



## Testimony

# The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic

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### Introduction

Chairman Neugebauer, Ranking Member Capuano and members of the Committee, I am pleased to have the opportunity to appear today to discuss the economic and budgetary costs of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”, Public Law 111-203). In this testimony, I wish to make four main points:

- Financial regulation imposes budgetary costs on the taxpayer. In addition, it imposes direct compliance costs and its distortions induce economic costs in the form of reduced capital investment, inferior risk-sharing, and lost competitiveness. Because of its scope and scale, Dodd-Frank will impose substantial costs of each type.
- Budgetary costs are the least difficult to estimate, and likely the smallest cost associated with Dodd-Frank. The most important aspects of the law from a budgetary perspective were its failure to include reforms to the Government Sponsored Enterprises and the creation of the Consumer Financial Protection Agency. The former will likely have significant budgetary consequences, while the latter has been inexplicably placed outside the annual appropriations and oversight process.
- Compliance costs are an important burden on the affected firms and industries. Moreover, past episodes such as the passage of the Sarbanes-Oxley (SOX) legislation suggest that these can be substantially larger than anticipated. SOX compliance for one provision of the Act was estimated at under \$100,000; the reality for most firms is easily 10 to 40 times greater.
- The economic consequences of Dodd-Frank will be to reduce investment in the United States.

Let me pursue each in additional detail.

## Budgetary Costs

Dodd-Frank will be an expensive federal endeavor. The Congressional Budget projects federal budget costs of \$1.1 billion over the first 5 years.<sup>[1]</sup> In part, this reflects the fact that the law creates 122 new councils, advisory committees, other panels, and consultation requirements. In addition, the Congressional Research Service (CRS) estimates there are up to 330 rule-makings that will have open-comment periods. These are costly undertakings that will require taxpayer resources.

In a June 28, 2010 cost estimate for the Dodd-Frank Conference Agreement, the Congressional Budget Office and the Joint Committee on Taxation (JCT) estimated enacting the bill would increase revenues by \$17.1 billion over the 2011-2015 period and by \$26.9 billion over the 2011-2020 period and increase direct spending by \$14.9 billion and \$26.9 billion, respectively, over the same periods.

The CBO's estimate includes estimated changes in direct spending over the 2011-2020 period for the following Dodd-Frank provisions:

- Consumer Financial Protection: estimated outlay of \$6 billion
- Derivatives Regulation: estimated outlay of \$200 million
- Financial Stability Oversight: estimated outlay of \$200 million
- Other Financial Oversight and Protection: estimated outlay of \$2.2 billion

Still, when viewed in the context of annual federal outlays totaling \$3.6 trillion it is clear that Dodd-Frank is not a key driver of federal deficit or debt accumulation. Indeed, the two most significant budgetary aspects of Dodd-Frank are those costs that are *not* on the federal budget.

The Congressionally-created Financial Crisis Inquiry Commission (FCIC) recently completed its investigation and reported to Congress.<sup>[2]</sup> As has been widely reported, the FCIC was unable to agree upon a single set of causes of the financial crisis. Instead, the majority report was accompanied by two separate dissenting views. Importantly, however, all three reports assign a significant role to housing market policy, in general, and the housing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, in particular. Thus, one might have expected Dodd-Frank to have GSE reform at its core and that this reform might have substantial budgetary impacts. In fact, no such reform has taken place and the Administration continues to exclude the GSEs from its

Similarly, the costs of the new Bureau for Consumer Financial Protection (CFPB) will not appear on the budget. Instead, the CFPB will draw from Federal Reserve resources and, thus, be exempted from the annual appropriations process and associated appropriations oversight process. One *might* be able to defend the creation of the CFPB as a matter of financial market regulation – I cannot – but it is mystifying that Congress would choose to fund such an entity in such a opaque and unaccountable fashion.

## Compliance Costs

The cost for firms affected by Dodd-Frank is both highly significant and highly uncertain. The uncertainty is exacerbated by the fact that rule making is ongoing and very substantial. For this reason, the true compliance cost will not be apparent for years into the future.

