CONSERVATISM AND REGULATION

Christopher DeMuth

D.C. Searle Senior Fellow

American Enterprise Institute for Public Policy Research

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Introduction

American conservatives have opposed the growth of government regulation in principle but accommodated that growth in practice. The disjunction was particularly striking during the fourteen years of Republican ascendency that began with the GOP congressional victories of 1994 and ended with the election of Barack Obama and a heavily Democratic Congress in 2008. This monograph explains the conservative hostility to regulation (Chapter 1), evaluates the growth of regulation through Republican as well as Democratic governments (Chapter 2), reviews the record and legacy of the George W. Bush administration (Chapter 3)—with a detailed analysis of the financial crisis of 2008 and its policy sequela (Chapter 4 and Appendix)—and concludes with suggestions for conservative thought and action (Chapter 5).

"Regulation" is a protean and potentially all-encompassing term: essentially every act of government aims to alter some course of events. A functional definition is that regulation is government prescription of terms and conditions of private transactions, usually in the form of rules written and enforced by specialized administrative agencies, aimed at achieving some public result.[1] That differentiates regulation from taxing and spending—but not entirely, because tax and spending programs are replete with detailed specifications of how taxes are to be calculated and funds awarded, and many of them are, like naked regulations, intended to alter private conduct. And, in the United States, the federal government regulates state and local governments through grant conditions and "unfunded mandates."

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[1] See Christopher DeMuth, "What is Regulation?" in *What Role for Government?* 262 (Richard J. Zeckhauser & Derek Leebart eds., 1983).

Beyond the functional definition, regulation has at least two political meanings in the American context: government efforts to control private markets and hence "free enterprise" and "capitalism," and federal government efforts to centralize policy-making within the federalist system. In both cases, regulation serves as a border agreement: the federal government does not own and operate the means of production (that is left to private enterprise), and does not operate a monolithic national government (the states have substantial autonomy); instead, it may intervene in private markets and state government strategically, imposing specific requirements for specified purposes.

Conservatism's dilemma with the growth of regulation has much in common with its dilemma with the growth of government tout court. Political liberals are generally proponents, and conservatives opponents, of increased taxing, spending, and regulating—and then, when initiatives succeed, conservative politicians (if not conservative intellectuals) generally acquiesce in them over time. But, as we shall see, regulation is unusually bipartisan at the time of origin and unusually resistant to conservative reform over time. That combination has made regulation a powerful and persistent force for government expansion.

1. Regulation in Conservative Thought

American conservatism, taken as a body of political thought rather than a political movement, is strongly disposed against government regulation. That disposition has four sources.

First, regulation generally takes the form of restrictions on private property or markets. Government rules may specify or limit prices, product designs, or production methods; the uses of land or other property; the information firms provide to investors, consumers, or employees; the forms of financial or operating arrangements among firms; or who may provide goods or services in certain markets—and in the limit the government may ban certain products or activities altogether. In every case, regulation impinges on property rights and economic freedom. Conservatives place a high value on property rights and economic freedom and regard them as essential, not secondary, to civil rights and political freedom.[2] And they admire the entrepreneur and the works of commerce and finance, both as expressions of human freedom and as sources of material prosperity. Conservatives readily acknowledge that some government impositions on property and business activities are appropriate and, if executed well, can vindicate property rights and economic freedom—classic cases are pollution control and antitrust restrictions on cartels and monopolies. But they oppose other purposes, such as restricting market competition and international trade, and they are skeptical of the "public good" rationales for many government impositions on property and commerce.

Second, regulation is a problematic form of government action—a font of "unintended consequences" and "perverse consequences" even when the formal purposes are accepted as valid. This is because of the narrowness and specificity that are defining attributes of regulation. The government prescribes one term of a private contract—a price term, a feature of product design, a disclosure statement, a production method—but leaves myriad other terms unregulated. And government is usually powerless to regulate the extra-contractual, behavioral responses of firms and individuals to its rules. The unregulated terms and conduct adjust and compensate for the prescribed term, reflecting

[2] The canonical statement of this position is Milton Friedman, *Capitalism and Freedom* (1962).

private purposes that are independent of the government's purpose: the result is always to compromise and sometimes to entirely defeat the government's purpose.[3] The minimum wage causes unemployment among workers whose labor is worth less than the minimum; controls on the introduction of new pharmaceuticals delay marketing and suppress research and development investments and thereby worsen public health; price controls often raise rather than lower prices by permitting sellers to coordinate price movements—and, if controls do lower prices, produce queues whose time costs gobble up the price savings; safety standards raise product costs and prices, deflecting some consumers to other products and activities with hazards of their own; unproductive financial regulations suppress desirable risk-taking and drive firms and markets to jurisdictions with superior rules (e.g., from the United States to Europe and Asia).

Regulatory ineffectiveness vindicates conservative skepticism about government intervention in private social and commercial arrangements: it demonstrates the market's robustness and adaptability, its generation and use of particular knowledge, and its subtle accommodation of variegated interests. But conservatives are offended by the waste and inefficiency, by the pretense that government regulators effectively "correct market failures," and by the corruption of popular understanding of the sources of social progress and problem-solving. Moreover, the pervasiveness of "regulatory failure" leads to the suspicion that regulation is chosen over other, more effective policies deliberately and for surreptitious reasons. For example, a substantial tax on gasoline would be a highly effective means of promoting energy conservation—and wildly unpopular for that reason. So Congress instead regulates the fuel economy of automobile fleets in a highly porous and ineffective manner.[4] Precisely because regulatory edicts are relatively easy to elide, they permit government officials to take credit for ambitious social goals without risking adverse political reaction to the substantial costs and disruptions that a full-throttled pursuit of those goals would entail. And regulation, by targeting specific firms, industries, and economic groups, provides public officials with great discretionary power to

[3] This argument is elaborated in Christopher DeMuth, "Unintended Consequences and Intended Non-Consequences," American Enterprise Institute, June 2009.

[4] See the research cited at note 61 below.

reward friends and punish foes for political reasons. Thus regulation facilitates the pursuit of unworthy purposes in the name of worthy purposes. Conservatives think policies should be judged by results, not good intentions—much less bad intentions.

Third, regulation is almost entirely the work of administrative agencies. There are exceptions—the U.S. minimum wage is a legislative enactment—but most regulations are produced by bureaucracies whose lawmaking authority is delegated to them by the Congress. And the modern regulatory state, in its structure, profusion, and minuteness, is an artifact of the bureaucratic state. It could not be operated through direct legislation, given the numerous constraints the Constitution places on legislating and the inherent cumbersomeness of legislative decision-making. Moreover, the problem of regulatory ineffectiveness described above—of private adaptations to narrow rules vitiating their intended effects—obliges close integration of lawmaking and administration. If regulation is to have any hope of success, the issuance of rules needs to be combined with continuous surveillance, enforcement, interpretation, and amendment. The elimination of checks and balances among those functions began with a legislative-executive hybrid, the regulatory commission, during the Progressive and New Deal eras—such as the Federal Trade Commission (FTC), Securities and Exchange Commission (SEC), and Federal Communications Commission (FCC). In this form, a mini-legislature of five commissioners, composed through proportional representation of the two political parties, made rules by majority vote and also administered an agency that policed and enforced the rules and recommended new and revised rules. Later, beginning in the 1960s, the commission form was replaced by the hierarchical regulatory agency—such as the Environmental Protection Agency (EPA) and National Highway Traffic Safety Administration (NHTSA). Here the legislative mimicry was dispensed with and a single administrator wrote the rules and supervised their enforcement, interpretation, and amendment. That was even more efficient.

Conservatives are limited-government constitutionalists. They are hostile to departures from the structure of government laid down by the U.S. Constitution, and few departures have been more dramatic than legislative delegation and the fusion of lawmaking, surveillance, and enforcement. At one level the conservative hostility is legalistic and traditionalist, born of devotion to the rule of law and fear of departures from tried-and-true arrangements. But it is also practical and consequentialist: administrative government has proved to be a powerful innovation for increasing the size, scope, reticulation, and general busybodiness of the state. This is not only because of the relative alacrity of the hierarchy versus the committee, but also because delegated lawmaking permits elected representatives to diffuse, and where convenient to evade, political accountability.[5]

Fourth, regulation has facilitated the growth of government in another way—by taking public spending off-budget and out of sight. Most of the expenditures occasioned by regulatory policies—for installing pollution-control equipment, disseminating financial reports in a prescribed manner, adding a certain amount of ethanol to gasoline, and maintaining compliance records—are realized entirely within the private sector; and the operating budgets of the regulatory agencies are a tiny fraction of the costs of complying with, or working around, their rules.[6] The compliance costs of regulated parties are public expenditures in the sense that they are required by law for public purposes, but they are imposed and incurred outside the procedures that constrain direct government spending—taxation and borrowing to raise revenue, legislative authorization and appropriation to spend the revenue, and budget controls. In an era of trillion-dollar budget deficits and hundred-billion-dollar spending authorizations, one might wonder whether traditional financial restraints amount to much anymore. Yet large spending bills and budget deficits are often front-page political contro-

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[5] David Schoenbrod, *Power Without Responsibility: How Congress Abuses the People Through Delegation* (1995).

[6] Estimating the costs of government regulations to the private economy is problematic in the extreme; the reigning guestimate is that federal regulation imposes $1.75 trillion in annual compliance and transfer costs. See Nicole V. Crain and W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, U.S. Small Business Administration, Sept. 2010; cf. U.S. Office of Management and Budget, *2011 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities* (June 2011). The budgets of the federal regulatory agencies totaled about $50 billion for Fiscal Year 2011. Susan Dudley and Melinda Warren, *Fiscal Stalemate Reflected in Regulators' Budget: An Analysis of the U.S. Budget for Fiscal Years 2011 and 2012*, The George Washington University and Washing University in St. Louis (May 2011). By the figures in these and other sources, the annual operating budget of the Environmental Protection Agency (about $4 billion excluding grant programs) is 2 percent of the annual costs of complying with EPA rules (about $200 billion).

versies—they prompted the successful "Tea Party" insurrection in the national and state elections of 2010—while regulatory costs seldom are. In the language of public finance, regulatory costs are "insalient": they are not revealed to citizens and consumers as costs of pursuing government policies, but instead are embedded, to an unspecified and largely unknown degree, in higher prices for private goods and services. Insalient taxes—such as the corporation tax, many excise taxes, the employer portion of the social security tax, and the value-added taxes of the European, Commonwealth, and many other nations—are handmaidens of big government.[7] The implicit taxes of complying with regulations are even more insalient: even the tax rates are unknown.

Regulation is not altogether free of checks and balances. Agency rules must survive judicial review. But that review is confined to ensuring that regulations are consistent with enabling statutes and the Administrative Procedure Act; it does not consider whether rules are cost-justified or otherwise necessary and appropriate. In recent decades, the growth of regulation has prompted the Office of Management and Budget (OMB) to establish cost-constraining procedures fashioned after budget procedures: agencies are required to estimate the costs and benefits of their rules and to justify them in these terms within Executive Branch councils. But cost-benefit analysis is much more abstract and subject to interpretation and manipulation than expenditure controls, and is therefore much less constraining.[8]

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[7] See Amy Finkelstein, "EZTAX: Tax Salience and Tax Rates," 124 *Quarterly Journal of Economics* 969 (Aug. 2009); Raj Chetty, Adam Looney, and Kory Kroft, "Salience and Taxation: Theory and Evidence," 99 *American Economic Review* 1145 (Sept. 2009); and Gary Becker and Casey Mulligan, "Deadweight Costs and the Size of Government," 46 *Journal of Law & Economics* 293 (Oct. 2003).

[8] Christopher C. DeMuth and Douglas H. Ginsburg, "Rationalism in Regulation," 108 *Michigan Law Review* 877 (Apr. 2010); Robert W. Hahn and Robert E. Litan, "An Analysis of the Tenth Government Report on the Costs and Benefits of Federal Regulations," Regulatory Analysis 07-02, AEI Center for Regulatory and Market Studies (June 2007).

2. Regulation in Political Practice

The conservative critique of regulation has had little durable influence on American politics and government. It has won occasional victories, and it provided the intellectual firepower for the "deregulation movement"—running from the Gerald Ford administration (1974–1977) through the Ronald Reagan administration (1981–1989)—whose achievements included the Airline Deregulation Act of 1978 abolishing the Civil Aeronautics Board (CAB). But the critique has not prevented regulation from growing inexorably over time, and it has not even caused the Republican Party, its natural political home, to be a consistent or forceful opponent of regulatory growth. Following the financial market collapse of 2008 and the strenuous government responses to that crisis, "deregulation" has become a bipartisan dirty word and "regulatory reform," which previously meant efforts to make worthwhile regulations such as pollution controls more economical and productive, has come to mean new regulatory controls of any sort, especially in the financial sector.

Of course, an intellectual critique is not a political program. The ideas described in the previous section are academic and reactive—the application of conservative precepts and microeconomic principles to the experience of government regulation since the Progressive Era and the New Deal. One finds those ideas mainly in law reviews, economics journals, and think-tank publications, from whence they are deployed in immediate policy debates mainly by conservative editorial pages, opinion magazines, pundits, and politicians. But the ideas are neither exclusively conservative nor all of conservatism. That regulation is often counterproductive—suppressing market competition, inflating prices, retarding innovation, increasing health and safety risks—is a concern shared by many economists and other scholars who are liberals (in the American sense of the term) on policy issues such as taxation, health care, and social insurance. At the same time, many American conservatives today are primarily concerned with issues of morals, culture, personal conduct, marriage and family, or foreign policy and are relatively indifferent to issues of the size, scope, and methods of domestic government. "Big-government conservatives" see government as a positive force for promoting better social norms and private behaviors through regulation as well as taxing and spending. "Neoconservatives" are focused on maintaining a robust role for the United States in international politics, and may or may not have conservative views in domestic policy; the neoconservative patron saints among practicing politicians, Daniel Patrick Moynihan and Henry M. Jackson, were forthright liberals on the domestic stage.[9] Economic conservatives vie with these and other schools, agendas, and constituencies both within the conservative movement and the wider Republican Party. And they are not consistently allied with any powerful interest group. Business firms and trade associations often favor regulation. Even when they oppose new regulatory programs, businesses often make peace with the programs or find them positively advantageous over time (on which more below). The growth of regulation has left business—especially large corporations in the best position to absorb regulatory costs and deploy regulation to competitive advantage—increasingly co-opted and unreliable as a force for reform.

These circumstances are obscured by the continuing prestige of Reaganism. Ronald Reagan's presidency was the modern conservative movement's greatest success in practical politics, and his conservatism had a strong intellectual core that included adamant opposition to the growth of regulation and bureaucracy. But America has long since regressed to normal politics. American political parties are not ideological parties. They exist to win elections on behalf of certain political constituencies and their characteristic political values, not to advance broad philosophic principles such as limited government—much less to oppose techniques of government, such as regulation, which could be useful to the electoral tasks at hand. The conservative movement has become increasingly allied with Republican Party interests since its heady ascendency in the Reagan era. It is increasingly an activist rather than intellectual movement, and judges itself by its success in the intensely practical environment of Washington, D.C., where most of its leaders now live and work. The context of normal politics rather than Reagan exceptionalism, and of conservatism's new position as a self-conscious part of the political establishment, provides a better basis for assessing the state of American conservatism and regulation today.

