

# Regulation

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Recently I've heard a number of people question free market principles, and call for greater government regulations. When each industry is broken down, I think the narrative is quite different, and we should think twice before any calls for greater government regulation.

**Housing-** The federal government decides that more Americans should own houses. Therefore the federal government sets up two government-sponsored enterprises to spur lending. To spur lending these institutions do a number of things. First they directly buy mortgages from banks; thus allowing banks to sell their assets and turn around and sell more mortgages. Secondly they secure mortgages, for a fee; which means they basically insure that the mortgage won't default so long as the mortgage 'conforms' to their standards. These secure mortgages then can be sold by the banks to other investors with the full backing of these government institutions, again freeing up the banks' assets to sell more mortgages.

Not surprisingly the government-sponsored enterprises led to an increase in mortgage lending. However, they changed lending practices, and instead of each banking institute lending by its own set of tried and true lending standards, banks began lending to the standards of the government-sponsored enterprises. All the bank had to do was provide a 'conforming' mortgage, pay a fee, and now the loan default risk was taken on by the government-sponsored enterprise; risk free lending, too good to be true.

Lending standards were no longer determined by the bank or direct lender; they were determined by the insurer and buyer of US mortgages. And the insurers were the government-sponsored enterprises that were given privileges from the federal government, which also made them mechanisms of the federal government and subject to political pressures. This led to decreased lending standards within the enterprises to include loans made without sufficient down payments, or sub-prime loans with adjustable interest rates. At this point the lending market was completely warped; risk was completely taken out of the equation, because all the assets were backed by these government-sponsored enterprises. Therefore these assets were bought and sold by the handful and became major holdings of our larger financial investment institutions.

To pour more gasoline on the fire, the interest rates that supported all this lending were not determined by market forces; rather, they were determined by the Federal Reserve, another government created institution. This government institution is again highly subject to political persuasion, its chairman is selected by the President, and interest rates are determined by a board, not markets. Therefore, interest rates were kept at historical lows for historically long periods of time.

Therefore, in a market with extremely low interest rates, lowered lending standards, and government-sponsored institutions that insure against default while approving of no down payment and sub prime adjustable rate mortgages, there becomes an extremely, maybe unhealthy, high demand for housing. However, housing prices are

determined by the market, supply and demand, and housing prices soar. As the prices increase, the loans only become riskier and riskier.

This creates a bubble. Markets didn't create the bubble, but markets pop the bubble. Eventually the prices become over inflated, even with maximum easy credit in place. And pop, housing becomes unaffordable, prices fall, the bad mortgages default, and the government-sponsored enterprises are left with the tab. The banks are not liable, they made 'conforming' loans and had the loans insured or sold them. Many individuals are at fault, as they overleveraged themselves, and most likely they will pay dearly for that mistake. Investors that bought large amounts of secured mortgages, mostly the big financial institutions, are left in limbo as to the value of their mortgages, as their insurer might default. These financial institutions' futures come at the mercy of the solvency of the government-sponsored enterprises.

In our recent case, the federal government decides to bail out the government-sponsored enterprises and take full ownership of them, and pay out taxpayer money to cover the default loss on the bad loans. The federal government also tries to cover the losses of the irresponsible borrower, but for the most part, is not efficient and timely enough to catch up with market effects. The crisis subsides with banks unaffected, the government-sponsored enterprises taken over, large financial institutions bailed out, and taxpayers left with the tab.

Today, while the markets continue to self correct and push home prices to sustainable levels; the federal government creates more regulations. The new regulations do not focus on the government-sponsored enterprises that are now fully government owned, on the irresponsible borrower, nor on the large investment institutions that were bailed out. The new regulations are focused at mid to small level banking institutions, and borrowers, further eroding local level tried and true lending standards with central one size fits all standards.

If the housing crisis was a lack of regulation, it was only a lack of regulating the government. The lending standards were set by the government-sponsored enterprises, now property of the federal government, and the interest rates were set by the government created Federal Reserve. Government blames the free markets for the mess it created; which is disgusting in its own right, but then it has the audacity to gain further regulations and control into a market it has so badly distorted.

**Health Care-** The cost of health care is crippling. The cost of life saving treatments are so high that it would destroy nearly all middle class families financially if they were to be incurred fully out of pocket. Even simple and common procedures would deplete most people's savings. These prices force Americans to be insured unless they are ultra wealthy and can self insure. Unfortunately, the government has been working hard to solve this problem for a while.