In light of this, whether the actual costs of Dodd-Frank remain smaller than the public policy benefits will depend importantly on an ongoing monitoring and assessment of the rule making under the law. To date, there exists only fragmentary information regarding the potential costs.

- The total costs to date as reported in Federal Register are \$836.6 million. The largest single item is \$245 million for a security-based swap data repository registration.
- Standard & Poors estimates that Dodd-Frank would result in a \$22 billion reduction in aggregate pre-tax earnings among large banks.
- International Swaps Dealers Association: \$1 trillion in capital and liquidity requirements.

If recent history is any guide, there is reason to be concerned about the ultimate scale of these estimated compliance costs. When the SOX legislation passed, CBO noted (as part of its obligations under the Unfunded Mandates Reform Act) that the private-sector costs would exceed the \$115 million threshold. The costs as

published in the Federal Register totaled \$1.29 billion, and the Securities Exchange Commission (SEC) estimated that compliance would cost each company \$91,000[GR1] .[4]

As it turns out, SOX is incredibly expensive. Financial Executives International estimates that the annual compliance costs average nearly \$2 million and for larger firms exceed \$4 million.[5]

## Economic Costs

From an economic perspective, the financial services industry provides important services to a market economy:

- It implicitly matches savers and borrowers, permitting households of each type to choose a spending pattern that suits them best;
- It funnels net savings to productive investments in skills, innovation, equipment and structures, thereby enhancing growth and future standards of living; and
- It permits risks – credit risks, operations risks, investment risks, and so forth – to be shifted from those averse to risk to those willing to bear the risk.

Importantly, in each of these economic functions, the financial services industry, and its constituent firms, act as *intermediaries* between other economic actors – households, entrepreneurs, pension funds, firms, and so forth. Accordingly, when costs are imposed on the industry, these costs are ultimately borne by savers and investors.

Thus, one can think of Dodd-Frank as imposing a set of implicit taxes on these groups. As with any “tax” issue, there are two important components to understanding its economic costs: (a) who bears the real burden of the new costs, and (b) in what ways does the presence of the new costs deter valuable economic activity that would have otherwise occurred?

In tracing through these effects, it is useful to recognize that the costs of Dodd-Frank are analogous to a tax on capital transactions (saving, investment, hedging risk, etc.) that occur through the formal financial services sector. Because U.S. firms operate in globalized financial markets, participants in the financial services sector will have a limited capacity to absorb costs by reducing returns to shareholders. Instead, additional costs will be shifted to workers – in the form of fewer jobs and reduced compensation – and financial services customers – in the form of fewer free services, higher fees, and increased borrowing costs.

The dominant response is likely to be higher costs for customers. The “Finance and Insurance” component of national employment is relatively small (5.6 million or just over 4 percent in February 2011). Thus, one can best think of the economic costs of Dodd-Frank as equivalent to a tax on the return to saving, investment, and risk management.

### *The Dodd-Frank “Tax”: Higher Costs, Slower Job Growth*

There exists a large empirical literature documenting the impact of capital taxation on economic efficiency and growth.<sup>[6]</sup> It finds that a 5 percentage point increase in the top marginal tax rate reduces GDP growth by 0.3 percentage points annually. Viewed from another perspective, at any point in time the cost of a \$1 of tax revenue is at least \$1.30 and perhaps much more.

What does this tell us about the impact of Dodd-Frank. The S&P estimate that the pre-tax return on equity for affected large banks will fall by as much as 270 basis points, on a base return of roughly 15 percent. This suggests that it is equivalent to a “tax rate” of approximately 18 percent on earnings. In order to restore post-tax earnings to their previous levels, firms will be forced to raise pre-tax revenues by as much as 22 percent. Thus, for example, if the sole source of revenue for firms was interest earnings from loans to borrowers, those interest rates that previously were 4 percent would have to rise to 4.9 percent; those that were 5 percent must rise to 6.1 percent; and those that were 6 percent would be forced up to 7.3 percent. In short the impact of Dodd-Frank looks similar to a roughly 100 basis point rise in borrowing costs.

This upward pressure on base interest rates, spreads for risky borrowers, and fees for financial activities will be spread pervasively through the financial system. In short, the Dodd-Frank “tax” will make capital market transactions more expensive.