In this context, several of the features of regulation that dismay the conservative intellectual will appear as advantages to the conservative

[9] But at its founding in the late 1960s and 1970s, neoconservatism was distinctly concerned with the problems of unintended consequences in domestic policy. See DeMuth, note 3 above, at 6–10.

politician. Making policy by "making a statement" while taking a wait-and-see attitude toward agency implementation; trumpeting the benefits of policies while obscuring their costs; avoiding frontal assaults on constituencies that are the sources of the problems one is purporting to solve—these are staples of the political craft of many legislators of all persuasions. As conservatism becomes more of an activist movement and less of an intellectual one, worries over such expedients will be increasingly confined to the fustier precincts of conservative thought. This is an aspect of conservative accommodation to the growth of government, which we will now investigate further.

Regulatory Persistence: Theory and History

There are three prevailing explanations for the political durability of regulation despite its frequent ineffectiveness or positive harmfulness. The most famous is the "public choice" explanation: regulatory programs, while parading in the rhetoric of the public interest, in fact favor narrow interest groups at the expense of the public at large, and survive because interest groups have higher incentives and lower costs of political organizing than the passive general public.[10] The second is the "public misperception" explanation: the general public is not merely inattentive to regulatory policies but, when it is paying attention, mistakenly thinks that such things as trade restrictions and price controls are effective and beneficial.[11] The third is the "natural progress" explanation: many of the benefits that regulatory programs aim to provide, such as safer products, cleaner air, and lower prices, are also provided by private markets in the course of natural economic and technological progress—and this progress masks the ineffectiveness or

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[10] Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965, 1971) and *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (1982); George J. Stigler, "The Theory of Economic Regulation," 2 *Bell Journal of Economics and Management Science* 3 (1971); Richard A. Posner, "Theories of Economic Regulation," 5 *Bell Journal of Economics and Management Science* 335 (1974).

[11] Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (2008) and "Special-Interest Secret," *Wall Street Journal*, May 12, 2007; David Romer, "Misconceptions and Political Outcomes," 113 *Economic Journal* 1 (Jan. 2003).

harmfulness of the regulatory programs and makes them difficult to oppose or reform.[12]

These arguments are powerful, well-supported, and mutually reinforcing. They help to explain why Republican politicians and conservative activists have not made greater use of the conservative critique of regulation. The result is that the history of regulation is one of bipartisan growth.

Although the Republican Party has been much more attuned than the Democratic Party to the virtues of private markets and vices of government intervention, in practice there has been no strong correlation of political party to regulatory policy apart from the New Deal. The Republican Party, from its founding by Abraham Lincoln down to the present day, has stood for business and commerce and the value of individual freedom. The Democratic Party, from its founding by Andrew Jackson down to the present day, has stood for the common man and the value of social equality. These broad generalizations gloss over many important features of the parties' evolving political platforms and electoral bases. They serve, however, to suggest why neither party has been a consistent friend or foe of government regulation, or economic intervention generally, in response to evolving social problems and political opportunities. Jackson's Democratic Party was the limited-government party of its day, founded in opposition to the Second Bank of the United States and regarding economic intervention as plutocratic. Lincoln's Republican Party was strongly protectionist and pro-tariff, and his administration collaborated energetically with commercial interests to achieve rapid internal development—both for its own sake and to crush the agrarian South in the Civil War and win freedom for the slaves.

A century later, the Democratic Party became identified as the party of regulatory activism primarily because of the New Deal and its profusion of expertise-based, law-writing regulatory commissions such as the SEC and CAB. But the regulatory agency was not a New Deal invention. The granddaddy was the 1887 Interstate Commerce Commission (ICC); the FTC went back to the Progressive Era; the Food and Drug Administration (FDA) was formed during the Calvin Coolidge

[12] Sam Peltzman, *Regulation and the Natural Progress of Opulence*, AEI-Brookings Joint Center for Regulatory Studies (Sept. 2004).

and Herbert Hoover administrations from statutory authorities pioneered by Theodore Roosevelt; and Hoover, as Secretary of Commerce, had vigorously championed the creation of the Federal Radio Commission in 1927—predecessor of the FCC (1934) and in retrospect a monumental mistake.[13]

After Dwight Eisenhower famously made peace with the New Deal, the record again became thoroughly mixed. John F. Kennedy was a strong supporter of labor regulation but was the first president to propose weakening the ICC. Richard Nixon loathed the bureaucracy but instituted economy-wide wage-and-price controls; created the EPA by executive order; signed into law the statutes creating the NHTSA, Occupational Safety and Health Administration (OSHA), and Consumer Product Safety Commission (CPSC); pursued aggressive antitrust policies (including opposition to "conglomerate" mergers and prosecution of the television networks for brazenly political reasons); and instituted racial "affirmative action" requirements in federal contracting. Jimmy Carter was a determined regulator of energy markets but deregulated the airline industry, began the deregulation of commercial banking, and beefed up the procedures Nixon had initiated for White House oversight of agency rulemaking. A month before leaving office, Carter signed the Paperwork Reduction Act, which established the institutional framework for Ronald Reagan's even stronger procedures for supervising regulatory policies under a cost-benefit standard. Those procedures were continued, in somewhat milder form, by Reagan's successors of both parties—George H.W. Bush, Bill Clinton, George W. Bush, and Barack Obama.[14]

To be sure, there has been a significant difference between Republicans and Democrats in their *posture* toward regulation. Beginning with the Progressive Era, Democrats, as representatives of the common man (now including "workers" and "the poor") and proponents of greater social and economic equality, have generally been committed advocates of new regulatory initiatives to correct perceived abuses and injustices. Republicans, as representatives of business and proponents of individ-

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[13] See R.H. Coase, "The Federal Communications Commission," 2 *Journal of Law & Economics* 1 (Oct. 1959).

[14] Additional examples of Republican regulatory and Democratic deregulatory initiatives are offered in DeMuth and Ginsburg, note 8 above, at 881–883.

ual freedom, have generally resisted new regulation and other interventions (the only presidential exceptions being Theodore Roosevelt in full flush and, as examined below, George W. Bush). But the Republican leaders have also been practical politicians, obliged to accommodate themselves to circumstances as they found them—including inherited government programs and the popular sentiments and organized constituencies that have grown up around them.[15] The temporal pattern is Democratic activism as the motive force for new regulation, followed by Republican acquiescence.

It is more than a detail to note that the constituencies favoring the regulatory status quo have often included staunchly Republican business groups who had opposed the programs at the outset but then learned to live with them and even to love them. The 1887 ICC was the product of a populist, agrarian, social-equality movement against the railroad barons in the big Eastern cities. But in operation the ICC became a price-fixing cartel, and thereafter the railroads worked to sustain it, to strengthen its enforcement powers, and, following the development of the automobile, to extend its grasp to those cartel-busting upstarts, the truckers and bus lines. No serious Republican or Democrat proposed to upset the ICC status quo until the late twentieth century, by which time the railroads had lost most of their capacity to charge monopoly prices even in concert, and many had been driven into bankruptcy by ICC resistance to their abandoning even hopelessly unprofitable services. In general, regulatory programs apply in the first instance to business firms, and it is business firms that invest in mastering their arcane details, forging compromises and working arrangements with their agency staffs and officials, and learning to operate in the interstices of their formal requirements. The firms thereby acquire an interest against the uncertainties that reform or abolition would entail, even when those changes would be highly beneficial to the market system and economic freedom. As students of regulation know, this tendency applies to "social regulation"—

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[15] For an impressive analysis of the use of popular support to build bureaucratic autonomy, see Daniel Carpenter, *Reputation and Power: Organizational Image and Pharmaceutical Regulation at the FDA* (2010).

addressed to health, safety, and environmental problems—as well as to economic regulation of the cartelizing kind.[16]

Thus it is not surprising that the first successful stroke of economic deregulation, the 1978 abolition of the CAB, was delivered by Democrats Edward M. Kennedy and Jimmy Carter against the concerted opposition of the airline industry. Both proponents and opponents believed that the CAB was running an effective cartel and that deregulation would result in more competition and lower prices for consumers. Neither side realized at the time what became clear following deregulation: that the cartel rents had been going mostly to unionized employees—pilots, flight attendants, and maintenance workers—rather than to owners and executives. If that had been known, the usual bipartisan alliance for the regulatory status quo might have held and the CAB might still be with us today.

Although business acquiescence contributes to Republican acquiescence, the phenomenon runs deeper. Typically, a regulatory program is highly controversial at the time of proposal, legislative debate, and enactment, but thereafter becomes a fact of life—a feature of the governmental landscape, a reality that citizens and politicians of all stripes have accommodated to and that would be costly to try to dislodge. It becomes institutionally entrenched in the government and in the wider society, and also legally entrenched as successive administrative actions and statutory revisions are interpreted by the courts and give rise to a body of precedent. Republicans, when they find themselves in power, are cautious about challenging this edifice—because they have accommodated themselves to it philosophically, because they are temperamentally conservative, or because they have other priorities. Richard Nixon—among modern presidents the Republican regulatory champ prior to George W. Bush—regarded many of his administration's regulatory initiatives as obnoxious nonsense (excepting environmental protection, where he was a sincere proponent of moderate regulation). But his overriding priorities were to bring the Vietnam War to an honorable conclusion, to forge a new strategic alliance with China, and, eventually, to save himself from the Watergate scandal. These

[16] See, for example, Jonathan H. Adler, "Rent Seeking Behind the Green Curtain," 19 *Regulation* 26 (Fall 1996); and Michael S. Greve and Fred L. Smith, Jr., eds., *Environmental Politics: Public Costs, Private Rewards* (1992).

required time and political space and the maintenance of legislative coalitions. Eisenhower's refusal to lead a counter-revolution against the New Deal was condemned by the then-nascent conservative intellectual movement, but very few business executives or Republican politicians would have had the heart for it, and Eisenhower was surely right in thinking that the general public would have opposed it.

President Reagan is the great exception, and an instructive exception. A movement conservative, he had been, in the years before his election, a crusading newspaper columnist who often inveighed knowledgeably against government regulation. In office, he made "regulatory relief" one of four cornerstones of his economic program (along with tax reduction, fiscal restraint, and stable money). His first, flamboyant act in office was to abolish petroleum price controls by executive order, and he promptly established strict White House procedures for reviewing agency rulemaking proposals and reconsidering existing rules. He presided over a sea change in antitrust policy and relished preaching the virtues of individual and commercial freedom and the vices of regulation. Apart from antitrust, however, the results were mostly transitory. Many inherited rules were modified or rescinded—perhaps the most consequential being the abolition of the FCC's Fairness Doctrine in 1987[17]—and the rate of regulatory growth declined markedly during his first term. But Reagan made no effort to reform or abolish any of the agencies that issued those regulations (the fate of the CAB was sealed before he arrived, and the ICC was not abolished until 1995), and his initial ambitions to reform the EPA were abandoned following a 1983 financial scandal involving the agency's Superfund program. He ended up acquiescing kin several major rules, such as the automobile airbag requirement, that he had strongly opposed. Regulatory growth had resumed by the end of his second term.[18]

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[17] The Fairness Doctrine had required that every individual radio and television broadcaster cover controversial issues and to provide fair accounts of all sides of those issues. Many on the Reagan White House staff opposed its repeal, on grounds that the three then-dominant television networks would become even more hostile in their news coverage of the administration, but Reagan himself supported repeal on economic freedom and First Amendment grounds.

[18] Christopher DeMuth, "Regulatory Policy in the Reagan Administration," in *American Economic Policy in the 1980s,* (Martin Feldstein ed. 1993).

Similarly, Newt Gingrich, the other successful conservative-movement politician of recent vintage, challenged regulation only at the margins and not at the core. His "Contract with America," which propelled the Republicans to congressional victory in 1994, was mainly concerned with tax and fiscal policy and crime, welfare, and cultural issues such as teenage pregnancy. It did include a few proposals to tighten oversight of agency rulemaking and to apply workplace safety and equal opportunity regulation to Congress itself. The major enactment, the Congressional Review Act of 1996, took a faint stab at the delegated-lawmaking problem by providing expedited legislative procedures for bills to disapprove agency rules.[19] But the act has produced just one statutory disapproval to date: the rescission of the Clinton administration's controversial OSHA "ergonomics" rule early in the George W. Bush administration (the new administration could have been rescinded the rule on its own, by rulemaking, but statutory rescission was faster and foreclosed the risk of judicial review). All other attempts, such as a 2010 bill to disapprove EPA regulation of greenhouse gasses under the Clean Air Act, have failed.[20] The proposal to extend workplace regulations to congressional employees was also adopted, but coverage and compliance have been less thorough than in the private sector.[21]

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[19] See Note, "The Mysteries of the Congressional Review Act," 122 *Harvard Law Review* 2162 (2009). The expedited procedures are key because they permit prompt votes on rescission resolutions without interference by agencies' oversight committees, which are often protective of "their" agencies.

[20] The act's procedures are something of a charade during the course of an administration because a president would be unlikely to sign legislation rescinding a rule issued by his own administration. In the case of EPA's greenhouse gas rules, President Obama announced that he would veto a CRA rescission if it passed—which made the bill a free vote for Democrats who wished to register their opposition to the EPA controls.

[21] See U.S. Congress, Office of Compliance, *State of Congressional Workplace, FY 2009 Annual Report*; and Jordy Yager, "More than 70 percent of congressional offices violate OSHA safety standards," *The Hill*, Feb. 24, 2010. Note that this step consisted of extending, not reforming, regulation. The Congressional Accountability Act of 1995 passed with huge bipartisan majorities (390-44 in the House and 92-2 in the Senate); some legislators favored it because they thought it would lead Congress to be more sensitive to the burdens of regulation on the private sector, some because they did not want Congress to appear to be above the law, and some because they wanted to extend regulatory benefits to Congress's 30,000 employees.

Conservative Politicians Otherwise Engaged

The record, then, is that even the most strong-minded conservative politicians are disinclined to challenge regulation at the fundamental level that their intellectual allies would favor. The economic cases for abolishing the FCC and OSHA, for example, are quite strong, and in the case of the FCC would produce enormous economic benefits, mainly through de-zoning the electromagnetic spectrum (removing use restrictions from spectrum segments) and vesting its allocation to private property and markets.[22] But no Republican president or congressional leader would even consider advancing either idea. These are not isolated examples. Conservative policy scholars would abolish many programs of economic regulation, and fundamentally restructure many programs of health, safety, and environmental regulation, but their proposals are altogether absent from serious political debate.

Part of the problem may be that conservative and Republican politicians are more temperamentally conservative—cautious, reactionary in the strict sense of the word, wary of disturbing the status quo for abstract reasons—than are their liberal and Democratic counterparts. After all, the liberal politician who champions an ambitious new regulatory venture is confronting a status quo that may appear as formidable as the subsequent status quo precipitated by the program itself. Liberals seem to be by nature more activist and confrontational than conservatives—perhaps more discontented and irascible, certainly more willing to overturn apple carts. A conservative temperament may lead one to a conservative political program as a philosophic matter but trump that program as a practical matter.

But temperament cannot be the whole story, because in other fields, such as tax, social security, and health care policy, Republican leaders routinely advance ambitious conservative reform proposals.[23] The distance between the intellectual and political wings of the conservative

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22 Peter Huber, *Law and Disorder in Cyberspace: Abolish the FCC and Let Common Law Rule the Telecosm* (1997); Jack Shafer, "New Wave: The Case for Killing the FCC and Selling Off Spectrum," *Slate*, Jan. 12, 2007.

23 For instance, the celebrated *Roadmap for America's Future* prepared by Congressman Paul Ryan (R-WI), which proposed ambitious reforms to tax, health-care, social security, and job training policies, and paved the way for his *Fiscal Year 2012 House Budget Proposal*.

movement is greater in regulatory policy than in any other area of economic policy. I can offer two explanations for the disjunction.

