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Opinion: Regulations and Economic Welfare

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The president recently signed an executive order fulfilling his pledge to reduce federal regulations because it is a widely held belief that unfettered business activity and free-market solutions are integral to economic growth and prosperity, and that government intervention and regulation would be inimical to growth and prosperity. It is difficult to argue with the success of a laissez-faire economic system especially when compared to the economies of the Eastern European countries of yesteryear. But at times can certain regulatory interventions promote a more competitive, efficient and fair economy? It is evident that in some instances, regulations can stimulate competition, fair play and innovation.

> **It is evident that regulations are a double-edged sword. In some instances, regulations promote inefficiencies, rent-seeking and wealth redistribution while in others, they stimulate competition, fair play and innovation.**

Keywords: Competition, Monopoly, Regulations, Government, Information Asymmetry, Externalities, Rent-Seeking, Economic Growth.

Introduction

Campaigns for the recent elections harped on the adverse effects of the regulatory burdens on economic growth. Many of the candidates promised to slash regulations which would create a business-friendly environment. Businesses would invest in future growth opportunities which in in turn would spur economic growth. This begs the question: Do regulations have only adverse impacts, or in some cases do they enhance competition and economic welfare?

Opinion

In order to make life easier for businesses, the president recently signed an executive order fulfilling his pledge to reduce federal regulations by up to 75 percent. This pledge resonated with a large percentage of the populace and business community who believe that unfettered business activity and free-market solutions are integral to economic growth and prosperity, and that government intervention and regulation would be inimical to growth and prosperity. It is difficult to argue with the success of a laissez-faire economic system specifically when compared to the central planning economies of the Eastern European countries of yesteryear. But can regulatory intervention, in some instances, promote a more competitive, efficient and fair economy? This article examines the pros and cons of regulatory intervention to demonstrate that some regulations can actually enhance economic welfare.

Neo-classical economists contend that the most beneficial economic system is perfect competition because it produces the best possible outcomes for consumers and society.

Neo-classical economists contend that the most beneficial economic system is perfect competition because it produces the best possible outcomes for consumers and society ("Perfect Competition," 2017). Because such a market is a hypothetical construct and the conditions for it to exist are specific and stringent, there are virtually no perfectly competitive markets. But that should not preclude us from using it as a benchmark. In perfectly competitive markets, neither sellers nor buyers have the power to set the price of similar products. One of the key conditions for such a market is for consumers and sellers to have equal knowledge of price and product quality, or to put it differently, informational symmetry between buyers and sellers. For example, SEC regulations prohibit investors from trading on insider information, which is information lacking full public disclosure. Dissemination of information to all investors at the same time levels the playing field, thereby encouraging more investors to trade, which in turn leads to greater market liquidity and efficiency.

The benefits of free-markets competition instead of regulation is an enduring topic of discussion. Are free-market solutions and competition the answer to keeping a lid on healthcare inflation? Proponents of free-markets in healthcare give the example of competition driving down prices for disposable contact lenses ("Price of Contact Lenses at Issue," 2015). Yes, this is an excellent example of competition driving down prices, but it is also a cherry-picked example; one that had the important ingredient of informational symmetry in place for competition to thrive. First, consumers are aware that they need corrective lenses. Second, they have the means to compare prices and assess the quality of the contact lenses that they are buying. But can the same be said about other healthcare purchases, especially those that require emergent care rather than elective care?

The rub against market-driven prices in healthcare is that many of the transactions between sellers and buyers abound with information asymmetry (Arrow, 1963). That is, the sellers of healthcare services have far more information than their patients, the buyers, about their medical needs. Patients rely upon their healthcare providers' diagnoses to buy their services and are often informed of the cost after the service. In 2012, the CBS program "60 Minutes" ran an exposé on a hospital chain that pressured its doctors to admit patients regardless of their medical needs (Croft, 2012). This is a classic case of information asymmetry because most patients lack the wherewithal to determine if they needed the required medical treatment. In such an environment the seller has an asymmetric advantage in determining the supply and price of goods and services. The asymmetric advantage is magnified when emergent care rather than elective care is needed because the consumer has neither the time nor wherewithal to shop around for the best provider.

In 2014, *The Tampa Bay Times* did an expose on the vast differences in fees charged by trauma centers in the Tampa Bay area (Stein & Zayas, 2014). It is unlikely that geographical location or severity of injuries could explain these variations. The only plausible explanations are extreme cases of information asymmetry. A severely injured or unconscious patient is in no position to negotiate or comparison shop between trauma centers.

Other examples of information asymmetry in healthcare include malpractice claims and disciplinary actions against providers. Some states keep this information from the general public, so it is potentially hard to judge the quality of the service provided without that information. The State of Florida offers information on the claims paid by malpractice insurance companies for doctors, hospitals and lawyers, although the database is not comprehensive ("Look Up Your Doctors," 2017).

