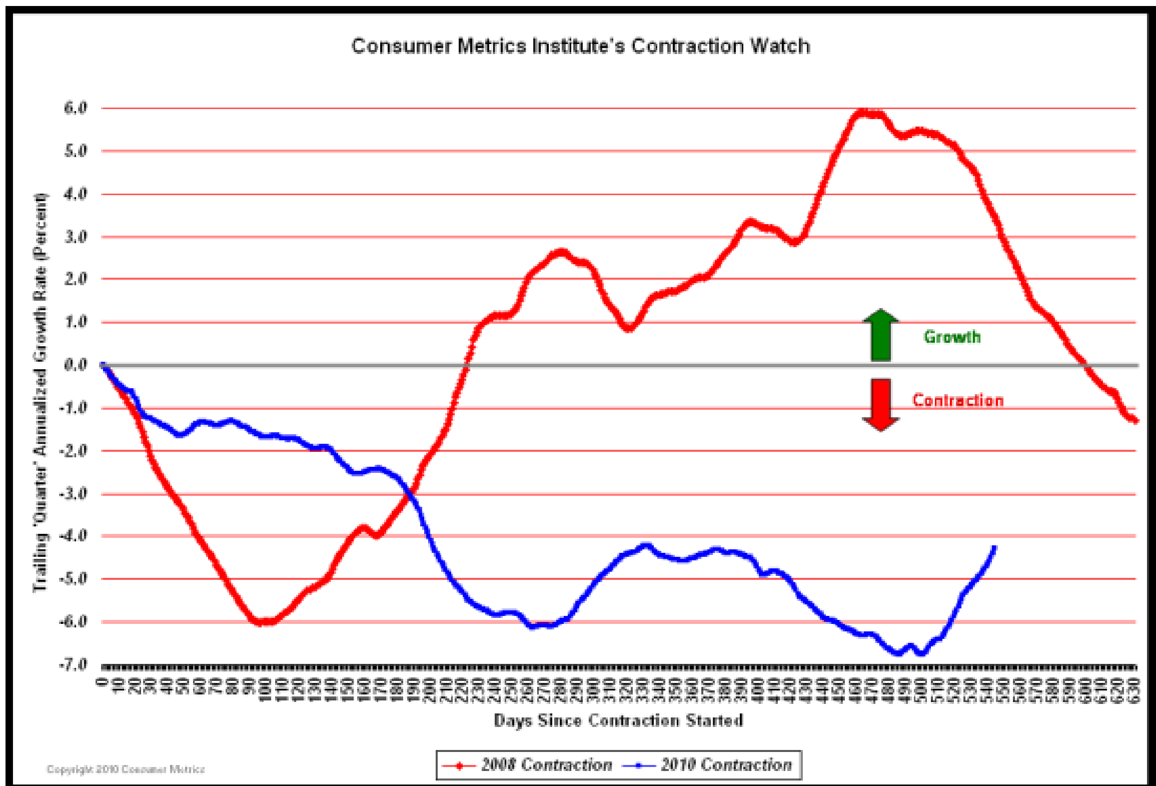
Consumer Metrics Institute Members News

July 9, 2011: Continuing Contraction Moderation; Shakespeare's Stimulating Idea

We are becoming more convinced with each passing week that the rate of contraction of on-line consumer demand for discretionary durable goods "bottomed" at the end of May 2011. The climb in the year-over-year contraction rate since then has been significant**:**