For starters the federal government decided to use taxpayer dollars to pay for the health care for all poor and elderly individuals. Not only are Medicare and Medicaid on the fast track to insolvency as they are completely unaffordable, but they have pumped billions and billions of dollars into the health care sector. These two programs continue to increase in their size despite the vast amounts of unfunded liabilities or promises they have made to future recipients. These expenditures encourage more health care usage as

the beneficiary's benefit is only made higher by the more health care received and no savings are gained by any lack of care.

The government has also encouraged the third party payer system in the private sector. The government gives tax breaks to companies for health insurance, but does not offer the same breaks to individuals; which promotes employer provided health coverage. Employer health coverage is like a third party payer system to pay for the third party payer system. Individuals are insulated first from the true costs of their premiums, and then they are insulated from the cost of their health care as the majority of it is paid for by insurance policies. Health insurance policies are no longer 'insurance' policies against unforeseen and catastrophic health events, but rather they cover nearly all health care expenses.

While government regulations have promoted employer provided health coverage, they have also mandated that many health care procedures be covered by all insurance policies. If the government had any interest in bringing down the costs of health care, it would remove the incentives for employer provided health insurance, and stop regulations that encourage the third party payer system for health care. The third party payer system makes demand highly inelastic; which means that rising prices have little effect on the demand of health services.

If the government taxing the private sector to provide health care for the poor and elderly was the end game, we might be ok, but it is not. The government has a chain around the health industry and is squeezing it to death. The third payer system is an economical no-no, but the regulation on the supply side of the industry is stifling. The government regulates the following:

1. The government regulates what schools can teach medicine.
2. The government regulates who can practice medicine
3. The government regulates medical facilities
4. The government regulates medical procedures
5. The government regulates the production of medicine and drugs
6. The government regulates the distribution of medicine and drugs

The entire health care industry is regulated by the government. The government distorts health care demand by subsidizing health care for the poor and elderly, giving tax incentives for companies to purchase health insurance policies for their employees, and mandating health care policies cover specific health care products and procedures. Meanwhile, the government controls and limits the supply of health professionals, products, and services. With inelastic demand, massive amounts of government subsidies, and a limited supply of health care, it should be of no surprise that health care prices are skyrocketing.

Again the government blames the insurers and drug companies for the high costs of health care, and passes a bill that increases its involvement into the health industry tenfold. The new health bill further regulates the supply of health care, mandates that individuals must use a third party payer, mandates third party payers cover more health care products and procedures, and vastly increases government subsidies into the health care industry. It doesn't take a skeptic to see that the new health care bill is going to bend the cost curve upward.

The end game should be quite obvious. As demand becomes further inelastic and supply is restricted further, prices will become so unaffordable that the government will be forced to regulate prices. However, private companies are unable to sell their products and services at a loss. Only a government would attempt the long-term prospect of selling goods and services for less than they are produced, deficits don't matter so we are told. The new health care bill is a push to move health care out of the hands of the private sector and into the hands of government, and whether that is its intent or not, that is where it leads.

**Oil industry**-Currently there is an oil leak in the Gulf of Mexico spewing oil all over those waters. We are told that this is the result of a lack of regulation, and a consequence of deregulation. This would be a difficult case to make when the evidence strongly suggests the opposite. The federal government regulates:

- 1) Who is qualified to drill
- 2) Where companies are allowed to drill
- 3) What procedures are allowed to be used in drilling
- 4) What safety procedures must be in place to drill

Apply these regulations to the current spill, and it quite clearly that shows that we don't need more regulation. BP and Deepwater Horizon were government approved companies. Why these companies were drilling for oil a mile below the surface of the ocean does pose some serious questions. It seems that the risk for accidents and spills would be higher offshore than onshore to begin with, but a mile deep seems like even more unnecessary risk. Government regulations are dictating where these companies are drilling. As far as the drilling and safety procedures are concerned, I think more information will be provided in the future, but for now it sounds as if government regulators were fully aware of the procedures in place.

While this author will not argue that accidents would be avoided in free markets, I will argue that regardless of government regulations accidents will happen in the future. Accidents will not simply be avoided because the government, not the industry, dictates safety procedures and methods. Government regulations will only hinder innovation, competition, complementary markets, and give a false sense of security as they force the industry into more complex and higher risk situations.