The Affordable Care Act introduced regulations to mitigate the adverse impact of information asymmetry in healthcare. To promote greater price transparency and information symmetry, hospitals are required to release a standard list of prices for their medical services because better informed consumers could comparison shop, which should reduce inflated medical pricing. Rescinding this rule would placate the hospital industry, but would reduce competition.

An example of information asymmetry is the vast difference in knowledge and skill between sellers of financial services and consumers of these services who lack the wherewithal to comprehend a financial document. The Consumer Financial Protection Bureau (CFPB), a government agency created by the Dodd–Frank Wall Street Reform and Consumer Protection Act, is responsible for consumer protection in the financial sector (Consumer Financial Protection Bureau, 2017). One of its goals is to protect consumers from unfair, deceptive, or abusive practices by ensuring that prices, risks and terms of the deal are clear upfront so that consumers can understand their options and comparison shop. Companies are required to play by the same consumer protection rules and compete fairly. The president has signed an executive order calling for a roll back of the Dodd Frank Act. It remains to be seen if it rolls back protections offered to consumers, for it would put some at a decided disadvantage when shopping for financial services.

The fiduciary rule for retirement accounts, which was to be phased this year, is an example of a government regulation intended to improve information symmetry ("DOL Fiduciary Rule Explained," 2017). This rule demands that investment advisors act in the best interest of their clients rather than their own interests. It explicitly states that all fees must be clearly disclosed in dollars to the client. The importance of this rule cannot be overstated because research has demonstrated that actively managed mutual funds with the lowest fees tend to outperform funds with the highest fees (Kinnel, 2015). Armed with this information, investors can best select the most suitable investments for their own needs. However, the implementation of this rule has been delayed allowing for a review to determine if it would adversely affect investors' ability to access financial advice. It is apparent that the delay was urged by the investment industry in order to protect their businesses.

Sellers feast on information asymmetry because it gives them the upper hand in transactions with buyers. For instance, the marketing and sales of goods and services focuses on the strengths of a product with no mention of its weaknesses. Consumers face a similar dilemma when transacting for repairs and maintenance services or buying a used item. They are at a decided disadvantage because sellers are often opaque rather than transparent about the product they are selling. The greater the information asymmetry between the two parties, the greater the potential for exploitation. The elderly citizens of our state are particularly vulnerable to predatory practices because advancing age makes it increasingly difficult to process information such as contracts written in complex legalese. In some cultures, such practices are revered because winning at any cost is paramount. Rarely is a win-win transaction considered a best business practice.

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Achieving informational symmetry in all transactions between buyers and sellers is a pipe dream. But is there a place for regulatory mandated transparency in big-ticket transactions such as in healthcare? One could make the case that the economy would be better served if there were more information symmetry between buyers and sellers. Regulatory intervention can require the seller to provide more information to level the playing field between buyers and sellers.

Perfect competition presumes that there are no externalities, meaning that there are no external costs to non-participants in a transaction. For instance, if persons A and B transact a business deal which ends up costing persons C and D who are non-participants in the deal, then they are bearing an external cost not of their making. The question then is: Who should pay for that externality, or should the activity be curbed to prevent the externality altogether?

Perhaps the most hotly debated externality today is the impact of human activity on climate change. According to a NASA website, several studies published in peer-reviewed journals reveal that climate change is real and that warming trends over the past century are likely due to human activities that result in the emission of greenhouse gasses ("Scientific Consensus: Earth's Climate Is Warming," 2017). The fossil fuel industry and some of its consumers object to these findings partly because regulations designed to reduce emissions would limit the profits of the former and impose substantive costs on the latter. In reality, getting rid of this externality would be unfeasible because it would cripple economic growth.

But some prominent former government officials contend that although the extent to which climate change is caused by human activity can be questioned, the costs associated with warming on future generations (an externality) are so severe that they should be hedged by regulating activity (Shultz & Baker, 2017). They suggest that any solution should incorporate the conservative principles of free markets and limited government. They recommend a gradually increasing carbon tax that is tax-neutral at the macroeconomic level by returning the tax proceeds to the citizenry in the form of dividends. To protect domestic competitiveness, there would be a need to establish border carbon adjustment taxes on imports from countries which do not meet U.S. carbon mitigation standards. Such taxes would encourage these countries to enact their own carbon reducing regulations.

Anti-trust laws, also referred to as competition laws, are a collection of federal and state regulations that are intended to promote competition (Bynum, 2017). These regulations were developed to ensure that sufficient competition exists to ensure a free-market economy. They are intended to prevent bid rigging, price fixing and the creation of monopolies. Pursuant to these laws, a U.S. District Judge recently blocked the merger of the medical insurers Humana and Aetna because their combined market share in the private Medicare Advantage supplemental plans for seniors would reduce competition (Coombs, 2017). One of the characteristics of perfect competition is that there is little need for government regulation, except to make markets more competitive.

