The CJ Investment Newsletter

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The Costs of Regulation

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	3.23%	3.15%
COMP	4.82%	9.67%
SPX	3.77%	8.39%
Gold	0.41%	7.15%

Market Note: Stocks made big moves in August. Note that August gains comprise *more* than 100% of the DJI's YTD return. August returns comprise over 50% of the YTD returns for both the SPX and the COMP. On the other hand, Gold eked out a small gain for the month, adding to its consistent positive action YTD.

- We look into the past to find some of the criteria of sound economic thinking. Indeed, sound thinking in general.
- Considering those criteria, we examine the cost of regulation, especially as related to the benefits.

How to Tell a Good Economist

The brilliant Frederic Bastiat published That Which is Seen, and That Which is Not Seen in 1850. See the Recommend Reading box on page 3 below for more details. In it, he provides a means of determining how a good economist should think. He also provides a means to determine a good economist from one who is not so good.

From Bastiat's opening paragraphs:

"In the economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause—it is seen. The others unfold in succession—they are not seen: it is well for us if they are foreseen. Between a good and a bad economist, this constitutes the whole difference—the one takes account of the visible effect; the other takes account both of the effects which are seen and also of those which it is necessary to foresee. Now this difference is enormous…

"This explains the fatally grievous condition of mankind. Ignorance surrounds its cradle: then its actions are determined by their first consequences, the only ones which, in its first stage, it can see. It is only in the long run that it learns to take account of the others. It has to learn this lesson from two very different masters—experience and foresight. Experience teaches effectually, but brutally…For this rough teacher, I should like, if possible, to substitute a more gentle one. I mean Foresight. For this purpose I shall examine the consequences of certain economical phenomena, by placing in opposition to each other those which are seen, and those which are not seen."

Bastiat then uses his famous example of the broken window to make clear what he means. His example is so well done that Henry Hazlitt, one of von Mises's protégés, used the same example to create the "lesson" in his famous short treatise, Economics in One Lesson, first published in 1946.

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> *"The best government is that which teaches us to govern ourselves."*
> \- **Johann Wolfgang von Goethe**

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Anyone wanting to read a short, but very enlightening, primer on economics should read this book. While a fine economist and theoretician, Hazlitt has the additional rare gift of being able to teach difficult concepts in a manner that non-experts in the field can understand, learn and apply. That is indeed a rare gift for any writer or speaker.

The point is: A good economist has trained his/her mind to look not only at the immediate logical consequences of economic actions, but to the consequences of the consequences as it were. And even further down a chain of events, based upon probabilities or predictable results. In other words, the good economist reviews a chain/web of decisions and consequences as they play out in the future economic sphere.

The bad economist (generally) will only seek to discover the immediate effect of economic actions and decisions and generally ignore the consequences that logically follow from a connected chain of events. Further, a bad economist will only discuss the immediate effects of a decision or proposed action. While they may be accurate in their assessment, failing to consider what happens as a result of a chain of events that is started may find the bad economist giving good short-term advice, but disastrous long-term advice.

People you talk to every day exhibit the same characteristics. Unfortunately, many more exhibit the thinking patterns of the bad economist. I have had discussions with experienced, grown adults who were quite bright, but really didn't know the difference between *causation, correlation and juxtaposition*. No matter how smart they are, we do not want such people making major economic decisions for our society.

Just for the record, let's define those terms simply.

- *Causation* occurs when an action actually creates or helps cause a following event to occur. The following event is a logical consequence of the causative action taken.
- *Correlation* happens when one event and another event are connected, perhaps to a prior causative event, but it can be clearly shown that neither of the two events caused the other.
- *Juxtaposition*, in the sense used here, happens when two events occur at approximately the same time, but are completely unrelated to each other, at least if the observer thinks it through.

Let's take a simple example.