All the regulation does is substitute all the different safety procedures and methods developed by drilling companies, with a set of standardized safety procedures and methods developed by a committee or task force. Whether the government procedures are any safer than the methods developed by those who stake their careers on the industry is debatable. What isn't debatable is that by standardizing the practices and methods of an industry, there will be fewer procedures and methods used by the industry. Instead of an entire industry working in multiple directions trying to build on company specific strengths in cost effective ways, the industry becomes homogeneous and innovation is stifled. This one size fits all method is made worse when each drilling location is dealing with different variables and problems.

The regulation also hinders competition in the industry. Tight regulations usually lead to oligopolies, with minimal competition, as the regulations act as a barrier to smaller companies entering the industry. Typically the government regulations will be

procedures and methods closely emulating the procedures and methods already employed by one or all of the large players in the industry, and members of the regulating committee are oftentimes former employees of the large companies in the industry. The larger a company gets the more policy driven it becomes, and by the time a company is the size of BP, Shell, or Exxon, its policies have become very cumbersome and inefficient.

Oftentimes, a smaller company, that is less policy driven, but more common sense and results oriented, might be able to choose more efficiently what policies are effective, and implement more appropriate safety procedures. However, due to the regulations, the smaller company is forced to use all the same cumbersome and inefficient policies and procedures of the larger company, regardless of their effectiveness. The lack of overhead costs is a huge competitive advantage for smaller companies entering an industry over the large established corporations, but the regulations eliminate or lessen that advantage, and make it financially impossible for new companies to enter the market. That is why regulation is so stifling to competition.

From my perspective there is only one worthwhile regulation that the government could put in place with respect to drilling. In order for a company to drill, it would have to show that it has the financial means to pay for the damages and the technology of the clean up of an accident that it causes. As all regulations go, this would also be subjective and not a perfect regulation. Each drilling location would have to be analyzed, costs would need to be estimated for possible accidents, and clean up technology in that particular environment would need to be demonstrated. I would liken it to liability insurance for a driver. If someone is going to risk the livelihood of another individual or company, then they need either sufficient insurance or backing to cover those liabilities. Then if a company has an accident, the mess can be cleaned up, and let the courts hold that company liable for damages. Instead current law caps the liability coverage at \$75 million; which again eliminates many smaller companies from entering the offshore oil industry, but is a mere drop in the bucket to what the final liability costs are for this oil spill. This one regulation may limit high risk drilling altogether, but isn't that the point?

There is another major advantage to deregulating the oil industry. Aside from more drillers, more innovation and cost effectiveness in procedures and methods, and a greater supply of oil from American companies, deregulation would mitigate the catastrophic risk in the industry. With many more drillers, and many new methods and procedures being used, there would likely be more accidents. However, with more accidents, and more companies' livelihoods depending on preventing damages and cleaning up after accidents, there would be a market and demand for products and services that clean up and contain oil spills. This would spur investment into equipment and technologies that can deal with oil spills. The accidents would be much smaller, containable, and repairable, as smaller companies would drill smaller and less risky wells. The clean up and prevention methods could then be developed and improved along with the oil industry. Our current regulations have put all its eggs in the 'don't let a catastrophe happen, ever,' basket and this has increased the consequences of this spill as the clean up and containment methods are 'light years' behind the drilling technologies.

The oil industry is already a proof of what I've been describing. The government already regulates the oil industry so heavily that only a handful of companies are allowed to compete in the industry. This has created an oligopoly of massive oil giants. It is only

because these companies have become so large, that they have the financing and capital to build rigs that can drill miles below the ocean surface.

The current oil spill is not a result of a lack of regulations; rather, it is the inevitable result of where the government regulations are leading the industry. Instead of a thousand companies drilling a million smaller less risky wells; there are only a small group of drillers, drilling massive size wells with a much higher risk of a catastrophe. It is the too big to fail model again seen in the oil industry.

I could go on and on in industry after industry to illustrate the destructiveness of government regulations. It is a natural human response when something bad happens to expect that somebody or the government does something about it. The truth is that accidents, recessions, and tragic events are part of life. While markets' self correcting nature can sometimes be painful, the non correcting nature of government regulation exacerbates the issues and turns minor problems into major catastrophes.