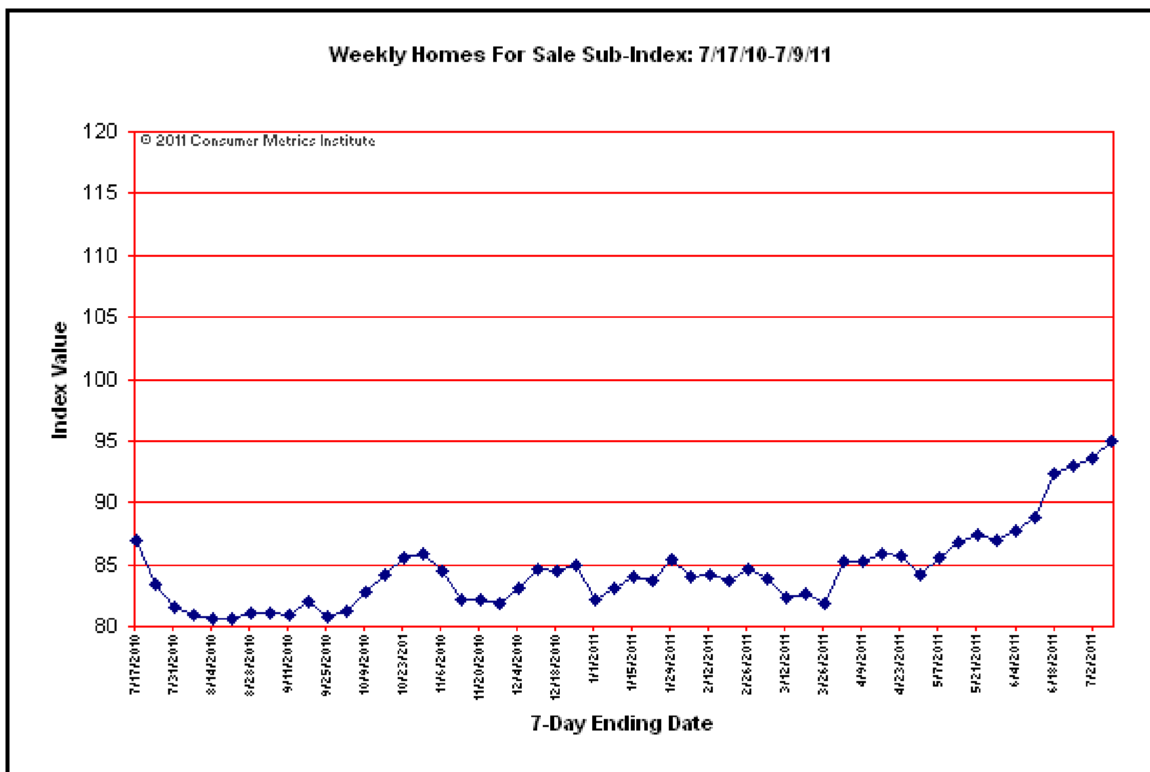


The above chart follows the course of our Daily Growth Index (actually just a 91-day moving average of the Weighted Composite Index, converted from the base 100 index to a +/- percentage) since that index first went into contraction (on January 15, 2010 -- now 540 days ago). The chart also shows what the Daily Growth Index was doing during the consumer contraction that occurred within the formally defined "Great Recession" of 2008-2009. The progress of each event is recorded as a track of Daily Growth Index values commencing on the left margin on the date that the index first went into contraction.

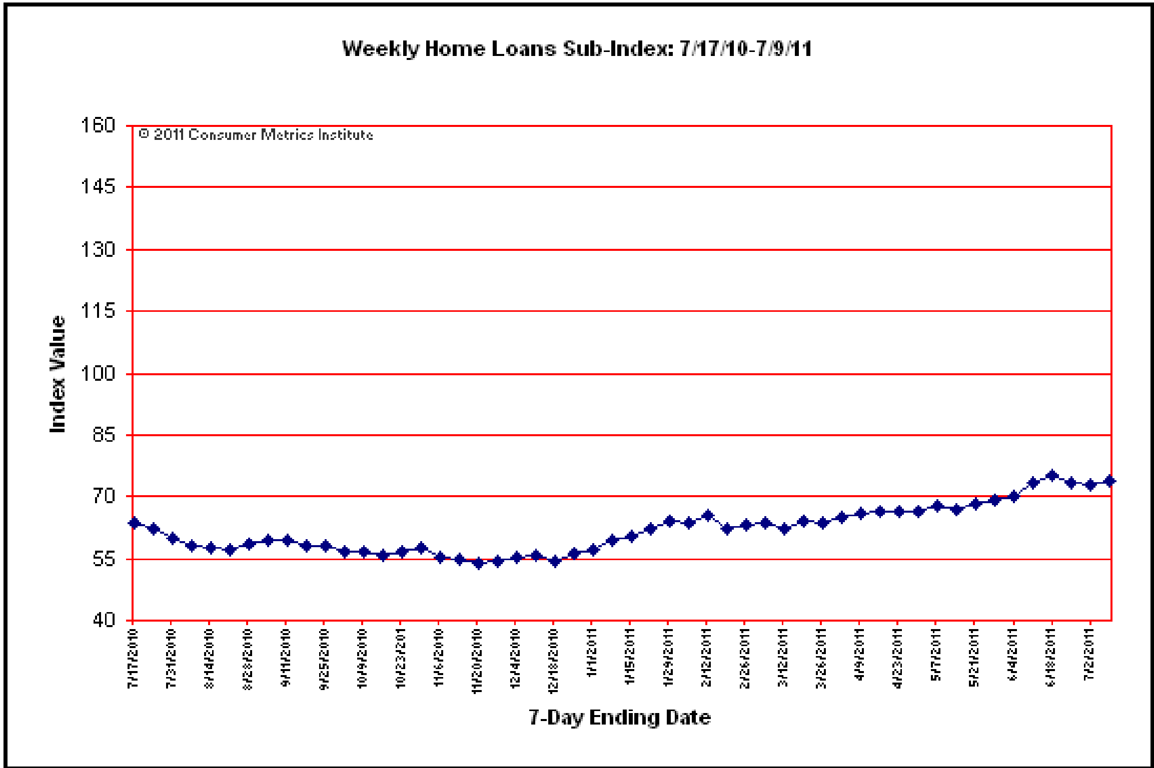
It is important to remember that the Daily Growth Index tracked in the above chart is actually a measure of the *rate of change or slope* of on-line consumer demand, not the demand itself -- i.e., only when the change in year-over-year demand zeroes out will the current absolute level of demand itself be leveling off or "bottoming." By analogy to a road trip in hilly country, our aggregate consumer demand passed the point where the car's angle of descent (i.e., slope) was greatest in late May, and we will reach the bottom of the aggregate demand canyon when that slope (our Daily Growth Index) returns to zero.