After decades of bad fiscal and tax policy, the result of which was the late 1970's (a very bad time in US history), Ronald Reagan was elected president in 1980. He implemented a series of fiscal, tax and regulatory policies that transformed America from a perceived second world power (under Jimmy Carter) to regaining its preeminent place in the world both militarily and economically before the end of his first term. Of course, not everything Reagan did was economically advantageous in the long-term, but most of it was.

Still, the immediate result of his polices made the US economy much worse. The cure Reagan implemented for the massive inflation of the 1970's created a deep, but short recession. Prime interest rates in excess of 21%. Even more massive unemployment than there was under the Nixon/Ford/Carter administrations. I could bore you a lot with what decisions he made and how they created their immediate and longer-term effects, but that would actually detract from the point being made here.

Most importantly, the policy changes Reagan made were done with the understanding of how people, and particularly entrepreneurs, work. The effects of his decisions created the boom that started in his administration and lasted all the way through the Clinton administration. Typically, the press and those who confuse juxtaposition with causation credited Clinton with the massive solid economic growth that happened in the 1990's. It's much more accurate to say that Clinton reaped the benefits of the Reagan decisions, was smart enough to know what he was looking at, and didn't kill the golden goose with big progressive fiscal, environmental and tax policies.

Which, incidentally, makes him much smarter economically than his predecessor as president, George H.W. Bush. Just to demonstrate a bad economist to you, Bush I ran against Reagan in 1980, calling Reagan's economic policies "voodoo economics." One would reasonably think that after having a ringside seat to the transformation and revitalization of the US economy *as a direct result of the changes Reagan implemented,* Bush I would have learned his lesson and kept the momentum up during his administration. As John Belushi used to say on SNL: "But, NOOOOOOO."

Bush I turned his back on those successful Reagan policies at the first sign of political and fiscal trouble. I watched in dismay as he did so. I'm not sure which world he was living in, but it sure wasn't the same American businessperson world that I was in.

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I guess it really is true: some people simply won't learn from experience. I think we call them ideologues.

Looking at President Clinton from another angle, I remember having a conversation with a very bright person about this exact subject. He disagreed with my assessment that the strong economy during Clinton's administration was the result of Reagan policies enacted over a decade earlier. He simply stated, "I don't know about that. I go by results."

Really? The US economy is not a canoe. It's not easily maneuverable. It's more like an ocean liner; it will take miles to make a simple turn. If you review Clinton's record, he made no MAJOR changes to economic or tax policy in his first administration. So, what did he do, exactly, to create this grand new economy? As I stated above, he knew what he was looking at and did not dismantle the sound ideas he was now reaping the benefits of and the credit for.

The Cost of Regulation

As with many things anymore, we trust our government to take care of things for us. Perhaps the responsibilities and time requirements in our own lives keep us too busy to monitor our governments. So, we choose to trust, even though government has overstepped its powers and has not earned our trust through performance and prudential measures. If our founders thought that way, there would be no United States of America.

How many times have you heard someone say, "There ought to be a law…."? Well, we have a whole lot of them now – and regulations, which constitute laws never passed by a lawmaking body, but whose authority is granted to certain government bodies in order to deal with issues of concern. What that means is that regulations, unlike laws, are not actually examined or voted on by you through your elected representatives prior to their implementation by the related regulatory agencies.

There are practical considerations to this system, but it certainly doesn't serve the cause of freedom very well. Let's look at a recent example from my own life.

My older dog has had problems with pain from hip dysplasia and thyroid issues her whole life. Because rimadyl can be fatal for some dogs, I refuse to put any of my dogs on that drug for pain. Tramadol, a very light narcotic, can be quite effective in helping to control her pain. In fact, Tramadol has been a very good drug for her. It's out of patent, so it's cheap; it's effective and isn't generally habit forming unless the patient is taking high doses of it, that is, abusing the drug. The DEA reported that 43.8 million Tramadol prescriptions were dispensed in 2013. Citation: http://www.deadiversion.usdoj.gov/drug_chem_info/tramadol.pdf

In the same report, the DEA reported that 3.2 million people over 12 years old or older used tramadol for nonmedical purposes *in their lifetime*s. Even if that was all in the same year, that would constitute roughly 1% of the US population. I wonder what comparable statistics exist for alcohol or marijuana.