First, mobilizing political support for deregulation is more problematic than mobilizing support for either liberal regulatory creation or alternative conservative reforms. The passage of a major regulatory statute is typically preceded by years or decades of preparatory work outside the government itself: publicizing, organizing, petitioning, and public-consciousness-raising concerning the injustices or abuses to be remedied. When the moment of legislating arrives, it often takes the form of a single stroke for social betterment—the legislator votes for clean air or fair prices or the corralling of railroad barons or Wall Street barons, and leaves the more contentious tasks of setting standards, building corrals, and imposing costs to piecework at the administrative agencies. Deregulation is different. The costs and benefits have been parceled out, the derivative economic adjustments have been accomplished, the compromises made and the coalitions formed. And, critically, the regulatory agency exists for purposes of enforcing the coalition in the face of reformist threats—rewarding those who remain in the fold and punishing those who attempt to defect. At the moment of regulatory creation, the prospective beneficiaries mostly know who they are and have organized themselves to a degree, while the prospective losers are usually less well identified. Once the program gets rolling, the losers may be somewhat more self-aware and organized but the beneficiaries are much more so—they are a team with a coach, a game plan, position assignments, and public funding.

Second, regulatory programs feature high complexity and narrow focus. As a result, undoing them lacks political leverage and popular resonance as compared to competing conservative projects such as reducing taxes, reforming entitlement or welfare programs, or defeating communism or terrorism. It is not surprising that ambitious politicians who do combine conservative philosophy with activist temperament devote themselves to projects that, however controversial, can be readily communicated and promise large, palpable benefits. The income tax, for all of its complexity, is less mysterious than the regulations of the FCC. The basic structure of the income tax and proposals to change it can be explained in straightforward percentage and dollar-and-cents terms; it directly touches and is familiar to vast numbers of people, and its influence extends to the entire economy.

3. Regulation under George W. Bush

The political dilemmas of achieving conservative regulatory reform have become vastly more acute following the presidency of George W. Bush, which brought a tremendous expansion of federal regulation along with spending and deficits. Much of that expansion came in response to a succession of crises and other external shocks—the terrorist attacks of September 11, 2001, the corporate accounting scandals of 2001–2002, the sharp increase in energy prices in 2004–2007, and the financial market upheavals and severe economic contraction of 2008. Crises invariably spur the growth of government through regulation and other means,[24] and those of the Bush years would have prompted regulatory growth under any president of either party. But President Bush was more than a bystander or crisis manager. He arrived at the White House with substantial expansionist ambitions of his own, and when crises arose he was disposed by political calculation and personal temperament toward aggressive responses. A "compassionate conservative," he was not acquiescent or tactical about regulation in the manner of Richard Nixon but rather assertive and authentic in the manner of Theodore Roosevelt.[25]

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[24] Christopher DeMuth, "Guns, Butter, and the War on Terror," *Wall Street Journal*, Apr. 29, 2004; Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (1987). During the Bush administration, most of the growth of "domestic discretionary spending" (federal on-budget spending other than for national defense and for "mandatory" domestic programs such as Medicare, social security, and congressional salaries) occurred in the years following the 9-11 attacks (FY 2002–2003) and during and following the financial crisis of 2008 (FY 2008–2009). In between (FY 2004–2007), domestic discretionary spending was essentially flat. See U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2011* Tables 8.2, 8.4 (Feb. 1, 2010); and Congressional Research Service (D. Andrew Austin and Mindy R. Levit), *Trends in Discretionary Spending* (Feb. 22, 2010).

[25] An excellent insider's account of regulatory (and other) policymaking in the George W. Bush administration is John D. Graham, *Bush on the Home Front: Domestic Policy Triumphs and Setbacks* (2010). Graham is a leading academic student of regulatory policy and was administrator of the Office of Information and Regulatory Affairs, the OMB office responsible for regulatory oversight, from 2001–2006. His book provides detailed accounts of many matters touched upon in this paper—the No Child Left Behind program, the Medicare prescription drug benefit, energy conservation and global warming policies, administrative efforts at "regulatory reform," and the financial crisis of 2008.

Administering the Regulatory State

Abnormal regulatory growth did not come in the day-to-day administration of the established regulatory programs, where the Bush record was similar to those of his predecessors, Republican and Democratic, other than Reagan. At the EPA, OSHA, and other agencies there were many public disputes over rulemaking proposals, many inside disputes between the agencies and OMB, and many charges that regulators were either going too far or not far enough. But regulation continued to grow, with no remarkable departures in pace or substance.[26] The number of new "major rules" (those estimated to cost $100 million or more annually or designated by OMB as unusually important for other reasons), and the costs and benefits of those and lesser rules, were not appreciably different than during the Clinton and H. W. Bush administrations.[27] Where administrative reforms were attempted, the results illustrated the general propositions emphasized earlier—that regulatory reform is usually secondary to other objectives and that ingrained regulatory policies are very difficult to modify even marginally. To wit:

- The administration's "Faith-Based and Community Initiative" involved significant deregulation of a sort: the elimination of restrictions that had prevented religious groups from competing for social-service grants and contracts.[28] But that was ambiguous from the standpoint of government intervention in private society. The purpose was to widen the array of institutions that could receive federal grants (funding increases were of course part of the effort). The re-

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[26] See the articles by John D. Graham and Paul R. Noe, Cary Coglianese, Jerry L. Mashaw, and Roger G. Noll in "Symposium: Reflections on Executive Order 13,422," 25 *Yale Journal on Regulation* 1 (Winter 2008); and Stuart Shapiro, "Presidents and Process: A Comparison of the Regulatory Process Under the Clinton and Bush (43) Administrations," 23 *Journal of Law and Politics* 393 (2007).

[27] See U.S. Office of Management and Budget, *2008 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities* 45–47, figs. 2-1 and 2-2 (Jan. 2009); and Robert W. Hahn, *Reviving Regulatory Reform: A Global Perspective* (2000) chap. 3.

[28] See The White House, *Innovations in Compassion: The Faith-Based and Community Initiative* 30–34 (Dec. 2008); and Melissa Rogers and E.J. Dionne Jr., *Serving People in Need, Safeguarding Religious Freedom: Recommendations for the New Administration on Partnerships with Faith-Based Organizations*, Brookings Institution (Dec. 2008) 22–26.

sult was increased government involvement in religious organizations and a new set of regulations—to ensure that public funds went only to social services and other secular efforts and not to religious instruction, worship, and proselytizing. Although the Obama administration came to office intent on revising many of the Bush administration's regulatory policies, it promptly announced that it would continue the faith-based initiative in all essentials.[29]

- Similarly, Bush's Department of Labor advanced a determined agenda of conservative economic reforms to OSHA, wage-and-hour, and labor-union rules—including stricter union financial disclosure requirements that *increased* regulation and paperwork.[30] In this case, the Obama administration moved quickly to rescind the requirements—citing their excessive regulatory burdens.[31]
- In environmental policy, the Bush administration pursued two important reforms under the Clean Air Act. The first was to permit substantial renovations of manufacturing and power plants without triggering costly "New Source" emissions standards applicable to all-new facilities; the purpose was to relax regulatory impediments to plant enhancements that would improve operating efficiency and thereby reduce pollution.[32] The second was to establish a regime of

[29] The White House, "Obama Announces White House Office of Faith-based and Neighborhood Partnerships," Feb. 5, 2009.

[30] See Graham, note 25 above, at 261–266.

[31] See Chuck Neubauer, "Bush's union transparency rules retracted under Obama," *Washington Times*, Mar. 11, 2010; one rescission is U.S. Department of Labor, Labor Organization Annual Financial Reports, 74 *Federal Register* 52,401–413 (Oct. 13, 2009).

[32] The Clean Air Act of 1970 imposed much more stringent pollution standards on new plants than existing, "grandfathered" plants. That created perverse incentives for firms to maintain production capacity through incremental upgrading, rather than replacement, of old, relatively higher-polluting plants. The result was a contentious enforcement battleground over what kinds of maintenance, repair, and renovation should and should not lead to imposition of costlier "New Source" standards—which delayed or prevented many needed plant improvements. The issue involved complex trade-offs between tighter regulatory standards and

> "marketable permits" for power plant emissions; the purpose (building on successful reforms introduced in the Reagan and H. W. Bush administrations) was to make pollution controls more cost-effective by allowing plants to calibrate abatement investments according to differing abatement costs. Both were worthy attempts to harness economic incentives to environmental improvement. But they were highly technical and easy to misrepresent as weakening environmental protection,[33] and ran aground on tactical disagreements and missteps and a series of adverse court decisions.[34] The efforts, lasting nearly eight years, were abandoned in late 2008 and accomplished nothing.

President Bush did not pursue any large legislative initiatives for regulatory reform or deregulation. Not for lack of opportunities. The FCC, as mentioned earlier, was a prospect for root-and-branch deregulation at least as attractive as the CAB had presented to President Carter. The Bush FCC did some important good deeds, especially in removing regulatory barriers to competition between telecommunications and cable television firms. This produced a surge of investment in the deployment of "broadband" technologies and enormous improvements in the quality and costs of telephone, Internet, television, and radio communications.[35] But for the most part the FCC was content, through eight years of Republican management, to continue a program of industrial controls that misallocated resources, suppressed innovation, and stimulated ferocious rent-seeking in a vital economic sector, all without any justification in monopoly or other "market failure."

"natural" pollution reductions through technological progress. But the concurrent Bush "marketable permits" initiative described in the text would have substantially resolved those trade-offs in favor of cost-effective pollution reductions, and would have rendered unnecessary the detailed policing of the "New Source" boundary.

[33] An egregious example is Bruce Barcott, "Changing All the Rules," *New York Times Sunday Magazine*, Apr. 4, 2004. But the efforts also garnered their share of good press, such as Juliet Eilperin, "Bush Pollution Curbs Are Rated Equal to Clinton's," *Washington Post*, July 22, 2006.

[34] See DeMuth and Ginsburg, note 8 above, at 899–900 and references cited therein.

[35] Cesar V. Conda and Lawrence J. Spiwak, "Kevin Martin's Record of Success," *Washington Times*, Jan. 22, 2009.

Throughout his tenure, President Bush opposed U.S. ratification of the Kyoto Protocol to establish international controls of carbon dioxide and other greenhouse gas emissions to avert the risks of global warming. This was not the obdurate resistance to a growing consensus for new regulation, or a reflection of Republican solicitude for business interests, that his opponents and the media often portrayed it to be. The Senate had voted 95-0 against the Kyoto Protocol in 1997 during the Clinton administration, largely because the treaty would have permitted unregulated emissions growth in China and India, thereby negating emissions reductions in the United States and Europe while inducing further migration of economic production to those nations.

The political and institutional obstacles to effective greenhouse-gas controls remained just as formidable and bipartisan after Bush retired.[36] Although President Obama came to office intent on establishing domestic and international "cap-and-trade" controls, those initiatives were effectively dead at the end of his first year in office.

Big-Government Conservatism

The big change in regulatory trajectory during the Bush administration came not at the quotidian administrative level but rather through the President's legislative initiatives and, eventually, responses to external shocks. In the first instance, the change reflected a calculated departure in Republican strategy, expressed in Bush's signature political slogan, "compassionate conservatism." President Bush and his advisers believed that the Republican Party was on the cusp of achieving a long-term governing majority potentially as durable as the Democrats' New Deal majority had been. That majority could be sealed, they believed, by embracing spending and regulatory initiatives that Republicans had traditionally opposed but were popular with important constituencies. More generally, they thought that traditional, limited-government conservatism, with its aversion to policy activism, had lost much of its cachet since the Reagan years and needed to be replaced with something more energetic and attuned to popular sentiments. In this view, a sustainable Republican Party required a

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[36] See Lee Lane and W. David Montgomery, "Organized Hypocrisy as a Tool of Climate Diplomacy," *AEI Energy and Environment Outlook,* Dec. 2009.

modernized conservatism that was less squeamish about the exercise of power.[37]

In his first term, President Bush won passage of two of his top election campaign proposals, the "No Child Left Behind" (NCLB) school-reform program and the addition of a pharmaceutical drug benefit to the Medicare insurance program for older Americans.[38] Both were important departures from traditional Republican positions. NCLB nationalized control over important aspects of primary and secondary schooling, long considered the province of local and state government, and expanded the U.S. Department of Education, which the Republicans had proposed to abolish as recently as 1996. The Medicare drug benefit had a Republican antecedent: Ronald Reagan had championed and won a similar measure in 1988. But the Reagan version had been wildly unpopular, primarily because it was financed by new taxes on program recipients (Reagan had insisted that it be deficit-neutral), and was repealed in 1989.[39] The Bush initiative learned from that failure and was a big-government fiscal innovation: the first new government entitlement unaccompanied by any taxes to support its costs.

Both programs were very costly. No Child Left Behind came in at about $10 billion per year, the Medicare drug benefit at about $40 billion, all of it financed by new borrowing. Both also required the construction of elaborate new regulatory programs. The NCLB statute, although regulating state and local school authorities rather than private industry, was structured very much like the Clean Air Act: it

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[37] See Sidney M. Milkis and Jesse H. Rhodes, "George W. Bush, the Party System, and American Federalism," 37 *Publius* 478 (2007); and Tim Conlon and John Dinan, "Federalism, the Bush Administration, and the Transformation of American Conservatism," 37 *Publius* 278 (2007).

[38] President Bush's election platform had three additional domestic policy planks: tax reduction, which succeeded in legislation enacted in 2001 and 2003, and immigration reform and Social Security reform, both of which failed despite energetic efforts. None of these was "big-government conservatism" and only one was a departure from established Republican doctrine—the proposal to provide illegal immigrants with a path toward legal resident status and citizenship. That proposal was the only one of this group with direct regulatory implications: it would have eventually eliminated the requirements that employers police their workforces for the presence of illegal immigrants.

[39] Thomas Rice, Katherine Desmond, and Jon Gabel, "The Medicare Catastrophic Coverage Act: A Post-Mortem," 9 *Health Affairs* 75 (Fall 1990).

combined extreme regimentation (every primary and secondary student in the nation was to take standardized proficiency tests in reading and math every year), lofty but vague objectives (every school must make "adequate yearly progress" toward "universal proficiency" by 2014), and bureaucratic remedies for failure to meet the objectives ("supplemental education services," "corrective action," "restructuring plans"). It also contained special performance requirements for low-income students, special-needs students, non–college-bound students, and "major racial and ethnic subgroups," as well as discrete programs or requirements for early literacy, teacher training, technology-in-the-classroom, parent involvement, constitutionally protected prayer, and much else. All of these matters needed to be elaborated through Department of Education regulations, and state and local compliance with the regulations needed to be monitored and enforced.[40]

The new Medicare drug program was less centralized than the established Medicare programs for hospital and physician care. It operated through contracts with competing private insurance companies, and the firms had some flexibility in designing coverage features and terms; among other virtues, these reforms obviated the need for a federal drug formulary.[41] Nevertheless, the program imposed numerous coverage requirements on the private insurers and also provided them with large and complex subsidies, and therefore entailed substantial new regulation. Moreover, the new benefit generated strong political pressures for the introduction of pharmaceutical price controls, just as traditional Medicare had led to de facto price controls on covered hospital and physician services.[42]

Also in his first term, President Bush signed into law the McCain-Feingold Campaign Reform Act of 2002, which introduced sweeping new regulatory controls on campaign finance and political speech. He

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[40] See the papers collected in Frederick M. Hess and Chester E. Finn, Jr., eds., *No Remedy Left Behind: Lessons from a Half-Decade of NCLB* (2007); and Gail L. Sunderman, ed., *Holding NCLB Accountable: Achieving Accountability, Equity, & School Reform* (2007).

