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No-Thought Regulation

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If you knew - "a few weeks ago, the federal government had to commit several hundred billion dollars for a guarantee of Citicorp's assets, though examiners from the Office of the Comptroller of the Currency (OCC) have been inside the bank full-time for years, supervising the operations of this giant institution, under the broad powers granted by the Federal Deposit Insurance Corporation Improvement Act of 1991 to bank supervisors" - what would you think about the effectiveness of U.S. bank regulation?

The above quote comes from a thoughtful and important new paper, "Regulation without Reason," by Peter J. Wallison, former general counsel of the U.S. Treasury and now a fellow at the American Enterprise Institute. Mr. Wallison warned for years - in books and articles - that Fannie Mae and Freddie Mac were headed for disaster, and now he is taking on the ill-thought out proposals to increase regulation of the financial industry, both by politicians and people who should know better.

The frightening thing is that many of the same intellectually and (alleged) financially corrupt politicians - e.g. Rep. Barney Frank and Sen. Chris Dodd - whose actions directly helped bring on the present crisis, have now been put in charge of the hen house and are tasked with "making reforms." Rather than acknowledge that their earlier poorly thought out "reforms" caused many of the current problems, they and the so-called "Group of 30" financial experts advocate expanding destructive bank regulation to healthy parts of the financial industry.

Those who are incapable of thinking through the consequences of their actions (like drunken teenagers with car keys) are likely to make matters worse rather than better, which characterizes all too many of the Washington elite - at the Fed, the Treasury, the Securities and Exchange Commission and particularly the Congress. It was they who created and then failed to supervise and provide adequate capital requirements for Freddie Mac and Fannie Mae. It was the members of Congress who, by not thinking through the consequences of their Community Reinvestment Act, forced banks to make loans to unqualified buyers. It was they who created the notorious Sarbanes-Oxley Act, a poorly thought out response to the Enron scandal. This act has driven accounting costs for businesses through the roof, destroying many hundreds of thousands of jobs in the process, forced companies to go private and driven the important initial public offering (IPO) market to London.

Last week the House of Representatives passed a "stimulus" bill that in actuality will slow the recovery and restoration of jobs. There is a "buy America" protectionist provision in the bill, which thoughtful and knowledgeable people understand will raise costs and destroy more jobs than it will create and invite destructive retaliation from foreign competitors. In their thoughtless vote for this bill, the vast majority of the Democrats in Congress ignored the lessons of the Great Depression with the disastrous Smoot-Hawley tariff, hundreds of years of economic history, and good economic theory.

Certain members of Congress have attacked foreign jurisdictions that have lower tax rates, and have proposed to penalize U.S. companies that use such jurisdictions in order to remain internationally competitive.

These members of Congress have shown themselves incapable of thinking through the ultimate consequences of their proposals, which include: making U.S. business less able to compete with foreign competitors that have lower tax burdens, reducing employment growth both in the United States and worldwide by increasing the cost of capital and its proper allocation, and undermining relations with many peaceful countries - which have a sovereign right to have any tax system and rates they so choose - and violating U.S. obligations under the World Trade Organization.

U.S. officials are trying to require foreign entities that bring badly needed foreign investment into the United States (through "QI procedures") to use only U.S. auditors. This is not only offensive to foreign friends but violates their own laws in many cases. How would the United States react to a requirement that companies operating in this country but sending passive foreign investment abroad be forced to use only foreign auditors? These thoughtless and destructive proposals will only damage international relations, which President Obama said he wants to improve, and to reduce investment in the U.S., which in turn will reduce both productivity growth and job creation.

Having previously spent several years as a financial regulator myself, I am keenly aware that regulation can be more destructive than beneficial. Regulation adds to systemic risk in that it reduces market discipline when people think the government is "protecting" them. Regulation favors large over small firms because the costs are more easily borne by large entities, and this in turn causes more industry concentration than is desirable (resulting in the "too big to fail" syndrome).

Regulation often impairs innovation by driving up costs and often adds costs not justified by the benefits, and all these additional costs are ultimately borne by consumers in higher prices, which mean a lower standard of living.

The current rush to regulate, without calmly and adequately thinking through the full ramifications and likely costs associated with each new regulatory proposal, is likely to end in another round of financial disasters.

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