It remains possible that the curve being traced by the blue line in the above chart will plateau long before getting to zero. If nothing else the current contraction event's duration has been unprecedented within our data horizons (dating back to January 2005) -- and judging by the recent unemployment news, this contraction may be unprecedented dating back to the end of "Great Depression." Although the current Weighted Composite Index has moved back to within day-to-day striking range of positive territory, we will remain guarded in our enthusiasm until we see sustained periods with substantial growth -- e.g., enough support to pull the Daily Growth Index above a potential plateau zone between -3% and -2% year-over-year contraction.

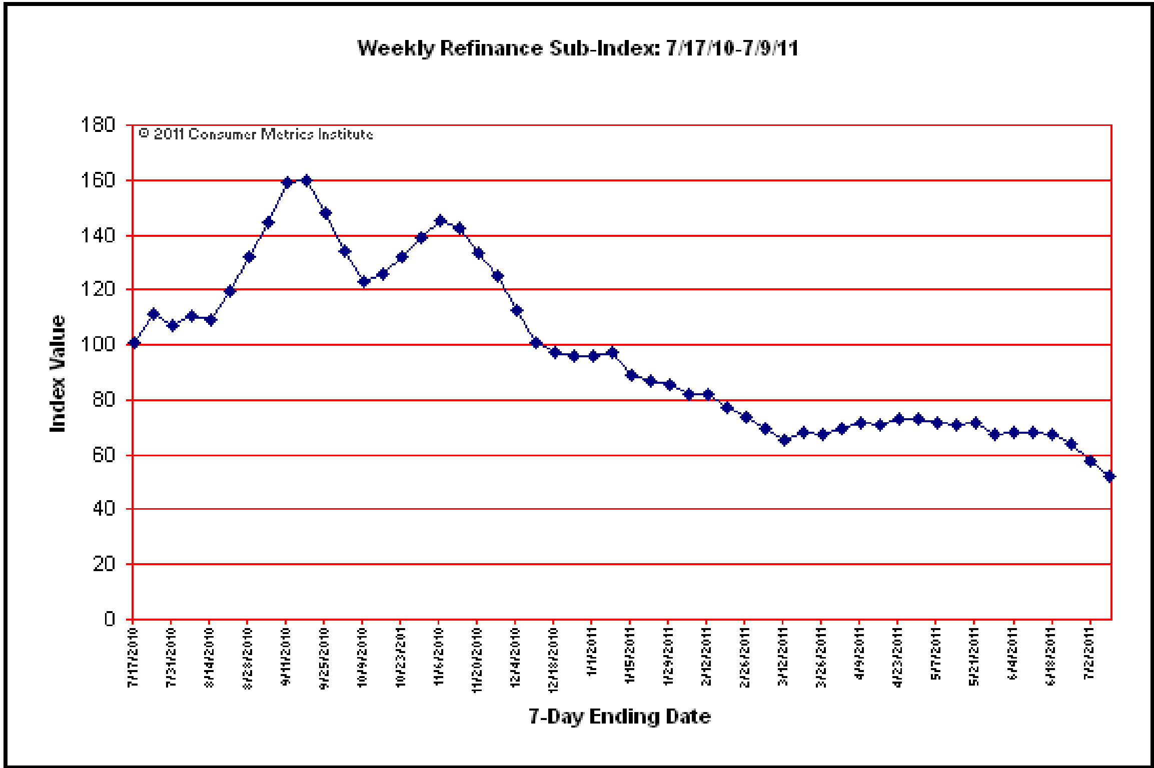
The upward movement of our Weighted Composite Index has been accompanied by some stirrings among people sitting on the vast inventory of available residential real-estate. In particular our measurements of people engaging listing services has shown some relative strength recently, perhaps as owners hope that the bottom has been reached:



Although the corresponding condition in the home loans marketplace is also up, that movement has been anything but spectacular:



And the flood of refinancing activities that we witnessed last year has continued to subside:



All of which may be an indication that the sharpest descent portion of this contraction event may be behind us, but we have a long ways to go before we should get excited about the immediate future.

Bardic Wisdom

(In a number of recent articles we have explored potential "unthinkable" solutions to both the U.S. sovereign debt problem and the fiscal consequences of a suddenly balanced U.S. Federal budget -- given that a balanced budget would suck about 14% out of the country's GDP, meeting the clinical definition of a depression. We discussed the historical backdrop to sovereign debt end-games, and solutions possible without major regime change, others requiring modest regime change, yet more that involve radical regime changes, one that uses regime change to de-securitize the mortgage industry, another that would selectively stimulate "Main Street" America, still another that would stimulate the economy through genuine reform to the health care industry, one that addressed the costs within the higher education "industry" and the impact that growing student loan debt and defaults are having on U.S. economic growth, some ideas that would address excessive regulation, and most recently the use of accelerated but highly screened immigration to offset the upcoming demographic drag as the "Baby Boomers" retire. As a point of reference we have used the report from the Simpson-Bowles commission as a sample framework for how to balance the budget, and have assumed that to prevent a Simpson-Bowles induced depression some form of non-fiscal stimulus would be needed that could provide excess growth to the U.S. economy on the order of 3% per annum over 5 or more years.)

In our ongoing search for a number of currently "unthinkable" initiatives that could stimulate the economy without recourse to deficit spending we have already twice encountered economic drag featuring the legal profession, prompting references to one of our favorite quotes from the late 16th century:

-- **"The first thing we do, let's kill all the lawyers ..."** *(Henry VI, Part 2)*

(Incidentally, the context of the famous line is a moment of not-quite comedic relief, featuring a ridiculous (and murderous) plot by a small band of none-too-bright thugs -- who correctly saw that the legal establishment would oppose any rebellion, however ludicrous. But Shakespeare's often pointed wit generally transcends the stage, and the lines immediately following the famous quote contained Jack Cade's eloquent condemnation of the oppression of unsophisticated common men through ill-advised contracts (as proxied by parchment and sealing wax): "Is not this a lamentable thing, that of the skin of an innocent lamb should be made parchment? that parchment, being scribbled o'er, should undo a man? Some say the bee stings: but I say, 'tis the bee's wax; for I did but seal once to a thing, and I was never mine own man since." *One wonders how those follow-on lines might ring today to anyone hopelessly upside-down in their mortgages -- this era's "undone" men.)*

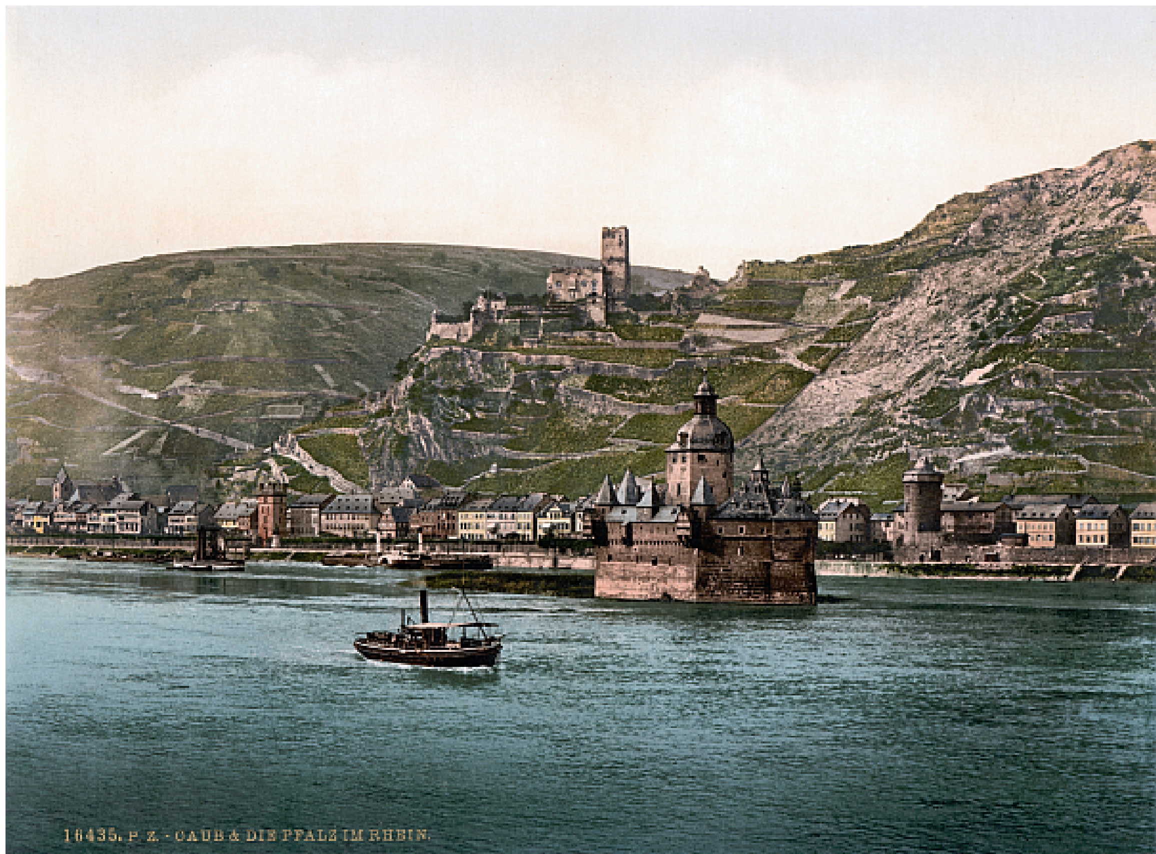
The quote certainly demonstrates that lawyer bashing is not new, nor are the public frustrations with perceived injustices (or economic oppressions) carried out at the behest of the "law." For our purposes however, the question is how the current practice of law can prove to be an impediment to economic growth.

Social fairness aside, we have always assumed that the sort of economic growth necessary to stave off a Simpson-Bowles induced depression cannot come from merely making the rich asymmetrically even richer. At minimum, the growth will need to be a broad based "rising tide" that lifts all economic boats, including those on "Main Street." Furthermore, at least some portions of the necessary growth will likely come in ways that will gore the current beneficiaries of the status quo -- persons and institutions who can be expected to deploy their armies of attorneys, parchments and sealing wax to defend their bastions of wealth.

And the problem of economic asymmetry pre-exists any future growth: our data supports arguments that the "Great Recession" has not been a fully shared experience -- at least not across all scales of wealth. Our data instead suggests that there has been a growing divergence between the experiences of those who shop at Neiman Marcus and those who shop at Walmart. And at a business level, following the collapse of Lehman Brothers the U.S. Government has repeatedly intervened to rescue firms selected largely on scale alone (e.g, the "Too Big To Fail" Primary Dealers), on the premise that the failure of those "key players" would cause the entire economy to seize up. Similar bail-outs have not been offered to the businesses of "Main Street," nor has the Federal Reserve been particularly diligent in ensuring that quantitative easing actually reaches the heartland. As a consequence the fortunes of small businesses have fared vastly differently from the literal fortunes of the S&P 500 peerage.

Robber Barons

In 1327 Ludwig IV ("The Bavarian") built the Burg Pfalzgrafenstein on an island in the middle of the Rhine, equipping it with toll collectors and chains that extended across the river:



Not surprisingly the already rich Ludwig IV got vastly richer, at the expense of merchants from hundreds of miles up and down the Rhine. But Ludwig was hardly alone (nor remotely the first): at their worst, the toll castles had sprung up about every 5 kilometers along the Rhine -- choking commerce until a French army invaded and destroyed many of them in 1689.

Ludwig and his peers did not build the Rhine. Nor did they make it a significantly safer for shippers. They simply extracted rents from a millenniums-old transportation "commons" by means of force. And their accumulated wealth allowed them to deploy private armies to protect their status quo for centuries -- making every-day merchants up and down the Rhine hopelessly over-matched in every way.

Our question is simply this: did Ludwig and his private army stimulate or impede economic growth along the Rhine?

Fast-forward to early 2005 when the Recording Industry Association of America (RIAA) launched the full force of its private army of attorneys against 83-year-old Gertrude Walton of Beckley, West Virginia -- filing suit for damages incurred when she allegedly shared 700 tunes online. Using the RIAA's math of $80,000 of injury per shared tune, the damages sought would amount to $56,000,000. Granny Walton was surely over-matched from a legal standpoint, because the 1998 Digital Millennium Copyright Act (DMCA) gave the RIAA the right to extract up to $150,000 in damages for each tune made available for sharing -- whether or not any actual sharing (or harm) occurred. Granny Walton, who hated computers and never allowed one in her house, escaped financial ruin only by virtue of having died months before the suit was filed. Jammie Thomas-Rasset, a Native American mother of four from Brainerd, Minnesota, has not been so lucky. Although she has claimed no knowledge of the alleged sharing that the RIAA attributed to her, she is still on the hook for $1,500,000 (after three trials) for sharing 24 tunes.

Restating our question from above: did the RIAA and their private army of attorneys stimulate or impede the growth of musical sales?

Our point with the above is not to defend file sharing, but rather to point out the litigious extremes that beneficiaries of the current status quo will pursue to defend their turf -- often resorting to oppressively disproportionate "punitive and exemplary" damages to change public behavior (the civil-law equivalent of randomly shooting pickpockets to discourage their behavior -- effective, perhaps, but of dubious constitutional muster). The RIAA legal offensive was in defense of a once hugely profitable business model that had become largely obsolete with the advent of downloadable music. Rather than embracing the new economic model offered by iTunes, the RIAA fiercely defended the doomed and archaic brick-and-mortar model for music distribution. And the DMCA had been part of the preemptive legal bastion constructed to defend the previously profitable hard-copy sales of CDs, tapes and records -- regardless of the preferences of the music buying public and contrary to the growth potential those preferences were affording the industry.

Reforming Torts

Tort Reform is an enormously complex issue with deeply vested pockets on either side. Some have argued that contingency fee arrangements and lottery-like awards are necessary to make civil-law justice available to "common-man" plaintiffs, while others contend that the costs of the

current tort system place at least a 2% average annual drag on the GDP (and add as much as 10% to the annual cost of the U.S. Health Care system). Still others have suggested that the current tort system has actually suppressed small to mid-range claims that don't offer the potential for contingency-based bonanza wins but still cost more than "comman-man" plaintiffs can afford on a fixed-fee basis. Furthermore, a number of studies have shown that only roughly 50% of the costs of the tort system end up as compensation to the injured parties.

Granting for the moment that the current civil law system represents at least some drag on the economy, what "unthinkable" options are available to relieve some of that drag and thereby stimulate the economy?

-- **No-Fault:** In 1967 the New Zealand Royal Commission on Accident Compensation (chaired by Supreme Court Justice Arthur Woodhouse) published its recommendation for a nation-wide blanket "no-fault" accident compensation scheme. The plan was adopted in the 1972 Accident Compensation Act and it has been modified several times since -- as recently as 2001, but most notably in 1999 when it was converted from a "pay-as-you-go" insurance plan to one that was fully funded. It created the New Zealand Accident Compensation Commission (ACC) as the sole provider of accident insurance for both work and non-work related injuries. It also made coverage by the ACC compulsory.

(The evolution of New Zealand's no-fault national insurance program has been influenced by the writings of Patrick S. Atiyah, including his seminal Atiyah's Accidents, Compensation and the Law. Dr. Atiyah has been an outspoken critique of the tort system, generally favoring its total abolition.)

Perhaps not coincidentally, in New Zealand the national cost of Health Care runs about 8% of GDP, roughly half of the comparable GDP share in the United States. Unfortunately, New Zealand's unique implementation and continued support for a no-fault paradigm is possible only because of the equally unique and politically "progressive" environment in that country -- an environment currently unlikely in any other Western democracy.

-- **Accelerated Statues of Limitation:** Reducing statutes of limitation to something closer to two years. In fact, the Simpson-Bowles Commission recommended a one to three year statute of limitation on medical malpractice claims as a major way to control soaring medical costs.

-- **Capping Non-Economic Awards:** Sharply limiting "punitive and exemplary" awards would remove a great deal of the incentives in the current tort system. If punishment needs to be meted out, the criminal law system is the place to do it -- if for no other reason than the higher standards of proof ("beyond a reasonable doubt") built into criminal law to protect the accused. However, the social flip side to this change is that negligence might need to be more extensively criminalized.

-- **Statutory Limits on "Pain and Suffering":** We understand the concept of "pain and suffering" compensation, we just don't understand how to put a price on it. Neither will any given jury. Placing limits on the awards by statute would remove the burden of emotions from the awards process.

-- **Limiting Fees:** In most of the world a contingency fee system is considered unethical and/or illegal. The economies of China, Germany and the Nordic countries work just fine without contingency fees in tort cases. In fact, most of the major countries which allow contingent fees

have a deeply rooted basis in English common law: Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States (with post-war Japan falling into that mix). In the U.K., however, contingent fees are capped at 200% of what the normal hourly billings would have been. What works for Germany or Sweden could presumable work in the U.S. as well, and it would lower the economic drag embodied in the current U.S. tort system. Other options include limiting all fees and costs to no more than the lesser of a statutory percentage (say 20%) of the total award, or some fixed statutory ceiling. And the public funding of cases with clear public health implications might also be appropriate.

-- **Special Courts and/or Compulsory Mediation:** The use of special jury-free courts could not only speed up the process but also standardize the compensations in ways simply not possible when they are put in the hands of novice citizen juries. This could also provide more equalized treatment, especially if the sitting judges or mediators viewed overblown case preparation or highly paid experts with some prejudice. Furthermore, if these specialized courts could reduce the cost of access sufficiently, the small to medium sized claims currently under-served by the U.S. tort system might finally find a home -- imagine a "small claims" version of malpractice courts, with a "Judge Judy" dispensing justice for the benefit of the common-man.

Inalienable Rights

Unfortunately, of all the "unthinkable" options for stimulating the U.S. economy, implementing significant reforms of the tort system may prove to be the most difficult to accomplish without radical regime change:

-- At about the same time that New Zealand was launching its experiment in the no-fault paradigm, a substantial number of U.S. states were implementing similar initiatives in no-fault automotive insurance. In general, insurance rates (and economic drag) were lowered when the new no-fault policies took effect. But most of those states have since reverted to tort systems. Why? No-fault paradigms disenfranchise powerful and well connected political forces that, through lobbying, public relation efforts and court challenges, are able to reverse the no-fault gains in a matter of years -- by appealing to the electorate's baser instincts of entitlement and greed.

To a large extent the political appeal of the U.S. tort system is thoroughly entwined with an entitlement mentality -- that Americans have an inalienable right to a trouble free life, and as a consequence any injury must be the fault of someone else. Certainly the personal injury attorneys who advertise on television promote that view**:** that accidents offer opportunities to not only make the guilty pay dearly for their negligence, but to handsomely compensate one's self in the process (i.e., turning the lemons of life into lemonade). Add to that the possibility of hitting a legal lottery, and you have have a sure-fire appeal to the perfect emotional storm of greed and revenge.

(All of which makes New Zealand's persistence with its no-fault paradigm all the more remarkable, particularly since they have managed to disenfranchise both the tort industry and the major insurance companies.)

-- Although some may argue that a financial oligarchy is running the United States, the halls of power are actually paved with law degrees**:** an overwhelming majority of the members of the legislative branch are professional lawyers, while its CEO and a super-majority of its highest court are all graduates *of the very same law school.* Is it even remotely conceivable that any

professional lawyer currently walking the halls of power in the U.S. would see his own profession as a liability to the economy at large?

In theory, governments and their laws are supposed to protect a citizenry from predation at the hands of more powerful forces**:** invading armies, war-lords, feudal masters, street gangs and robber barons. Popular mythology holds that courts exist to protect the "little guy" from the forces of tyranny. But what happens to people (like Granny Gertrude Walton) when the institutions entrusted with their protection instead become the agents of predation?

Maybe Shakespeare got it right after all.

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