[41] Joseph Antos, "Ensuring Access to Affordable Drug Coverage in Medicare," AEI Working Paper No. 118, American Enterprise Institute, Dec. 6, 2005.

[42] Mark McClellan et al., "Medicare Part D and Prescription Drug Prices," AEI Policy Fact Sheet, American Enterprise Institute, Jan. 5, 2007.

had not advocated the legislation during his presidential campaign—indeed he had opposed it, and his reversal was a particularly striking departure from limited-government conservatism. As a candidate and during his first year in office, Bush expressed pointed, specific, well-founded constitutional objections to the bill then working its way through Congress. But when the bill passed with all of the objectionable provisions intact, he (somewhat sheepishly) signed it and said he would let the courts sort out the constitutional issues. He then instructed his Justice Department to advocate the statute's constitutionality in court, which it did with success.[43]

Moralism in Politics

President Bush's departures from traditional conservatism were more than a strategic effort to broaden the Republican Party's political base and popular appeal. He was also a strong moralist, strongly inclined to interpret issues through clear, definitive categories of right and wrong. Moralism translates to an expansive view of government—as it did, among American presidents, for the one other conservative moralist, Theodore Roosevelt, and the two liberal moralists, Woodrow Wilson and Jimmy Carter. Like all modern presidents, Bush celebrated private morality from the presidential pulpit, regularly calling attention to exemplary deeds of average citizens. But the point here is a different one. To an extraordinary degree, Bush's official addresses and pronouncements used moral language to describe public issues and moral appeals to advocate political choices. That was so across the full range of domestic and foreign policies, from the war on terror to energy conservation.[44] And his rhetoric was an authentic expression of his conception of political leadership, which was to treat policy questions primarily as matters of right versus wrong, good versus evil, and ethical imperative. Indications of this mindset were the words he used to summarize his political philosophy—"compassionate conservatism," elaborated as "when someone hurts, government must act." Also in the absurd title of his school-reform program, No Child Left Behind, setting forth a utopian, intrinsically unachievable goal.

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[43] As recounted in Christopher DeMuth, "Unlimited Government," *The American Enterprise*, Jan./Feb. 2006.

[44] As carefully documented and analyzed in Colleen J. Shogan, *The Moral Rhetoric of American Presidents* (2006).

And consider his striking description of his executive role as "the decider"—much more august than the usual conception of the chief executive who pragmatically navigates and adapts to a succession of events. Complementing this self-conception was his impressive serenity in the face of mounting reversals and declining public approval during his second term, which was surely grounded to a considerable degree on moral certitude.

Bush was, accordingly, relatively uninterested in institutional considerations such as limited government and federalism, and impatient with economic calculation, trade-offs, and the balancing of costs and benefits in government policy and in private behavior—all of them involving practical constraints on the pursuit of the categorical good. His two Inaugural addresses and seven State of the Union addresses were profuse, detailed, and frequently eloquent in addressing matters of private and national character—duty, sacrifice, charity, tolerance, faith—and in associating those virtues with the innumerable initiatives his administration was pursuing. At the same time, the addresses said next to nothing about limited government, federalism, subsidiarity, overregulation, or the merits of competition, private enterprise, and free markets.[45] In the terminology of Max Weber, Bush was guided by "the

[45] In Bush's two Inaugural and seven State of the Union addresses, amounting to more than 40,000 words, I find fewer than ten references to limited government, federalism, private enterprise, or regulation—all of them brief, formulaic, and qualified. Here are representative passages. On limited government: "Government should be active but limited, engaged but not overbearing" (2001 State of the Union). On federalism: "We should not, and we will not, run public schools from Washington, DC. Yet when the Federal Government spends tax dollars, we must insist on results" (2001 State of the Union). On private enterprise: "We will work for free markets, free trade, and freedom from oppression" (2001 State of the Union). On regulation: "We must free small businesses from needless regulation and protect honest job-creators from junk lawsuits" (2005 State of the Union). There are no references at all to the merits of competition as a principle of economic or social organization. Apart from many references to international trade and the need to keep America competitive in the global economy, the addresses mention competition four times. Two of them describe his efforts to allow faith-based organizations to compete for federal funds. One proposes federal subsidies to make ethanol competitive with other fuels. And one calls on Republicans and Democrats, after they have competed for votes, to cooperate in Washington to produce results.

ethics of conviction" rather than "the ethics of responsibility."[46] An approximate modern formulation of Weber's dichotomy is the maxim that government policies should be judged by results (the ethics of responsibility) rather than intentions (the ethics of conviction). George Bush would probably subscribe to that maxim in the abstract, but in practice he almost always put conviction in the forefront.

This point should not be overstated. Successful democratic politicians are, ipso facto, pragmatists. President Bush was not indifferent to the consequences of his decisions, and he favored many economic policies whose benefits rested on material calculus. In his first term he won major reforms to reduce taxation[47] and correct abuses in civil litigation.[48] He was an adamant free trader and the first president to forthrightly champion social security reform (although he advocated "personal retirement accounts" not for their economic advantages but rather as a means for building an "ownership society" with greater personal responsibility and family stability[49]). As noted earlier, his Medicare drug benefit established a beachhead of private, competitively supplied insurance within the traditional Medicare framework of

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[46] Max Weber, "Politics as a Vocation," *The Vocation Lectures* 32 (David Owens & Tracy B. Strong eds., Rodney Livingstone trans., 2004). Weber's "ethics of conviction" is sometimes rendered as "ethics of ultimate ends." "Conviction" is the closer translation of Weber's *gesinnungsethik*, but "ultimate ends" captures an additional strand of his argument: because government policies rest ultimately on the application of force and violence, and because the politician makes and executes policies on behalf of citizens whose ends, moral and other, differ and often conflict, the responsible politician cannot be content with identifying an ultimate good but must compromise and balance goods and bads. The ethics of conviction means that "… if an action performed out of pure conviction has evil consequences, then the responsibility must lie not with the agent but with the world, the stupidity of men—or the will of God who created them thus. With the ethics of responsibility, on the other hand, a man reckons with exactly those average human failings. …Whoever makes a pact with the use of force, for whatever ends (and every politician does so), is at the mercy of its particular consequences" (pp. 84, 89).

[47] On this and other Bush tax reforms see Alan D. Viard, ed., *Tax Policy: Lessons from the 2000s* (2009).

[48] See Ted Frank, "The Class Action Fairness Act Two Years Later," *AEI Liability Outlook*, Mar. 2007.

[49] See The White House, "Fact Sheet: America's Ownership Society: Expanding Opportunities," Aug. 9, 2004.

regimented, command-and-control government insurance.[50] And, in the much-debated instance of government funding for medical research employing embryonic stem cells, he personally crafted a nuanced policy replete with ethical trade-offs.[51]

Yet he was strongly inclined to see presidential leadership and decision-making as matters of ethical categorizing. This played an important role in his response to crisis. He was a prodigal spender in response to developments that involved human suffering, even when they were far removed from any Republican grand strategy. Following Hurricane Katrina in August 2005, federal emergency-relief spending exceeded $120 billion, vastly higher than for any previous natural disaster. Foreign aid—one of the least popular categories of federal spending—more than doubled during his administration, even without accounting for Iraq and Afghanistan.[52] His responses to the crises that punctuated his tenure were similarly extravagant when it came to new regulation.

Crisis and Response

The first crisis to inspire new regulation was the terrorist attacks of September 11, 2001. The attacks prompted (among a great many other things, of course) elaborate new "homeland security" procedures and documentation requirements at airports and other transportation depots, along with tighter regulation of immigration and certain financial transactions. Those measures accounted for most of the growth in regulatory-agency budgets during the Bush administration prior to the financial crisis of 2008,[53] and probably for most of the growth in (vastly larger) private compliance and opportunity costs. The programs would certainly have been instituted in some significant

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[50] See Kimberley A. Strassel, "Competence Man: The Dr. McClellan Medicare Cure," *Wall Street Journal*, Apr. 20, 2007.

[51] See The White House, "President Discusses Stem Cell Research," Aug. 9, 2001; and "Advancing Stem Cell Science Without Destroying Human Life," Apr. 2007.

[52] President Bush's longtime speechwriter and policy adviser, Michael J. Gerson, in *Heroic Conservatism* (2007), makes the case for big-government conservatism on both ethical and political grounds. But the political arguments are themselves strongly moralistic: "My party … must carry this message of idealism and courage to a tired nation in a pivotal moment or face a severe judgment of history" (p. 10).

[53] See Dudley and Warren, note 6 above, at 5.

degree by any administration of either party. America found itself in a strange new form of warfare with a shadowy enemy whose modus operandi was the surprise attack by a small group of suicidal combatants in a congested civilian venue, intended to kill as many innocent people as possible. Defending against such terrorism demanded not only ex post military counterattacks but also ex ante regulation of civilian commerce, communications, transportation, and finance. Death by airplane crash is a matter of special dread to a great many people, and in the aftermath of the horrific 9/11 crashes the public was prepared to support security precautions costing many times (in dollars and inconvenience) what a standard cost-benefit analysis would justify.

Nevertheless, the regulatory responses were extraordinarily ungainly and heedless of relations of cost to risk-reduction. The new airport passenger boarding procedures—dubbed "security theater" by specialists—were over-centralized, rule-bound, intrusive, indiscriminate, and impervious to improvement with experience.[54] They went well beyond what any other nation had imposed in the face of similarly grave security threats (as in the case of Israel[55]) and may well have set new records for regulatory cost-ineffectiveness. The creation of two gigantic new government bureaucracies, the Department of Homeland Security in 2002 and the Office of the Director of National Intelligence in 2004, was similarly bureaucratic. Both reorganizations were based on the principles of centralization and suppression of competition and pluralism within government, with consequences for improved security and intelligence that were dubious in the extreme.[56]

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[54] See U.S. Travel Association, Blue Ribbon Panel for Aviation Security, *A Better Way: Building a World-Class System for Aviation Security* (Mar. 2011); Jamie Belcore and Jerry Ellig, "Homeland Security and Regulatory Analysis: Are We Safe Yet?" Working Paper No. 08-13, Mercatus Center, George Mason University, June 2008; Jeffrey Goldberg, "The Things He Carried," *The Atlantic*, Nov. 2008; Robert Poole, *Airport Security: Time for a New Model*, Reason Foundation (Jan. 1, 2006); and any issue of Poole's superb *Airport Policy and Security Newsletter*.

[55] See David Asper, "Learn a lesson from Israel on airport security," *National Post*, Dec. 28, 2009.

[56] On the organization of intelligence gathering and analysis, see Richard A. Posner, *Uncertain Shield: The U.S. Intelligence System in the Throes of Reform* (2006), and "The Reorganized U.S. Intelligence System after One Year," *AEI National Security Outlook*, Apr. 2006.

The second crisis—far less substantial than the first but nevertheless a political preoccupation for nearly a year—was the corporate accounting frauds of 2001 and 2002. The exposure of financial fraud at Enron Corporation in late 2001 led to the firm's bankruptcy and the prosecution of its top executives. The exposure of fraud at WorldCom in mid-2002 was similarly followed by bankruptcy and prosecutions. In between and subsequently, several major corporations announced substantial retroactive earnings restatements, many prompting federal, state, and private legal actions. In response, the Bush administration energetically supported, and Congress promptly enacted, a sweeping expansion of federal authority over corporate governance (previously largely a matter of state law) and accounting—the Sarbanes-Oxley Act. In signing the Act in July 2002, President Bush declared, "This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law." Sarbanes-Oxley did indeed leave no boardroom behind, imposing intricate and costly procedures and audit requirements on management for scant evident benefit, and significantly increasing the regulatory power of the SEC.[57] The Act also created a new regulatory agency, the Public Company Accounting Oversight Board (PCAOB), with unprecedented bureaucratic autonomy: its members were not appointed and confirmed by the president and Congress and could not be removed by the president, and they

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[57] See Henry N. Butler and Larry E. Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned, How to Fix It* (2006); Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 114 *Yale Law Journal* 1521 (2005); papers and discussion at "Is Sarbanes-Oxley Impairing Corporate Risk-Taking?" (seminar, American Enterprise Institute, June 18, 2007); Alex J. Pollock, "Has Sarbanes-Oxley Harmed Entrepreneurs?" (speech, Hudson Institute, May 24, 2007); and Peter J. Wallison, "Sarbanes-Oxley As an Inside-the-Beltway Phenomenon," *AEI Financial Services Outlook*, May 2004, and "Blame Sarbanes-Oxley," *AEI On the Issues*, Sept. 2003. The record is mixed even on the accuracy of financial reports: Sarbanes-Oxley seems to have made them more accurate in some respects but less accurate in others. Compare Shimon Kogan, Bryan R., Routledge, Jacob S. Sagi, and Noah A, Smith, "Information Content of Public Firm Disclosures and the Sarbanes-Oxley Act" (Apr. 5, 2010), and Erin Syron, "Career Concerns and Earnings Distortion," Department of Economics, University of California, Berkeley (Nov. 13, 2009). Whatever the net effects, they failed to prevent the staggering financial surprises of 2008, when several leading firms with sterling balance sheets were suddenly discovered to be insolvent. Alex J. Pollock, "Sarbanes-Oxley in the Light of the Financial Crisis," *AEI Regulation Outlook*, Nov. 2009.

were vested with independent authority (not dependent on congressional action) to set and collect taxes to fund the Board's operations.[58] In the course of responding to the accounting frauds, the Justice Department employed criminal prosecution in unprecedented fashion to liquidate one of the nation's most distinguished accounting firms, Arthur Anderson, for the document-retention violations of a few employees. The Supreme Court eventually reversed the conviction (unanimously),[59] but by then the firm was irretrievably out of business and its 26,000 U.S. employees had been dismissed.

The third development—again a serious shock rather than a full-blown crisis—was sharp and sustained increases in energy prices beginning in 2004. In response, President Bush championed and won a series of measures to subsidize alternatives to petroleum and regulate energy production and consumption. In his 2006 State of the Union address, he defined the problem in stern moral terms: "America is addicted to oil, which is often imported from unstable parts of the world. The best way to break this addiction is through technology." In that address he proposed a variety of new research and development projects for solar and wind energy and biomass and hydrogen fuels. A year later, in his 2007 State of the Union, he upped the ante with proposals for goals and timetables and new regulatory requirements for reducing energy use, increasing domestic oil production, and increasing the substitution of ethanol and other alternatives for petroleum. These proposals were bolstered by a succession of administrative directives to reduce energy consumption, tighten the CAFE fuel economy standards for cars and trucks, and regulate motor vehicle greenhouse gas emissions under the Clean Air Act.[60] He also proposed substantial expansion of exploration and development of new domestic sources of oil and gas, but Congress largely rejected these. But the major enactment, the

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[58] In *Free Enterprise Fund v. PCAOB* (560 U.S.__ , June 28, 2010), the Supreme Court held that Sarbanes-Oxley's provision for removing (but not for appointing) PCAOB members was unconstitutional. The Board's unilateral taxing power was not challenged in the case.

[59] *Arthur Andersen LLP v. United States*, 544 U. S. 696 (2005).

[60] See Executive Order 13423, *Strengthening Federal Environmental, Energy, and Transportation Management, 72* Fed. Reg. 3919 (Jan. 26, 2007), and The White House, *Fact Sheet: Twenty in Ten: Strengthening Energy Security and Addressing Climate Change*, May 14, 2007.