As similar pervasive rise in financial costs occurs when overall interest rates rise because of Federal Reserve

policy decisions or shifts in financial market conditions. Thus, for example, in a recent analysis of the impact of sovereign debt volatility on the U.S. economic outlook, the Macroeconomic Advisers, LLC estimated that a 50 basis point increase in risk spreads would lower the near term GDP growth rate by 0.65 in the first year and 0.43 in the second year.

This estimate can be used to translate the roughly 100 basis point rise from the Dodd-Frank tax to an impact on near-term growth rates of -1.3 and -0.86 percentage points. Of course, slower near-term GDP growth from Dodd-Frank would also translate into slower labor market recovery. To get a sense of the magnitudes, note that in the context of evaluating the stimulus legislation, the Congressional Budget Office estimated that a 1 percent increase in GDP yielded 700,000 additional jobs. Using this as a rule of thumb, such a decline in GDP growth would lower employment by 900,000 jobs in the first year and an additional 600,000 in the second.

It is important to emphasize that this is a very rough estimate and assumes a pervasive impact on all interest rates, spreads, and fees of over 20 percent. Not every financial institution will be affected to the same degree as the largest banks, so the aggregate impacts are likely much smaller. At the same time, the fact that there is a differential rate of effective costs means that Dodd-Frank is creating purely policy-based winners and losers. Firms or activities that had created a competitive niche on the basis of market fundamentals will find themselves displaced by the costs of Dodd-Frank, while other activities or firms that had previously been less competitive will relatively benefit from the act. When policy, not fundamentals, determines what succeeds or fails, it represents a misallocation of resources across industry segments and firms.

These computations are intended to be illustrative, not definitive. However, their potential scale suggests that tracking the ongoing cost of the legislation is an important aspect of public policy.

## **Conclusion**

Dodd-Frank will have dramatic impact on the evolution financial markets and the economy. It will impose budgetary costs on the taxpayer. In addition, it imposes direct compliance costs and its distortions induce economic costs in the form of reduced capital investment, inferior risk-sharing, and lost competitiveness. Because of its scope and scale, Dodd-Frank will impose substantial costs of each type. Thank you and I look forward to answering your questions.

For a PDF of the testimony from the House Financial Services Committee, [click here](#).

[1] The CBO cost estimate for the Dodd-Frank Conference Agreement is available at <http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf>

[2] See <http://www.fcic.gov/report> .

[3] The CBO has (correctly) concluded that the combination of taxpayer funding and their use for housing policy purposes makes Fannie Mae and Freddie Mac *de facto* government agencies and includes them in its budget projections.

[4] SEC Release No. 33-8238, June 5, 2003.

[5] See [http://www.financialexecutives.org/eweb/DynamicPage.aspx?site=\\_fei&webcode=adv\\_sox](http://www.financialexecutives.org/eweb/DynamicPage.aspx?site=_fei&webcode=adv_sox)

[6] A good summary is found in Katherine Baicker and Jonathan Skinner, “Health Care Spending Growth and the Future of U.S. Tax Rates,” National Bureau of Economic Research, Working Paper 16772, February 2011.

**[GR1] Citation for SEC estimate for SOX Section 404 compliance:** SEC Release No. 33-8238, June 5, 2003.

From Committee on Capital Markets Regulation: This SEC estimate only covered 404(a), and the SEC did acknowledge that some commenters believed the costs of the 404(b) auditor attestation report would be significant.

#### **From Committee on Capital Markets Regulation study on SOX 404:**

“The actual implementation costs in 2004 can be compared with the SEC’s original estimate, in 2003, of compliance costs for management attestation under Section 404(a). The SEC originally estimated that internal costs (exclusive of audit fees) would average \$91,000 per issuer. Audit costs are estimated to be roughly 25–30 percent of total Section 404 expenditures, meaning that internal costs in 2004 (based on a \$5 million midrange estimate) were on the order of \$3.5 million per issuer. Thus, on a like-for-like basis, actual implementation costs in 2004 were *more than 35 times higher* than the SEC’s original estimate.” P. 126 of 2006 Interim Report available at [http://www.capmksreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf)