

The role of “Mickey Mouse” in serious government

Former President, Nelson Mandela, referred scathingly to “Mickey Mouse” opposition parties. A recent article by a Prague-based investment service (Mendès Prior) indicates that Mickey can indeed be a nuisance. He may even slow up government activity. Mendès Prior concludes that “...in a democracy, political diversity may be bad for government regulators – but it’s great for market growth”.

In the interests of that diversity and growth the Free Market Foundation reprints below the essay by the Mendès analyst.

Introduction

The US federal budget is in surplus after 29 deficit years, its monetary policy is on cruise control, and the bond market has hit the snooze button. What better time to explore one of the funkier indicators that affect the US economy and its financial markets, and what it implies for everyone else.

Let’s explore an indicator called “regulation”. The US Federal government catalogues all of its regulatory activity in a huge tome called the Federal Register, which includes legislation and the significant rule-making activity of federal agencies.

In 1998, the US Federal Register totalled 73,350 pages, or 287 pages of meddling for each business day. Because the cost of complying with all those regulations is so huge, the Federal Register has some identifiable relationships with financial asset prices and total returns.

Jim Bianco, president of Bianco Research in Barrington, Illinois, tracks the verbosity of the Federal Register for just that reason. Among his findings: while a politically divided government is bearish for regulation, it is definitely bullish for financial markets.

When one political party controls the White House and the other Congress, regulatory growth nearly grinds to a halt. In the past 60 years, the median growth of the Federal Register has been limited to 1.54 percent per year when the two are split as compared with 9.56 percent under single-party rule.

Divided government and reduced regulatory activity mean superior returns for stocks and bonds. (In the post-war era, single-party rule has been synonymous with Democratic rule, with the exception of the 1953-54 congressional session.)

United they fall

No wonder the bond market used to quake at the suggestion that the Democrats were about to ascend to power in Washington. For the last 60 years, whenever the Federal government was unified, bonds posted a meagre total return (2.44 percent) – under-performing even the three-month bill in all instances since 1950 – compared with the periods of divided government (8.63 percent).

With stocks, the difference is less pronounced, but it’s still there. The Standard & Poor’s 500 Index produced a median total return of 11.98 percent under a unified government versus 13.60 percent with divided government.

The impact of regulation isn’t limited to stocks and bonds. The CRB/Bridge Future Price Index and the Federal Register are almost perfectly correlated.

It makes sense, too. Government regulatory activity has long focused on agricultural and energy prices. In an inflationary environment, when commodity prices are rising, it attracts a lot of attention in Congress. They pass some laws to protect consumers, and end up making things worse. It is clearly a law of unintended consequences.

No free lunch

Correlation is a statistical term that seeks to explain one variable in terms of another. Correlation does not imply causation.

Using annual averages for the last 60 years, Bianco calculates the correlation between the CRB Index and the Federal Register as 95 percent (100 percent represents a perfect correlation). Between the Federal Register and bond yields, the correlation is somewhat lower – 83 percent – but only because of an unusual divergence in the last four years.

Scholars have attempted to quantify the economic inefficiencies created by regulation, not to mention the sheer cost. Washington's Cato Institute estimates the cost of compliance at some US\$700 billion, or 12 percent of nominal gross domestic product. And that doesn't include the cost of either banking regulation or state and local regulation.

Someone has to bear the cost; there are no free lunches. (Remember that the next time a government official assures you that "it doesn't cost the taxpayer a cent", it invariably costs much, much more.) The added costs can be borne by the producer or the consumer. If the producer bears the cost of compliance, corporate profits will be reduced, and investors will value the stock accordingly.

If the producer successfully passes the cost along to the consumer, it raises consumer prices and has potential inflationary implications, like a tax.

The correlation between the Federal Register and markets makes perfect sense. Correlation does not seek to define a causal relationship, to describe a cause-effect relationship between two variables. But in this case it's easy to see how causation would flow from regulation to returns. Increased regulation acts like a tax, reducing returns and raising prices.

Producers and consumers in the US and other democratic countries will be better served by ensuring that government remains divided. For those under more unitary or authoritative regimes, even growth can be regulated. But a word to the wise, reality cannot be postponed forever.

Further reading

O'Dowd, MC (1998) *South Africa as an "Open Society"?*, FMF Monograph 20, Johannesburg.

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