Energy Independence and Security Act of 2007, was all regulation: it set ambitious new requirements for ethanol in gasoline, further tightened CAFE regulation and efficiency standards for a variety of consumer appliances and industrial machinery, and established lighting standards requiring, among other things, the abolition of the incandescent light bulb. Ethanol subsidies and energy efficiency regulations are renowned among economists for their ineffectiveness and perversity.[61]

The Bush administration's responses to the accounting scandals and energy shocks were similar to its efforts to improve domestic security through grand gestures of bureaucratic centralization. The emphasis was on action for its own sake—action as a demonstration of concern and determination, rather than action derived from an assessment of causes and effective response. The perpetrators of the accounting frauds were all ruined by criminal prosecution and civil litigation under pre–Sarbanes-Oxley laws and by the bankruptcies of their firms, which also imposed heavy losses on their investors. It added nothing, and subtracted a great deal, to subject all public corporations to a new layer of national regulation that focused the attention of executives and directors on regulatory compliance rather than business performance. The costly new energy regulations and subsidies promised at best trivial reductions in energy use and dependence on foreign oil. (A sufficiently stiff energy tax would have actually achieved the results the administration and Congress pretended they were achieving.) That an avowedly conservative administration responded to conventional economic shocks as it did—careless of the relationship of action to consequence and of the values of pluralism, competition, and markets—dramatized the disappearance of conservative thought and advocacy in regulatory policy. Those responses were harbingers of what was to come in the administration's final year, when a far deeper crisis arrived.

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[61] See Pietro S. Nivola, *The Long and Winding Road: Automotive Fuel Economy and American Politics* Brookings Institution, Feb. 25, 2009; Sam Kazman, "Automobile Fuel Economy Standards," Competitive Enterprise Institute, 2008; Robert W. Crandall and Hal J. Singer, "Don't Drink the CAFE Kool-Aid," AEI-Brookings Joint Center for Regulatory Studies, Publication 07-24 (Sept. 2007); Andrew Kleit, "CAFE Adieu," AEI-Brookings Joint Center, Publication 04-14 (July 2004), and papers cited therein; and Kenneth Green, "Ethanol and the Environment," *AEI Environmental Policy Outlook*, July 29, 2008.

4. The Financial Crisis of 2008

The financial collapse of 2008 began, in the second half of 2007 and first half of 2008, with the appearance of serious deterioration in the liquidity and capital positions of many banks and other firms with large investments in home mortgages and "mortgage-backed securities." Those initial tremors were followed, in September 2008, by the insolvency of several leading financial institutions, by panic and paralysis in credit markets, by a stock market collapse (the major price indices declining by more than one-quarter), and by the onset of a "Great Recession" featuring sharply falling consumption and production and rising unemployment.

The unfolding events prompted increasingly aggressive government responses. In the course of the year, the Federal Reserve Board (FRB) and Federal Reserve Bank of New York provided a succession of special lending programs and targeted capital infusions into several major financial firms, increasing the Federal Reserve's balance sheet from about $800 billion to more than $2.2 trillion. The Treasury Department made equity investments of $300 billion in more than 200 financial and commercial firms. Regulatory powers were used as levers to arrange mergers of insolvent investment banks into commercial banks and other rescue transactions. By the time the Bush administration left office in January 2009, the federal government had bailed out,[62]

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[62] A government "bailout" is the provision of loans, investments, or other benefits to a business firm to save it from bankruptcy. In bankruptcy, a firm's creditors are repaid to the maximum extent possible from its remaining assets, with equity investors receiving the residual, if any. So a bailout generally saves some or all of a firm's creditors but not its shareholders—who may realize substantial losses or be wiped out altogether, depending on the degree of the firm's insolvency and the terms of the bailout. The bailout allows the firm to continue in business (in bankruptcy, it might be liquidated), and in all events to repay its creditors on better, often much better, terms than they would receive in bankruptcy. The purpose is to prevent economic disruptions among the firm's suppliers, customers, and creditors—and, in a financial crisis such as that of 2008, to reassure credit markets that might otherwise panic into foreclosing on loans to other, healthier firms. While bailouts are usually ad hoc responses to financial troubles at very large ("too big to fail") firms, failing commercial banks are always bailed out to a degree by the "resolution" procedures of the Federal Deposit Insurance Corporation (FDIC), which typically merge insolvent banks into other, healthier banks while guaranteeing their deposits up to some limit (now $250,000). During the 2008 financial crisis, the FDIC lifted its deposit limit, extended its insurance to

and acquired significant control of, many of the nation's largest commercial banks, one of its largest insurance companies (AIG), the two quasi-public mortgage firms Fannie Mae and Freddie Mac, and two automobile manufacturers (General Motors and Chrysler).

The administration's management of the crisis was not action for action's sake. Treasury Secretary Henry M. Paulson, Jr. and Federal Reserve Chairman Ben Bernanke, who led the response, believed the economy was on the brink of a profound calamity and were determined to do whatever necessary to prevent it.[63] Some of their rescue actions were successful, such as the provision of liquidity to commercial credit markets and the extension of bank deposit insurance to money market funds to avert a run on the funds. Yet they made momentous errors—errors of excessive and excessively freewheeling interventionism—that seriously worsened the crisis and set the stage for expanding many of the harmful regulatory policies that had been among its primary causes.

Causes of the Collapse

The financial collapse originated in the housing sector, where the Federal Reserve's low-interest-rate policies in the early 2000s stoked a spectacular speculative "bubble." By standard measures, U.S. home prices doubled from the beginning of 2000 through the middle of 2006—the steepest increase on record—and then plunged 18 percent in the two years through the middle of 2008 and 25 percent by the end of that year.[64] Bubbles are unsustainable asset price inflations driven by speculation that prices will continue to rise (rather than by changes in supply and demand); they are a recurrent and apparently incorrigible

banks' non-deposit debt, and collaborated with the Treasury and Federal Reserve to bail out a few major banks more quickly and favorably than its own procedures would have allowed. The Troubled Assets Relief Program (TARP), discussed in the text at note 100 below, was described as a mass bailout but provided investment funds to many banks at little or no risk of failure, in order to reassure creditors of banks holding "troubled assets."

[63] As recounted in Henry M. Paulson, Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (2010). Cf. Phillip Swagel, "The Financial Crisis: An Inside View," *Brookings Papers on Economic Activity* 1–63 (conference draft Spring 2009).

[64] See U.S. Home Price Values, S&P/Case-Shiller Home Price Indices. Home prices continued to fall throughout the crisis—by about 32 percent by mid-2009, at which point prices began to stabilize.

feature of financial markets.[65] When bubbles burst, the losses can be large and painful to those who bought in at inflated prices, with derivative losses to their customers and suppliers. But the damage is usually confined: it does not ordinarily paralyze wider financial markets and precipitate a sharp economic contraction.[66] For example, the 1990s "dot-com" bubble in technology stocks burst in 2000–2002 when the NASDAQ stock index plunged by 70 percent. The aggregate loss of stock equity values was about $5 trillion, and many once-touted technology firms vanished from the scene—yet financial markets continued to function, and the effect on U.S. economic growth was relatively moderate (GDP growth flattened for a time but there was no recession). The bursting of the housing bubble similarly destroyed about $5 trillion in home equity values (about $3 trillion by mid-2008)—but the consequential damage was far more severe.[67]

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[65] See the landmark study of Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2009), concerned primarily with sovereign-debt and economy-wide crises (such as the 2008 financial collapse) rather than sector-specific asset bubbles (such as the 2006–2008 housing collapse that led eventually to the wider financial collapse). On asset bubbles that may or may not precipitate a financial collapse, see Steven Gjerstad and Vernon L. Smith, "Monetary Policy, Credit Extension, and Housing Bubbles: 2008 and 1929," in *What Caused the Financial Crisis* (Jeffrey Friedman ed., 2011), chap. 3, summarized in "From Bubble to Depression?" *Wall Street Journal*, Apr. 6, 2009; and Charles W. Calomiris, "The Subprime Turmoil: What's Old, What's New, and What's Next," 15 *Journal of Structured Finance* 1 (Spring 2009) 6. The superb Friedman collection, referenced several times in this paper, reprints with revisions a 2009 edition of *Critical Review*. Finally, Alex J. Pollock, *Boom & Bust: Financial Cycles and Human Prosperity* (2011), is short, witty, and deep.

[66] Robert J. Barro and José F. Ursúa find that non-wartime stock-market crashes (declines of 25% or more) increase the chances of minor economic depressions (declines of 10% or more) from a background probability of 3.8% up to 22%, and of major depressions (declines of 25% or more) from 0.9% up to 3%. See "Stock-Market Crashes and Depressions," Working Paper, Department of Economics, Harvard University, Sept. 2009. Not all stock market crashes are the bursting of speculative bubbles—some, like the crash of 1919–1921 during the global influenza epidemic, are caused at least in part by negative external shocks that depress economic activity and thereby stock market values. In these cases, worsening economic conditions are a cause rather than result of the stock market fall.

[67] The figures in this paragraph are derived, for the housing bust, from the FRB Flow of Funds balance sheet for households, and, for the dot-com bust, from NASDAQ indices. It is possible to derive a somewhat higher figure for the loss of housing equity by using Cast-Shiller indices rather than the FRB data. Gjerstad

The housing bubble was different because of two developments that greatly magnified its size as it grew and its consequences when it burst. The first was innovation in the design and marketing of financial instruments and the organization of financial markets, a trend that had been underway for several decades. Traditionally, commercial banks and savings and loan associations that provided home mortgage loans, and were in immediate contact with mortgagor-homeowners, had held and managed the loans to maturity; increasingly, they instead sold the loans to investment banks (or to Fannie Mae or Freddie Mac, discussed below), which in turn pooled numerous mortgages to create and sell tradable bonds. Secondary mortgage markets had existed for many decades but became vastly larger and more reticulated in the 1990s and 2000s (along with secondary markets in commercial real estate, credit card, student loans, and other kinds of primary debt). Mortgage-backed securities (MBSs)—combining hundreds or thousands of mortgages of various sizes, interest rates, geographic regions, credit ratings, collateral, and other characteristics—came to be an important component of the asset portfolios of many commercial and investment banks and pension funds and were actively traded in international markets.

The MBS market was facilitated by further innovations, including complex mathematical risk-assessment models (employed by buyers and sellers and by credit-rating agencies such as Moody's and Standard & Poor's); "credit default swaps" (which insured against the risk of MBS defaults); and "collateralized debt obligations" (second-derivative securities pooling riskier components of MBSs with other, uncorrelated forms of secondary debt). With the support of these techniques, the diversification of MBSs—in particular, the diversification of loans on homes in all regions of the country—was thought to provide investors with protection against the risk of default on remote individual

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and Smith, note 65 above, note that the dot-com crash destroyed $10 trillion in stock equity value. But their $10 trillion figure includes the loss of all U.S. holdings of corporate equities. The dot-com bubble was very heavily focused on NASDAQ stocks, and the NASDAQ crash preceded the decline in other equity prices, so the $5 trillion NASDAQ crash is the appropriate comparison to the housing crash when we are concerned with the consequences of a collapsing asset bubble on wider financial and commercial markets.

mortgages, in place of the particularized knowledge and hands-on management that local mortgagee-bankers had relied on previously.[68]

The second development was a dramatic relaxation of traditional mortgage lending standards. The changes were primarily the result of a many-faceted government campaign, begun in the 1990s and expanded in the early 2000s, to promote homeownership among minority groups and people of low income and poor (or no) credit histories. The campaign included a few explicit, on-budget subsidies to low-income homebuyers; but mostly, and critically, it was waged through regulation and other forms of market intervention aimed at making homeownership easy and cheap. And it was, for the time being, a stupendous success. The measure of that success was the appearance of vast numbers of "subprime" and "Alt-A" mortgages—previously unthinkable loans combining little or no documentation of mortgagors' income or credit-worthiness, little or no down-payment (mortgagors had traditionally been required to pay in at least 20 percent of a home's purchase price), and extremely liberal payment terms (but at higher rates of interest than conventional "prime" mortgage loans).[69] Before the 1990s, such "nonprime" mortgages were limited to the Federal Housing Administration and to specialized private markets focused on higher-risk loans but with traditional down-payment requirements.[70] Their numbers grew significantly beginning in the mid-1990s and then dramatically in the 2000s; new mortgages requiring down-payments of 3 percent or less of the purchase price grew from less than 1 percent of all mortgages in 1990 to 5 percent in 1996, 10 percent in 2000—and then skyrocketed to nearly 40 percent in 2006.[71] By mid-2008, nonprime

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[68] The displacement of "relationship-based knowledge and case-by-case due diligence" by "blind diversification in liquid, anonymous markets" is emphasized by Amar Bhidé in "An Accident Waiting to Happen," in Friedman (ed.), note 65 above, chap. 2.

[69] "Subprime" and "Alt-A" denote somewhat different departures from conventional lending standards and are jointly described as "nonprime" mortgages.

[70] See Edward Pinto, *Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study*, American Enterprise Institute (Feb. 5, 2011), 43–46.

[71] See Pinto, *Forensic Study*, note 70 above at 23–29, 135. See also Edward Pinto, "High LTV, Subprime and Alt-A Originations Over the Period 1992–2007 and Fannie, Freddie, FHA and VA's Role," in *Three Studies of Subprime and Alt-A Loans in the U.S. Housing Market*, American Enterprise Institute (Feb, 5, 2011) 37; and

mortgages constituted nearly half of the first mortgages and mortgage debt in the United States—27 million of a total 55 million mortgage loans, amounting to $4.6 trillion of a total $9.4 trillion in outstanding mortgage debt.[72]

The federal government had promoted homeownership since the 1920s through tax advantages and other policies.[73] Home mortgage (and other) interest payments had been deductible since the beginning of the income tax. The Tax Reform Act of 1986 continued the interest deduction for mortgages while eliminating it for other consumer credit such as auto and credit loans, thereby encouraging consumers to shift their debts into mortgages. A further step was the 1997 elimination of capital gains taxation on up to $500,000 of profit from home sales used to purchase another home.[74] These measures had the incidental but powerful effect of encouraging homeownership through borrowing. One reason the housing price collapse had much greater financial ramifications than the dot-com price collapse is that homes are generally purchased with much greater debt than stocks: when the housing bubble burst, it produced not only large losses of personal wealth but widespread mortgage defaults that impaired the capital positions of lenders, including owners of MBSs.

But the fifteen-year homeownership campaign preceding the 2006 housing price collapse had been more focused and purposive than

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Souphala Chomsisengphlet and Anthony Pennington-Cross, "The Evolution of the Subprime Mortgage Market," 88 *Federal Reserve Bank of St. Louis Review* 31, 36–40 (Jan./Feb. 2006).

72 Edward Pinto, "Sizing Total Exposure to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08," in *Three Studies,* note 71 above at 2, 5 (table 1).

73 See Roger Lowenstein, "Who Needs the Mortgage-Interest Deduction?" *New York Times Magazine*, Mar. 5, 2006; and Steven Malanga, "Obsessive Housing Disorder," 19 *City Journal* (Spring 2009). The first major initiative was Secretary of Commerce Herbert Hoover's "Own Your Own Home" campaign, aimed at countering the "growing menace" of tenancy by encouraging banks to provide more home mortgages and other means. This is another instance of Hoover's conservative regulatory activism, which included the establishment of federal control of the electromagnetic spectrum mentioned in Chapter 2.

74 The effect of this tax change on inflating the housing bubble is emphasized by Gjerstad and Smith, note 65 above; see also Vernon L. Smith, "The Clinton Housing Bubble," *Wall Street Journal*, Dec. 18, 2007.

earlier policies. Beginning in 1993, regulations under the Community Reinvestment Act (CRA) required commercial banks to extend mortgage loans to people of lower income through the adoption of "flexible underwriting standards."[75] Henceforth, bank regulators, whose traditional role was to insist on "safety and soundness" in banking practices, instead insisted that banks loosen their mortgage lending standards—and this insistence had real teeth because CRA compliance was an important factor in securing approval of bank mergers.[76] The volume of nonprime mortgages induced by CRA regulation is difficult to gauge, because enhanced CRA enforcement coincided with complementary initiatives (discussed below); a fair estimate is that the $4.6 trillion in nonprime mortgage loans in 2008 included $900 billion of CRA loans.[77] But the consequences went beyond the CRA mortgages: the relaxation of lending standards, especially the introduction of low– and zero–down-payment mortgages, could not as a practical matter be limited to low-income CRA applicants, and led to looser standards and greater "leverage" (higher loan-to-value ratios) throughout the mortgage market.[78] Although the CRA applied only to commercial banks, the Department of Housing and Urban Development (HUD) applied CRA-like lending standards to other mortgage firms beginning in 1994.

The Bush administration, in its efforts to promote "the ownership society," continued and expanded the Clinton-era CRA and related initiatives through such measures as the American Dream Downpayment Act of 2003, which subsidized mortgage downpayments and

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[75] Ably documented and discussed in Pinto, *Forensic Study,* note 70 above, and in Peter Wallison, "Cause and Effect: Government Policies and the Financial Crisis," *AEI Financial Services Outlook*, Nov. 2008, (also appearing in revised form in Friedman (ed.), note 65 above).

[76] Raphael Bostic, Hamid Mehran, Anna Paulson, and Marc Saidenberg, "Regulatory Incentives and Consolidation: The Case of Commercial Bank Mergers and the Community Reinvestment Act," Working Paper 2002-06, Federal Reserve Bank of Chicago, May 2002.

[77] See Edward Pinto, "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08," in *Three Studies,* note 71 above at 18, 29–32; and Financial Crisis Inquiry Commission, *Preliminary Staff Report: The Community Reinvestment Act and the Mortgage Crisis*, 5–6 (Apr. 7, 2010).

[78] See Wallison, note 75 above, and research cited therein.

closing costs; official endorsement of zero–downpayment mortgages; and subsidization of high-risk mortgages by the Federal Home Loan Bank System and the Federal Housing Administration.[79] As late as 2006, Congress passed legislation that encouraged credit-rating agencies to relax their rating standards for subprime mortgage securities.[80] Bank regulators and HUD officials became enthusiastic boosters of subprime mortgage specialists such as Countrywide Financial and IndyMac Bank—among the first firms to collapse in 2008.

But by far the greatest impetus for the nonprime mortgage boom came from the two "government-sponsored enterprises" (GSEs), Fannie Mae and Freddie Mac.[81] The firms' public function, justifying their government sponsorship, was to promote homeownership by facilitating secondary mortgage markets so as to increase the capital available for financing home buying. They did this primarily by purchasing individual mortgages from originators and brokers, pooling them into MBSs, and selling the securities to investors—along with guarantees of the payment streams from the component mortgages. (They also purchased individual mortgages, and "private-label" MBSs from private issuers, for their own investment portfolios.) Although shareholder owned and nominally private (before their collapse in 2008), the firms could borrow at near-Treasury interest rates because of the implicit government guarantee of their debt. And they enjoyed many explicit tax and regulatory exemptions and very low capital requirements. These special privileges made them extraordinarily profitable and responsive to Congress.

Beginning in 1992, Congress assigned Fannie and Freddie the mission of promoting "affordable housing" by making a friendly secondary market for mortgages for people of lower income. By statute and HUD regulations, the firms were directed to promote mortgages with very

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[79] See for example "America's Ownership Society," note 49 above.

[80] This was the "anti-notching" provision of the Credit Rating Agency Reform Act of 2006, discussed in Charles W. Calomiris, "The Debasement of Ratings: What's Wrong and How We Can Fix It," e21—Economic Policies for the 21st Century, 9–10, Oct. 26, 2009.

[81] An excellent history and analysis of the firms' role in the nonprime bubble-and-burst is Peter J. Wallison and Charles W. Calomiris, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," *AEI Financial Services Outlook*, Sept. 2008.

low down-payments and to be lenient with borrowers with a history of payment delinquencies. The directives were enforced by progressively higher quotas on their mortgage purchases—by 2008, 56 percent for families of "low- and moderate-income," 27 percent for families of "very low-income," and 39 percent for housing in designated "high-minority" and "low-income" census tracts.[82] And after 2004, Fannie and Freddie had another reason for promoting easy homeownership: to maintain congressional support in the wake of accounting scandals at both firms (following the wider accounting scandals discussed in the previous section). Fannie and Freddie became aggressive promoters of zero–down-payment, low-or-no documentation mortgages. During the most frenzied years of the housing bubble, 2002–2006, they purchased more than $2 trillion in nonprime mortgages—40 percent of the U.S. nonprime loans originated in those years.[83]

At the time of the financial crisis, essentially the entire nonprime mortgage market—which had grown to half of all U.S. mortgages as noted above—was the artifact of federal programs and regulations. Here was the breakdown in mid-2008:[84]

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[82] See Financial Crisis Inquiry Commission, *Preliminary Staff Report: Government Sponsored Enterprises and the Financial Crisis* (Apr. 7, 2010); Department of Housing and Urban Development, Final Rule, "HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," 69 Fed. Reg. 63,579 (Nov. 2, 2004).

[83] See Pinto, *Three Studies,* note 71 above at 44 (table 1). For striking evidence (from internal documents) that Freddie Mac risk managers knew they were relaxing lending standards dangerously and that their doing so was affecting the entire mortgage market, see Charles W. Calomiris, "Statement before the House Committee on Oversight and Government Reform," Dec. 9, 2008.

[84] Derived from Pinto, *Three Studies,* note 71 above at 5 (table 1). Pinto's studies, and especially the calculations cited here, are criticized in David Min, *Faulty Conclusions Based on Shoddy Foundations,* Center for American Progress (Feb. 8, 2011). The criticisms are presented as fundamental and as absolving Fannie and Freddie from major responsibility for the degradation of mortgage standards. But actually they are terminological and marginal, concerned mainly with Pinto's having classified many loans as subprime and Alt-A that Fannie and Freddie and others had classified differently (as Pinto had explained in detail), and that these loans were somewhat less risky than "self-denominated" subprime and Alt-A loans (although their characteristics were clearly much laxer than those of

Nonprime Loans (Subprime, Alt-A)	Number of Loans (Millions)	Outstanding Principal ($ Billions)
Fannie and Freddie	11.939	1,835
FHA and other federal	5.073	587
CRA/HUD	2.240	312
Private (MBS)	7.448	1,888
Total	26.700	4,622

In this table, "Fannie and Freddie" refers to loans held or guaranteed by Fannie Mae and Freddie Mac, and "FHA and other federal" refers to loans guaranteed by the Federal Housing Administration and a few other federal agencies and those originated by the Federal Home Loan Banks. These nonprime loans, amounting to $2.4 trillion, did not jeopardize credit markets because they were held or guaranteed by government entities; instead they jeopardized taxpayers, as became clear when defaults on the loans and guarantees soared and Fannie and Freddie collapsed into federal "conservatorship." The second two categories were a different matter—"CRA/HUD" refers to loans originated by private firms in compliance with the CRA and HUD programs and held by private investors (additional CRA/HUD loans of about $600 million were held by Fannie and Freddie), and "Private (MBS)" refers to nonprime loans originated and held privately, essentially all of them in the form of mortgage-backed securities. These loans, amounting to $2.2 trillion in debt, were distributed in MBSs around the

traditional mortgages). What is undisputed is that Fannie and Freddie aggressively championed the relaxation of lending standards and were by far the largest purchasers of both nonprime mortgages and private-label MBSs however defined, that Fannie and Freddie deliberately concealed the extent to which they were marketing and investing in very-high-risk loans through terminology and other means, that delinquency and foreclosure rates on those loans during 2007–2009 were far higher than those of conventional mortgages, and that those failures precipitated the financial collapse. For the blow-by-blow of the Pinto-Min debate, see Peter J. Wallison, "The True Story of the Financial Crisis," *The American Spectator Blog*, May 24, 2011, and "Left Still Clueless about Financial Crisis," *The Enterprise Blog*, May 26, 2011; David Min, *Why Wallison Is Wrong About the Genesis of the U.S. Housing Crisis*, Center for American Progress (July 12, 2011); and Edward Pinto, "Government Housing Policy: The Sine Qua Non of the Financial Crisis," *The American*, July 26, 2011.

nation and world; they did not carry government guarantees against payment defaults, although most were covered by "credit default swaps" and other private insurance.

The spread of private-label nonprime MBS exposure was stimulated by two federal initiatives going beyond the CRA and HUD programs. First, Fannie and Freddie were the largest purchasers of these securities, effectively underwriting their issuance and buttressing there sales to private investors. Second was a critical change in regulatory policy. In 2001, the FRB, Federal Deposit Insurance Corporation, Comptroller of the Currency, and Office of Thrift Supervision (agencies with regulatory jurisdiction over various forms of commercial banks) amended their capital requirements to provide strong incentives, in the form of unusually liberal asset-weighting rules, for banks to invest in private label MBSs. The change was not part of the government's homeownership campaign but rather a response to the perceived low risk of MBSs, which the government backing fortified. Indeed the new rules set the same ultra-low 2-percent capital requirement for investments in private-label MBSs that had previously been limited to Fannie's and Freddie's own, guaranteed MBSs (the only lower capital requirement—0 percent—was for government bonds and gold). Nonprime MBSs were designed and marketed to fit the new rule, with notable results.[85]

Bubble and Burst . . . and Wider Collapse[86]

The two developments described above—the growth of secondary mortgage markets and the government homeownership campaign—powerfully reinforced each other during the 2000–2006 period of skyrocketing housing prices. The nonprime segment of the MBS market was built on government regulations and guarantees, and expanded low-income homeownership with greater energy and scope than a government spending program could have accomplished. Securitiza-

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[85] The change in capital requirements and its effect on bank MBS investments are analyzed in Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (2011). The book's argument is summarized in Friedman and Kraus, "A Silver Lining to the Financial Crisis: A More Realistic View of Capitalism," *AEI Regulation Outlook*, Jan. 2010, and in Jeffrey Friedman, "Capitalism and the Crisis," in Friedman, note 65 above, chap. 1.

[86] For a valuable chronology of the events of the crisis, see Federal Reserve Bank of St. Louis, *The Financial Crisis: A Timeline of Events and Policy Actions*.

tion expanded the capital available to finance home purchases beyond the traditional sources of commercial banks in demand deposits; that complemented the government regulatory programs, and the Federal Reserve's low-interest-rate policies, in making mortgages cheaper and more affordable (so it appeared) for people of low income. And the new capital was undemanding capital, relatively indifferent to the risks of individual mortgages because of the design and diversification of MBSs and the further spreading of risk through credit default swaps. To be sure, the government initiatives added significantly to the demand for housing and therefore to housing prices.[87] But as long as the price inflation continued, it greased the skids for the government's efforts to liberalize lending standards: if a zero-down-payment mortgagor defaulted, the mortgagee (including the remote owner of an MBS) would still be protected by the increasing value of the mortgaged property. These expectations were built into the risk models used by investors and credit-rating agencies and into the pricing of credit default swaps; and mortgage delinquency and foreclosure rates did remain low as long as housing prices continued to climb.

Then, when the bubble burst, the reinforcements worked powerfully in the opposite direction. As housing prices fell precipitously beginning in mid-2006, millions of Americans found themselves with mortgage debts greater than the market values of their homes, and those with little or no equity in their homes had scant incentive to continue making payments.[88] Nonprime payment delinquencies and mortgage foreclo-

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[87] Because government policies simultaneously (a) increased home prices and (b) made it easier to purchase homes with little or no downpayments and very low initial interest rates, it is an open question whether, even before the bubble burst, the policies helped or hurt those of low income who were the intended beneficiaries of the liberal lending policies. Harmful consequences would have been most likely in states such as California and Arizona where price inflation was particularly great because of local land-use and other restrictions. Thomas Sowell, in *The Housing Boom and Bust* (revised edition 2009), emphasizes the unusual price inflation in such jurisdictions and (at 161) quotes a 2005 news report that roughly 60% of first-time homebuyers in Tucson made no downpayment.

[88] Under the "nonrecourse" laws of many states, notably including Arizona and California where the housing price collapse was particularly severe, a mortgagee's recourse in the event of a mortgagor's default is limited to seizing and selling the mortgaged property—if the sale price is less than the amount of the outstanding mortgage loan, the lender may not seek additional compensation from the mortgagor's other assets. Other states permit recourse to other assets but restrict

sures soared[89] and, with housing prices declining rapidly with no bottom in sight, private-label MBSs suddenly became "toxic." They were toxic not so much because their value had fallen sharply and surprisingly as because their ultimate value was unknown. That rendered the securities uninsurable and unmarketable. The disappearance of the private-label secondary market contributed further to the housing price collapse.[90]

The effect of these developments on firms holding MBSs was immediate and profound. Under then-prevailing "mark-to-market" accounting rules, assets were required to be valued at current market prices—an approach that made sense only so long as there was a market for the assets in question. So when MBSs became unmarketable, the firms that held them, or insured them through credit default swaps, were required to mark them down drastically. Their capital positions were thereby substantially impaired, often to the point of possible insolvency. Commercial and investment banks are typically very thinly capitalized, a problem discussed in detail in the Appendix. So if a bank's equity capital amounted to 3 percent of its assets, and its MBS investments were also 3 percent of its assets, then the MBS meltdown would leave it insolvent (if the market values of its other assets were unchanged).[91] At

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the procedure in various ways. For evidence that non-resource policies encourage default when home values fall below the value of mortgage loans, see Andra C. Ghent and Marianna Kudlyak, "Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States," Working Paper No. 09-10R, Federal Reserve Bank of Richmond, June 10, 2010.

[89] In the boom years preceding the housing price collapse in 2006, payment delinquencies on subprime mortgages had hovered around 15% and mortgage foreclosures had been about 3%; by late 2008, delinquencies exceeded 30% and foreclosures hit 10%. The increases for Alt-A mortgages were even greater—delinquencies from 5% to 14%, foreclosures from 1% to 6%. See Lender Processing Services, "LPS Mortgage Monitor: Mortgage Performance Observations," Jan. 2009. Pinto, *Forensic Study,* note 70 above at 150 (chart 53).

[90] New issuances of private-label MBSs (prime as well as nonprime) fell from $1.146 trillion in 2006 to $707 billion in 2007 and $58 billion in 2008. See International Monetary Fund, Global Financial Stability Report, fig. 2.7, Oct. 2009.

[91] See Friedman and Kraus, "The Interaction of Regulations and the Great Recession," *Engineering the Financial Crisis*, note 85 above, chap. 3. The role of equity capital in preventing credit market collapses is discussed in the Appendix to this monograph.

the same time, mortgage defaults on MBSs issued by Fannie and Freddie caused their guarantee obligations to soar; that, along with the plummeting value of the private-label MBSs in their own investment portfolios, is what pushed them into insolvency.

In the world of old-fashioned mortgage finance, mortgages were limited to borrowers with a demonstrated capacity to make interest and principal payments, borrowers assumed at least 20 percent of the risk of loss of a home's value, and lenders possessed specific information about the circumstances of individual mortgages. In that world, the housing bubble would not have grown nearly so large, even in the low-interest-rate environment of the early 2000s. And, when it burst, the losses would have fallen on those with incentives and knowledge to make prompt adjustments: as in the bursting of the dot-com bubble, the economic pain would have been acute but contained. In the new world of high-tech, far-flung, low-accountability, socially-engineered mortgage finance, the loss in value was rapidly transmitted to wider financial markets—including the balance sheets of many remote banks and investment firms, where the ultimate extent of the underlying losses was poorly understood and the ability to manage mortgages on a case-by-case basis was nonexistent.

The collapse of housing prices metastasized throughout the financial system not only because of the size, liquidity, and anonymity of the nonprime mortgage and MBS markets, but also because of the nature of risk-taking by regulated financial institutions. All financial firms seek to manage risk through diversification, but those with a prospect of being rescued by a government "bailout" when risks go sour will also seek exposure to risks that are correlated with those facing many other firms. A failure that is part of a "systemic" financial collapse will be more likely to prompt a government rescue than the idiosyncratic failure of a single firm—so one wants to be part of the system. This may explain the otherwise curious prevalence of credit default swaps, by which competing financial firms insured each other against private-label MBS losses. Most firms' MBS portfolios were already highly diversified, and it is most unlikely that the firms selling the insurance possessed better information on MBS risks than the firms that owned the securities (a major provider of U.S. credit default swaps was an AIG trading affiliate in London). So what the swaps achieved was not so much insurance of MBS risks facing individual firms as the socialization of aggregate MBS risk across firms, plus the opportunity to place broad bets on the course of the housing market. An indication of this effect is that many of the firms hardest hit by the nonprime collapse were exposed not by holding private-label MBSs but trading in derivative securities. If the herd was seeking safety in numbers, its instincts were right: in the aftermath of the September 2008 financial collapse, the government bailed out essentially everybody.[92]

Response to the Collapse

The policy antecedents of the financial collapse were an extreme instance of the problematics of regulation described in Chapter 1 ("regulation" here including efforts to manage and channel markets through direct participation and guarantees—Fannie and Freddie—as well as through rulemaking). Although promoting homeownership has deep roots in American politics, it is inconceivable that trillions of dollars could have been committed to low-income homeownership through legislative appropriations.[93] Regulations and guarantees were able to do so with little restraint or even public notice, and also with great leverage—infiltrating credit markets so pervasively that the sudden loss of portfolio values yielded paralysis and collapse that spread quickly (because banks became unable or unwilling to extend business loans) to equity markets and the commercial economy.

That is not, however, how the crisis was perceived in the fall of 2008. Campaigning for president in September 2008, Barack Obama opined

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[92] I am indebted to V.V. Chari for the argument of this paragraph. It recalls John Maynard Keynes's oft-quoted observation that "a 'sound' banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows so that no one can really blame him." "The Consequences to the Banks of the Collapse of Money Values" (1931), reprinted in Keynes, *Essays in Persuasion* (1963) at 168. But Keynes was referring to a sociological rather than regulatory phenomenon—the tendency of large uncertainties ("unknown unknowns") to induce conformity and adherence to conventional wisdom among members of an affected group. That might have contributed to the ubiquity of nonprime MBS investments, but it would have been a much weaker inducement that collectivized moral hazard, which would have held down the cost of credit and thereby increased current profits.

[93] Pinto, in *Forensic Study,* note 70 above at 3–4, notes that the efforts to promote low-income homeownership off-budget, through Fannie/Freddie and regulation, came soon after the Budget Enforcement Act of 1990 had placed new controls on discretionary spending, including the subsidy programs of the Federal Housing Administration and other agencies.

that the financial collapse was caused by "Republican deregulation," John McCain that the cause was "greed on Wall Street." These were mere political fillips: there had been little financial deregulation during the Bush administration, and greed, a constant of human nature, cannot explain an extraordinary event. But they certainly had verisimilitude. Not only Fannie and Freddie but many recently high-flying banks and investment firms were revealed to be insolvent—and to have been operating at degrees of leverage (ratios of assets to capital) that were recklessly high, while earning immense profits and making multi-millionaires of traders for cooking up mysterious devices like MBSs that now looked like quackery. When the stock market cratered, private and public retirement funds (and the retirement expectations of millions of individuals) suffered grievously; America's three iconic automobile companies appeared bankrupt (two of them were); and a few Ponzi schemes came unraveled, including the spectacular Bernard Madoff fraud, which alone imposed losses of $17 billion, much of it falling on charities. In every case, the only solutions in sight were taxpayer bailouts, legal prosecution, and re-regulation.[94]

The remarkable thing was that the Bush administration seemed to have no view of its own about the sources of the crisis, and acted in ways that reinforced the impression of a "crisis of capitalism" and extended the politicization of financial markets. As the crisis unfolded, Secretary Paulson and Chairman Bernanke acted as dealmakers rather than policy makers—as market überparticipants rather than providers of public rules and resources for market restoration:

- In March 2008, Bear Sterns, a mid-sized investment bank, was merged into J. P. Morgan Chase, a commercial bank, with exceedingly generous government financing that made even Bear Sterns's unsecured creditors whole.[95] That announced, implicitly but unmistakably, a policy of protect-

[94] The Appendix to this monograph evaluates the argument that deregulation was a major cause of the financial collapse.

[95] The disastrous sequence of the Bear Sterns bailout followed by the Lehman Brothers non-bailout is analyzed in depth in Vincent R. Reinhart, "A Year of Living Dangerously: The Management of the Financial Crisis of 2008," 25 *Journal of Economic Perspectives* 1 (Winter 2011). The analysis is summarized in Vincent R. Reinhart, "Getting Lehman Profoundly Wrong," *The American*, Sept. 21, 2010.

ing creditors of impaired investment firms—thereby relieving the firms of the necessity of taking difficult steps to repair MBS and related credit problems on their own.

- Then, in September, the much larger investment bank Lehman Brothers went bankrupt, and into liquidation, following the denial of government aid. The reversal of the Bear Sterns policy was at once astonishing and unconscious—Lehman was allowed to fail for no other reason than that Paulson and Bernanke could not find a merger partner who would agree to deal terms they thought appropriate. Six critical months had been lost between the initial policy and its precipitate reversal; it was at this point that panic set in throughout credit markets, leading to many more failures, rescue efforts, and the stock market collapse.
- The day of the Lehman bankruptcy, another large investment bank, Merrill Lynch, was merged into Bank of America with no publicly acknowledged financing or pressure. But in fact there had been plenty of pressure behind the scenes—and the next day, the insurance firm AIG, which had enormous liabilities to Merrill Lynch, was saved from bankruptcy with an $85 billion Federal Reserve loan.

In these and other cases, Paulson and Bernanke and their subordinates were tight-lipped about the transactions they had orchestrated and those they passed over; and they instructed the financial executives they were dealing with to keep mum as well. That is customary for private deal-makers with business strategies and other proprietary information to protect—and perhaps the government crisis managers, now acting as market participants with billions to invest or withhold, thought of themselves as obliged to protect the value of the public investments they were making. But they thereby violated the first rule of financial crisis management, which is to provide unvarnished market information and clear principles of government action promptly and widely. Their closed-door extemporizing increased market uncertainty, suppressed private remediation, and, in the aftermath of the surprise non-rescue of Lehman, precipitated a devastating market panic.[96]

Other rescue efforts were similarly focused on getting deals done rather than reforming underlying policies and providing clear market signals. In early September, when Fannie Mae's and Freddie Mac's mounting losses on their MBS holdings and guarantees made it inescapable that they were insolvent, the firms were placed in government "conservatorship" with initial Treasury Department commitments of $100 billion to each firm and the promise of more to come.[97] That was two missed opportunities of historic proportions. It had been decades since one could argue with a straight face that government participation and subsidy were necessary to the existence of secondary mortgage markets, yet Fannie and Freddy's huge expenditures on lobbying and "crony capitalism" with government officials and ex-officials had prevented reform by a succession of administrations and Treasury secretaries. The GSE's central role in the financial fiasco, and their abject insolvency, left them uniquely vulnerable—and also provided a singular moment for focusing on the nonprime mortgage collapse as the key to resolving the credit market crisis. That would have been accomplished by placing the seized firms in receivership and employing their immense assets to stabilize mortgage and MBS values in the course of liquidation. Instead, they were treated as just two more imperiled firms to be rescued, or not, according to the contingencies of the moment. "Conserving" them, and leaving their fate to be decided *mañana*, meant that the bailouts were for resurrecting them as agents of government finance and "affordable housing."

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[96] The contribution of the administration's opaque improvising to the September market panic is emphasized and analyzed by John B. Taylor in "Monetary Policy, Economic Policy and the Financial Crisis: An Empirical Analysis of What Went Wrong," in Friedman, note 65 above, chap. 5, at 167–171.

[97] The authorization for these immense commitments came in a statute enacted a month earlier, which for the first time made the federal government's guarantee of the firms' debts explicit. The announcement of the commitments on Sept. 6 strongly reinforced the post-Bear Sterns complacency in MBS and wider debt markets that was to be shattered a week later by the Lehman bankruptcy. By mid-2010 the government had provided about $150 billion to cover Fannie's and Freddie's losses and the Congressional Budget Office had projected total losses at $389 billion. See Congressional Budget Office, *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac*, Jan. 2010.

A final misstep was Secretary Paulson's decision, a few weeks after enactment of the $700 billion "Troubled Asset Relief Program" (TARP) in October 2008, to use the funds not to buy troubled assets (toxic mortgages and MBSs) at all, but rather to make investments in the firms holding the assets and thus to shore up the firms themselves. That the funds were to be used for purchasing assets, not equity ownership, had been a condition of Republican support for the statute, and the understanding was enshrined in the program's name; but Paulson and his Treasury colleagues had pretty clearly been contemplating investments all along. This was yet another instance of their preoccupation with rescuing firms rather than markets. It kept the focus of public attention on the conduct of particular banks and investment firms and the merits of bailing them out, rather than on remediating the underlying causes of the financial crisis. Rescuing the MBS market was postponed into 2009 and 2010, when the FRB purchased $1.25 trillion in agency MBSs.[98]

The Treasury's TARP investments—eventually about $550 billion in 700 firms[99]—were in the form of preferred (non-voting) stock, and most were redeemed in a matter of years at little cost to the government.[100] But the precedent of government ownership was important. It further legitimized the practice, pioneered by Fannie and Freddie, of direct government participation in private markets. The practice threatened to become routine in the following years—as the Obama administration invested in General Motors and Chrysler and participated aggressively in their reorganizations and management, as it proposed (unsuccessfully) to establish a government health insurance company to compete with private firms, and as the Dodd-Frank Act (discussed below) moved the government further into direct management of financial firms.

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[98] See Federal Reserve Board, "Frequently Asked Questions: MBS Purchase Program," Aug. 20, 2010. GAITNER PROGRAM

[99] Detailed on the *New York Times* website at "Tracking the $700 Billion Bailout."

[100] In the final accounting, the Treasury's receipts from sales of its TARP preferred stock may exceed its original investments in that stock. The "taxpayer bailouts" were instead the large pre-TARP rescue operations, especially the government funding of Fannie's and Freddie's payments on its mortgage loss guarantees—funding that revived the holders' share prices, including the Treasury's TARP holdings.

All of these measures, involving industries that were already heavily regulated, violated the border agreement between government regulation and ownership described at the outset of this paper. Regulation is supposed to consist of rules of market conduct applied equally to all firms in a market, intended to correct market failures or otherwise to promote public purposes. Within the constraints of those rules, firms are supposed to be free to compete and otherwise conduct themselves as private entities. In practice, regulation often favors some firms at the expense of others, or all incumbent firms at the expense of new entrants, but such cases are universally regarded as abuses, as departures from public-interested policy. The situation is fundamentally different when the government at once regulates a market and acquires a financial stake in some of the firms in that market. Then the government's actions are sometimes public and on-the-record (regulation) and sometimes private and confidential (management and oversight); then abuse becomes policy itself by dint of the government's conflict of interest. Fannie and Freddie, in their decades of market dominance before their collapse in 2008, possessed an array of special tax and regulatory privileges and financial guarantees that enabled them to combine political purposes and lavish private profits to an amazing degree—and with complete respectability, indeed prestige. Similar conflicts, at least in appearance, arose during the 2009–2010 period when the government was an investor in major automobile and financial firms at a time when important new regulations of both industries were being fashioned.[101]

The TARP about-face was also a significant advance for unilateral executive government. Throughout 2008, Paulson and Bernanke had taken rescue actions with scant statutory authorization, and the Federal Reserve had made de facto appropriations of hundreds of billions of dollars without congressional involvement. Now the Treasury was using an actual statute and $700 billion authorization in ways that flouted congressional intent of less than a month's standing. The justification for these maneuvers was extra-legal—simply the exigencies

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[101] The creation of the Transportation Security Administration in November 2001 had created similar (though less politically odious) conflicts by making TSA both the regulator of airport security services and the provider of those services. See Robert Poole, "Airports Considering Outsourced Screening," in *Airport Policy and Security Newsletter #63*, Dec. 10, 2010.

of the crisis and the need for decisive action of a kind that a legislature could not provide. But they nevertheless fortified the longstanding trend of legislative delegation that had been the essence of regulatory growth. Although the initial congressional response to the TARP usurpation was one of bipartisan fury, Congress soon ratified it through supporting statutes.

More was to come. The gargantuan Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, although more than 400,000 words in length, set new standards for delegated lawmaking—launching hundreds of rulemaking proceedings, often with extraordinarily open-ended statutory standards. Here for example was Congress's mandate to a new Consumer Financial Protection Bureau (CFPB): "ensure that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive." Moreover the new Bureau, like Sarbanes-Oxley's Public Company Accounting Oversight Board (PCAOB) mentioned in Chapter 3, was established with its own independent fisc, free of congressional appropriations. Whereas PCAOB was given its own taxing authority, CFPB was given an automatic slice of the profits of the Federal Reserve Banks (capped at about $500 million annually). Here as in the cases of government dealmaking and selective financing of regulated firms, crisis prompted the use of policy expedients that left them more familiar and accepted after the crisis had receded.

The most ominous provisions of the Dodd-Frank Act were those that entrenched the very policies that had contributed most directly to the financial collapse. The Act did nothing to reform (never mind abolish) Fannie Mae and Freddie Mac, and nothing to reverse the government's promotion, through lax bank capital standards and other means, of excessive leverage in the financial system. Instead it designated all bank holding companies with more than $50 billion in assets as "systemically important," and created a Financial Stability Oversight Council, a committee of financial regulators chaired by the Secretary of the Treasury, with essentially unlimited discretion to designate additional financial institutions as "systemically important." Firms with this designation were to receive more stringent government oversight than other firms, and the Act established formal "resolution" procedures for failing investment banks, complementing the FDIC procedures for commercial banks. Yet the very act of anointing selected firms as systemically important meant that the government would be bound to rescue them in a crisis by whatever means necessary to mollify the system. That almost certainly set the stage for more government-business partnerships of the Fannie and Freddie variety, with the government providing valuable protection against failure (which would reduce borrowing costs and amplify profits) in return for cooperation in pursuing political goals.[102] Dodd-Frank codified the new reality created by the Bush administration's 2008 rescue efforts: the establishment of government-sponsored enterprises throughout the financial sector, operating at the discretion of the Federal Reserve and Treasury.

