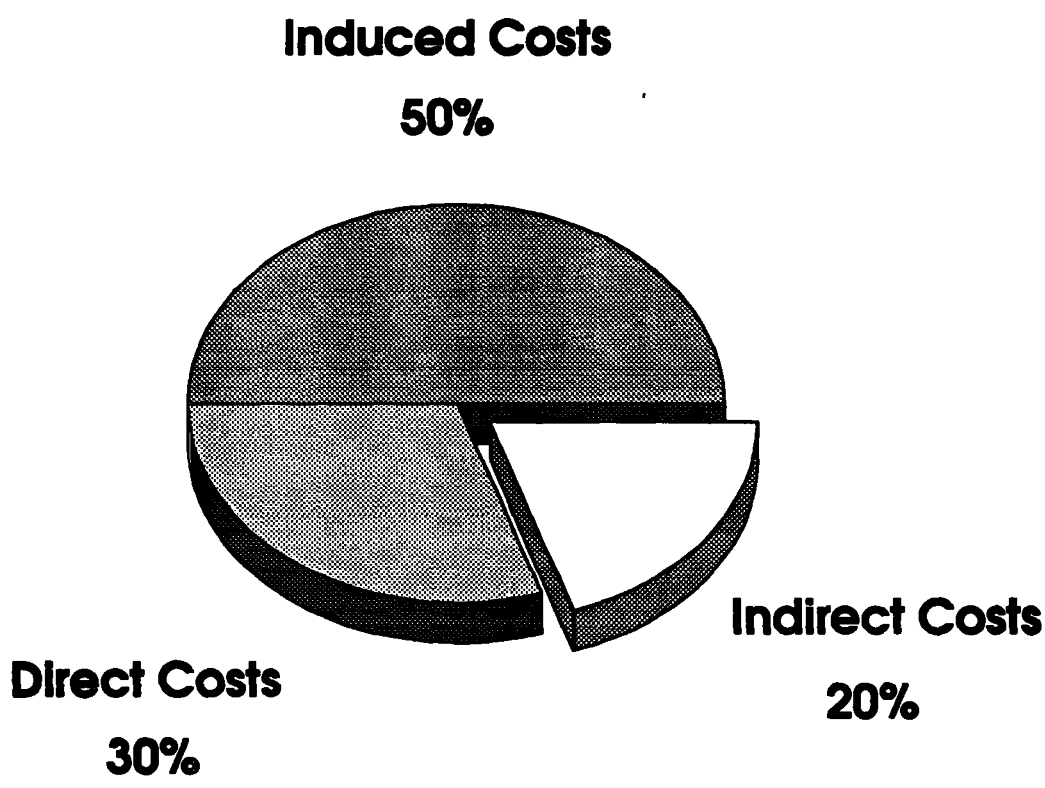
This does not necessarily imply that the United States will automatically capture a greater share of the Japanese automobile market, of course, if regulation disappeared tomorrow. But to the extent forces of free enterprise in the United States are not artificially constrained by government economic and social regulation, they will, at least, be better able to realize their potential through innovation, new product development, enhanced investment opportunities, fewer tax penalties, and less uncertainty.

Election Year Oportunity. The key to realizing a less burdensome regulatory regime must be to go to the root of new regulation, and that is legislation. Merely declaring a moratorium on regulation writing and review of existing regulation is not enough if new legislation requiring more regulation is being generated by law makers. In this election year we have an opportunity to elect legislators pledged to regulatory relief for our beleaguered economy. Let us do so in order that we may keep our rightful place as an effective global competitor.

Appendix

Chart 1

Estimated Impact of Regulation on Business Activity



Heritage DataChart

Chart 2

Impact of Regulation on Economic Development and Global Competeviness

Type of Regulation	Level of Impact		
	High	Moderate	Low
Economic Taxation	X		
Financial Institutions and Markets		X	
Corporate Formation			X
Antitrust		X	
Social Regulation/Health& Safety		X	
Environmental Regulation	X		