Recently, the DEA decided that, after having been unregulated on the market in the US since 1995, that tramadol needed to be regulated now. It was placed into Schedule IV of the Controlled Substances Act effective 8/18/2014. I found this out the last time I went to my Vet for another matter. I was told that now my dog would have to be "monitored" in order to continue using Tramadol to control her pain.

My reaction was not particularly positive to the news. But, then again, what do you expect from the US government these days? Still, I became angrier about it when the Vet tech, who is very nice and smart, said, "Well, the cost of the drug isn't going up."

Seriously? The cost won't go up? I guess that's true if you don't consider that which is not seen:

- The cost of having my dog examined more frequently for this new purpose, including office visits and blood tests.
- Additional costs in car usage to shuttle her to the Vet more frequently.
- The higher per unit cost of acquiring the drug in smaller amounts more often.

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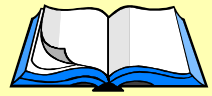

Recommended Reading

The Bastiat Collection, Frederic Bastiat, 1850. Available for free (I think) as either in PDF or eBook formats. Available in print for a small price. To obtain a copy: http://mises.org/document/6299/The-Bastiat-Collection

This book includes many of his writings, including That Which is Seen, and That Which is Not Seen and perhaps his most famous work, The Law. I highly suggest you acquire a copy of this book, in whatever format, and begin reading it.

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- The cost of my time for these additional requirements.
- Additional compliance costs to the Vet from additional required data collection and reporting to the DEA. Such costs will be passed on eventually to customers.
- Additional costs to the government (and, therefore, taxpayers) from additional staffing required to deal with the addition of a newly scheduled drug.
- The costs to our psyches as people, communities and country to have yet another decision removed from the realm of freedom and responsibility and replaced by government control.

The above additional points can also be repeated for every human patient taking Tramadol, too.

Not all costs are monetary. How does our governments' failure to trust us to act properly influence our individual and collective behaviors? Is there no societal cost to restricting our freedoms a little more every year? What is the cost to deliberately making us more dependent upon our governments every year?

While I did not make an exhaustive review of my Google search of the new Tramadol regulations, I did review several government documents related to this change and new classification. It seems notable that no cost versus benefit comparison information was presented. It would be hard to state that no such information was considered in the reclassification of Tramadol to Schedule IV. However, if it was considered, why was that information not presented to those who would want to read the reasons why the government made this change? Unfortunately, since such information was not presented, it would not be unreasonable to conclude that it was not considered in the decision process.

This is but one example. Repeat this example millions of times each year for products and services that are now regulated and will become regulated. Remember, none of these regulations provides a single bit of benefit to responsible patients who need the drug. It only provides barriers to entry through laws and additional costs. The additional governmental costs are also paid by taxpayers who don't receive any kind of benefit at all.

Every first year accounting student is taught that prior to implementing new procedures, the cost of implementing the procedure needs to be compared to the benefit derived. When I was an accountant in the '80's and '90's, it was called, "Don't put a $50 solution on a $5 problem." That our own government does not see the need to think this way is incredibly disrespectful, disturbing and wasteful.

There will always be laws and projects that we, as a society, will undertake that will likely not pay for themselves, but that we want to do, as a society, nonetheless. Memorials to people and wars, national, state and local parks, and other such things. But to fail to consider costs in our societal structure is a path to being wasteful and uncompetitive on the world stage. What does it mean that our elected representatives do not need to consider the costs we as taxpayers must pay in making important decisions?

We need to demand that brilliant economists like Bastiat, Hazlitt, Mises, etc. be taught to our kids so they can learn to see that which is not seen. Today, even educated adults seem to lack that ability.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.