Some companies have earned their monopoly positions by offering a superior product. Google's greater than 70 percent market share of the search engine market would classify the company as a monopoly (Schwartz, 2015). Absent predatory practices on Google's part, it would be unwise for the government to regulate the company's growth. Google's market share is evidence enough that consumers derive greater utility from using its search engine. The foundation of microeconomic and finance theory is based on the premise that consumers and investors wish to maximize utility.

On the flip side, some regulations are designed to limit competition by creating artificial barriers to entry. One would think that such regulations are universally detrimental to consumer well-being. But there are two sides to this story (Thiel, 2014). The mission of the U.S. Patent Office is to preserve monopoly positions for entities that have designed new and innovative products. Companies have the luxury to innovate because patent protection incentivizes them to invest capital in risky ventures that can take many years to come to fruition. For instance, it makes economic sense for pharmaceutical companies to invest considerable sums of money to develop new medications because competitors cannot copy and sell the same drug as a generic equivalent without waiting for a considerable period of time, usually more than a decade.

Unfortunately, patent laws are also used to stifle innovation. Entities, pejoratively referred to as patent trolls, purchase patents usually from failing companies, but do not manufacture products protected by the patents. Their intent is to use the legal system to extract royalties from "patent infringing" companies. Fearing expensive litigation costs, the latter usually settles out of court. Such activities impede economic welfare by stifling innovation (Blumberg, 2016).

Regulations should not tilt the playing field by imposing dissimilar rules and costs on different participants in the same industry ("Internet Firms' Legal Immunity Is Under Threat," 2017). The taxicab industry is subject to a host of regulations mostly to protect consumers of their services. The need for some of the regulations can be debated, but that is not the issue. Uber and other ride-hailing services have pried market share from taxi-cabs due to convenience and lower costs, partly because they are not burdened by the same set of regulations. The ride-hailing companies claim that they are technology companies, and so they are not subject to the same set of regulations as taxi-cabs. Although the ride-hailing industry might dominate market share in the future, winners and losers should not be determined by heterogeneous regulations that impose unequal costs. A similar argument can be made in the battle between Airbnb and the hotel industry.

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Perhaps the most onerous set of regulations being deliberated currently are a substantial increase in tariffs on imported products. The goal is to increase domestic manufacturing, so that jobs lost to other countries will return to the U.S. But an estimated 88 percent of jobs losses are attributable to automation such as the use of robots rather than unfair trade practices (Lehmacher, 2016). Increasing taxes on imports might satisfy populist and nationalist tendencies in the short-run, but will have little impact on employment in the long-run. Besides, they might invite retaliation by other countries, disrupt complex global supply chains and increase inflation.

Much of the economic malaise is due to a widening wealth distribution between owners of capital (the rich) and labor (lower middle-class and poor). Import tariffs will hurt lower income earners the most because a greater proportion of their income is spent on cheap imports. A less intrusive though not perfect approach to reduce this inequity would be to broaden the earned income tax credit (EITC) for low income earners at the expense of additional taxes on higher wage earners. The EITC is not welfare for the jobless. Rather it supplements earned income with a refundable tax credit for lower income workers, particularly those with children ("How Much Are the EITC and CTC Worth?," 2016). The EITC also offers the added benefit of increased consumer spending and economic growth because lower income earners spend more of their income compared to high wage earners who tend to save more.

It is evident that regulations are a double-edged sword. In some instances, regulations promote inefficiencies, rent-seeking and wealth redistribution, while in others they stimulate transparency, competition, fair play and innovation. Business activities can create monopolies, information asymmetry and impose externalities. Changing the regulatory landscape needs to be done carefully. An overzealous effort to reduce regulations could eliminate regulations that actually enhance economic welfare.

Conclusions

Painting the regulatory environment with a broad-brush stroke by assuming that regulations result from government overreach and are thus inimical to economic growth and well-being is counterproductive and could lead to cures that are worse than the disease. Regulations that reduce competition need to be eliminated. However, some regulations promote economic welfare and growth because they stimulate transparency, competition, fair play and innovation. These regulations need to be protected.

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Review

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Biography

Murad Antia teaches financial statement analysis and investments at the University of South Florida's Muma College of Business. He is an expert in portfolio management and has many years experience managing equity, trust, foundation and retirement accounts. He earned a PhD from the University of Houston and an MBA from Duke University. He has held senior-level positions in several area financial institutions, including Barnett Banks Trust Company and AmSouth Bank. He received the University of South Florida's Outstanding Undergraduate Teaching Award in 2004 and 2009 and the Kahn Teaching Award for 2006/07. He also received the 2010/11 Outstanding Research Award for Instructors and has published in many finance research journals.