Coda

The Obama administration mounted a surge in regulatory activity going well beyond the management of the financial crisis and enactment of Dodd-Frank. To a degree, the growth reflected the arrival of a Democratic administration in place of a Republican one; for example, the EPA proposed to tighten all of its National Ambient Air Quality Standards that govern enforcement of the Clean Air Act, and the FDA significantly tightened it controls over the introduction and marketing of pharmaceutical drugs. But for the most part the new administration simply followed, like Dodd-Frank, the trajectory of regulatory growth established by its predecessor; for example, the Department of Energy and EPA launched a fusillade of energy-efficiency rulemakings under the Energy Independence and Security Act of 2007, and the Transportation Security Administration continued to make its airport security procedures more intrusive and burdensome.

In November 2010, the Republicans won control of the House of Representatives, riding the crest of the strongly conservative "tea party" movement dedicated to reversing the growth of government. The movement was motivated, however, primarily by the growth of spending and deficits and imminent increases in taxes. Its immediate impetus was reaction against the Obama administration's enormous "stimulus" spending and expansion of government control of health care. While it was also opposed to the Bush's "Wall Street bailouts," it had little to say about Dodd-Frank—which was understandable, given the statute's complexity and opacity. The new Republicans won

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102 See Peter J. Wallison, "The Dodd-Frank Act: Creative Destruction, Destroyed," *AEI Financial Services Outlook*, July-Aug. 2010.

immediate, substantial concessions from the Obama administration on taxing and spending, where legislation was inescapable. But a large share of lawmaking was now being conducted downtown, in the Executive Branch agencies, immune from effective legislative influence. The new conservatives, like their predecessors, were rhetorically opposed to the growth of regulation but incapable of resisting it in practice.

5. Conservatism and Regulation—The Prospect

In the inauspicious circumstances described in the preceding pages, members of the deregulation wing of the conservative movement, and economic conservatives in general, would do well to double down with time-tested principles and methods. Our intellectual traditions have always been in tension with the natural propensities of the political world that we study and sometimes participate in. Yet our traditions have continued to grow and have developed their own structure and integrity. They have proved useful in understanding, explaining, and solving exigent problems. Although they are now out of fashion, practical developments may summon them and demonstrate their utility once again. These considerations suggest three intellectual strategies.

The first is to devote renewed attention to regulatory policies that are ineffective or perverse. Regulations that are merely very costly or flunk a cost/benefit test will be regarded by many as "good enough for government work." It is quite another thing to show that regulations are making matters worse. Demonstrations of policy perversity have been politically effective in the past—for example, when it was shown that unregulated intrastate airline fares were lower than regulated interstate fares, and that FDA regulation was preventing U.S. marketing of life-saving pharmaceuticals widely in use in other nations. There are many such cases in current policy—including energy conservation and alternative-energy regulations and subsidies, increasingly detailed regulation of new pharmaceuticals and medical devices which may metastasize into price controls, and the escalating regulation of financial markets, corporate governance, and medical care. The advantage of such arguments in the current political environment is that they are philosophy-free. They do not require adherence to distinctively conservative precepts concerning the value of property rights or efficacy of markets and consumer choice; they appeal directly to the American spirit of pragmatism.

The second strategy is to forge alliances with liberals, as was done with great effect in achieving airline and surface transportation deregulation. The Democratic Party now in power is statist rather than liberal. Yet there are many traditional liberals in the academic and intellectual worlds, and some in active politics, who take their egalitarianism, environmentalism, and other isms seriously. In labor markets and education, in civil litigation, and in the vast fields of state regulation (as of insurance) and licensure, populist rhetoric is used to mask regulatory policies that enrich tightly organized groups by restricting individual freedom, to the disadvantage of the less-well-connected and less-well-off. Environmental regulation has become so costly, and so encrusted with ineffective rules and endless litigation, that fundamental reform now promises large gains to all sides. Two examples of thoroughly cross-partisan reform efforts are Common Good, devoted to reforming civil litigation with special emphasis on medical care, schooling, and recreation;[103] and Breaking the Logjam, devoted to producing a new generation of environmental laws.[104] There are many more such opportunities. In regulatory policy, economic conservatives work in a small political tent but a big intellectual tent.

The third strategy is to beaver away on problems of fundamental importance to the health of the private enterprise system. Among these are ending the FCC's cartelization of communications markets (and efforts to cartelize the Internet) and averting the threat of pharmaceutical price controls. But the top priority is protecting the efficiency and competitiveness of financial markets in the aftermath of the collapse of 2008 and passage of the Dodd-Frank Act.

Financial markets are the heart of capitalism—they are capitalism, in the sense that they provide capital by market competition rather than political direction to projects whose economic value is yet to be realized. Because modern banking operates at fractional reserves and serves as an arm of monetary policy, the case is very strong for safety-and-soundness regulation and obligatory insurance of some categories of assets. But financial markets are also vulnerable to harmful regulation and "politicization," and the fact that they are already regulated for good reasons increases this vulnerability. Exchanging money for future obligations rather than current goods involves an inherent, irreducible degree of uncertainty and speculation, and also raises the possibility of bubbles (there are no bubbles in goods except where, as in the case of homes, they also serve as financial vehicles). These circumstances mean

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[103] The Common Good website is commongood.org. See also Philip K. Howard, *Life Without Lawyers* (2009).

[104] Breaking the Logjam is a project of the New York University School of Law and New York Law School.

that, when mistakes are made, financial markets are exposed to political second-guessing and reallocation of gains and losses, and to the imposition of supposedly corrective regulation that can succeed only where regulators are more prescient than market participants.

In addition, politicians, even in advanced market economies, are especially interested in the allocation of capital. They do a good deal of it in the course of customary government functions (as in the financing of roads, bridges, and national defense), and come to realize that participation in financial markets presents opportunities for pursuing political objectives outside the constraints of taxing and spending.

The housing bubble-and-bust, which took the entire financial system down with it, is a terrifying example of the "systemic risk" of rigging financial markets for purposes of political redistribution. The policy sequelae, including the Bush administration's rescue efforts and the Dodd-Frank Act, suggest that the politicization of American finance has become strongly self-reinforcing; the result is likely to be increased instability and further crashes. There is an immense literature on economically sound financial regulation, and it should be cultivated and improved until the moment arrives when it might in desperation be taken seriously.[105] A serious program of financial regulatory reform would combine (a) robust capital standards for commercial and investment banks to reverse the excessive leverage of recent decades (discussed in the Appendix to this paper); (b) commitment to clear ex ante rules for government response to financial bubbles and busts and resolution of failed financial firms; (c) development of transparent, on-budget substitutes for politicized finance such as Fannie Mae and Freddie Mac[106]; (d) sensible safety-and-soundness regulation and insurance against financial runs; and (e) removal of regulatory impediments to competition in corporate control, financial risk-assessment, and price-discovery.

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[105] An excellent start is Charles W. Calomiris, "An Incentive-Robust Program for Financial Reform," *Journal of International Money and Finance* (forthcoming 2011).

[106] On the reform of housing policy and restoration of prudent mortgage lending standards, see Peter J. Wallison, Alex J. Pollock, and Edward J. Pinto, "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market," AEI Policy White Paper, American Enterprise Institute, Jan. 20, 2011; and Edward L. Glaeser and Joseph Gyourko, *Rethinking Federal Housing Policy: How to Make Housing Plentiful and Affordable* (2008).

Delegation

In addition to the matters of policy substance reviewed above, conservatives need to address the now-routine delegation of lawmaking from elected legislatures to executive agencies. The issue presents deep dilemmas, well illustrated by the proposed REINS (Regulations from the Executive in Need of Scrutiny) Act, currently being debated in the Congress under the sponsorship of Congressman Geoff Davis and Senator Jim DeMint. The REINS Act is modeled on the Congressional Review Act[107] but changes the default rule: major new regulations could not take effect until approved by a joint resolution of the Congress and signed by the President, with expedited procedures guaranteeing up-or-down floor votes promptly after regulations were issued.

The REINS Act would reclaim regulatory delegation in a stroke, establishing interbranch political accountability for major regulatory initiatives on a par with taxing-and-spending accountability. And such accountability would at least promise to produce a corpus of regulations that was at once (a) smaller and (b) more focused, robust, and effective than the one we have today. Although the regulatory agencies are more efficient than the Congress in generating and issuing laws, this advantage comes at a price in what might be called "democratic quality." Freedom from legislative process means that agency rules are less likely to reflect a consensus of public sentiment. They are therefore more likely to be too aggressive—when an agency, lacking a budget of regulatory expenditures, pursues its mission too single-mindedly or self-righteously, or with too little regard for the competing public concerns of the day. But they may also be too timid. Environmental initiatives, for example, are often highly popular, and EPA, beset by interest groups whose métier is exaggeration and alarmism, may find it difficult to see past the lobbying fog: it may underestimate as well as overestimate popular support in a way that constituency-minded legislators would not. And agency rules may contain subtle flaws, affecting their acceptability and durability, which the legislative gauntlet would have exposed and remedied.

By subjecting major rules to the test of attracting two legislative majorities, the REINS procedure would, at a minimum, cull out

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[107] See text at note 19.

extremes of regulatory overreaching—almost certainly more reliably than the internal Executive Branch review procedures have done. At the same time, rules written with the aim of securing congressional approval could reveal areas of broad political support for certain initiatives. In all events, REINS-approved rules would treated with greater deference and less second-guessing by courts, regulated parties, lobbying groups, and the general public. Some of the most effective and durable regulations (in terms of achieving their purposes, whether worthy or not) have been statutory regulations and those written by agencies according to specific statutory directives. Examples include EPA controls on toxic water pollutants, automobile emissions (including unleaded gasoline requirements), acid-rain producing power plant emissions, and stratospheric ozone destroying chemicals.

But it is well to acknowledge that REINS is much more than an incremental rebalancing of rulemaking prerogatives or an expression of Republican opposition to Obama administration regulatory ambitions. It is rather a frontal challenge to the central development of modern government in America and other politically advanced nations—the migration of policymaking authority from elected legislatures to special-purpose boards and agencies. The migration began in the United States with the creation of the first regulatory commissions during the Progressive and New Deal eras. It then resumed dramatically beginning in 1970, with the creation of EPA and other new regulatory agencies mentioned earlier. We now seem to be at a further stage in the evolution of legislature-free government, with the appearance of specialized mini-governments with increasingly comprehensive power to tax, spend, and regulate, and under leadership whose appointments are increasingly distant from legislative review and approval. As we have seen, these developments have been thoroughly bipartisan, with the greatest advances occurring during the Nixon and George W. Bush administrations before more recent steps in the Obama administration. And they have many analogues in other nations, including the proliferation of "quangos" ("quasi-autonomous national government organizations") in the United Kingdom and, in Europe, the migration of policy authority from national governments to the unelected commissions, councils, committees, and directorates of the European Union.

A shift in government structure so pervasive and continuous must reflect powerful political, economic, or technological forces. For Congress to reclaim the final say over dozens or scores of regulations each year is to throw itself athwart those forces, whatever they may be, in a central area of government policy. It is highly uncertain whether Congress will be willing to take this step, but the debate over the measure is bound to be revealing. When one asks the question, "Should elected representatives be required to stand and be counted on $100 million government initiatives?", it is difficult to avoid the affirmative answer. But when one turns to questions of legislative capacity and incentives, and the effect of the procedure on the substance of policy and the size and scope of government, one encounters the dilemma of the modern "democracy deficit" in the starkest of terms. If Congress decides to take a pass on the REINS proposal, this will itself be evidence of the intractable nature of the trend, and will give it further momentum. If Congress adopts and makes good use of the proposal, that could be the beginning of a democratic Restoration.

Policy Competition and Limited Government

This paper has not discussed the regulation of international trade per se, but it will be a fitting subject to conclude with, because of the growing importance of international competition as a discipline on domestic policy.

Free trade was, until recently, a bipartisan, consensus issue in American politics. It has ceased to be so—because of the rise of China as an economic power, the resurgence of unions in domestic politics, and, for the time being, a serious economic downturn involving high unemployment. But free trade retains a well-grounded consensus among economists, and now is a critical moment to redeploy that consensus against protectionist pressures. Trade wars, like bank runs, are a special hazard during economic busts because they can greatly deepen and prolong the agony. And today there is an additional reason for protecting freedom in international markets: to preserve competition not just in goods and services but in government policy itself.

Globalization—the increasing mobility of capital, commerce, people, and ideas across national boundaries—constrains national governments by reducing their effective policy jurisdiction. One example, mentioned earlier and documented in recent research on the Sarbanes-Oxley Act, is that relatively costly and ineffective U.S. regulation of financial markets may drive firms to relocate elsewhere. In earlier times, before the development of today's travel, communications, and information technologies, the geographic market for most financial activities was no larger, and often much smaller, than the territory of a single nation, especially that of a very large nation such as the United States. In that world, a U.S. regulator such as the SEC held a strong policy monopoly. If the Commission's rules were inordinately costly, regulated firms and their customers adapted to them as best they could. For the most part, firms could not escape them altogether by moving their operations to friendlier jurisdictions, and customers could not shift their purchasing to firms operating from such jurisdictions. Today, many financial markets are effectively global and many firms have achieved international scale. In these circumstances, some firms will shift their operations to jurisdictions with more efficient regulatory regimes, and those that do not will lose business to firms in more efficient jurisdictions. There is strong evidence of this phenomenon in the initial market reactions to the Dodd-Frank Act.[108]

Government policies are hardly the only factors affecting a nation's relative commercial attractiveness. The United States offers a large internal market, wealthy consumers, and laws that are generally transparent and fairly enforced—virtues that can compensate for a multitude of policy vices. The effect of globalization on a nation's policies is at the margin, in conjunction with other factors pro and con. But three tendencies are important. First, globalization reduces each state's policy monopoly over its citizens. Second, the loss of monopoly power leads individual states to seek less burdensome policies. Third, the loss of monopoly, and therefore the tendency to seek less burdensome policies, will be most pronounced with regard to more mobile factors of production such as capital and information. Taxes on corporate income and capital-gains were previously very difficult to avoid (other than through the unattractive means of reducing income and asset values); they have recently become the subject of intense international competition and consequent reductions in tax rates. The FDA tried for a time to restrict the access of U.S. citizens to foreign websites that contained information on uses pharmaceuticals that went beyond uses the agency had approved for Americans; the effort was only partially successful and the increased information that is seeping through will dampen the FDA's long-time enthusiasm for suppressing domestic information about drug efficacy.

108 *[Add citations and summarize their findings.]*

Governments have devices of their own for forestalling the decline in their policy discretion. Individually, they can attempt to expand the extra-territorial reach of their policies; collectively, they can attempt to harmonize their policies—in effect forming policy cartels. They have been pursuing both strategies, especially in taxation, antitrust, and labor, environmental, and financial market regulation; and the financial crisis has prompted renewed efforts at creating a global financial regulator. Fortunately for conservatives, those efforts have been less than successful so far, because of the immense coordination problems and increasing diversity of national economic interests. But policy harmonization efforts will continue with increasing intensity so long as efforts to subdue globalization and re-balkanize markets through overt trade protectionism fail. There are certainly many cases, such as public health and climate change, where the nature of the problem requires a coordinated international response. But where harmonization aims to suppress competition in domestic policy, it should be strongly opposed.

The importance of international policy competition is particularly urgent in light of the decline in traditional conservative political values such as limited-government and the difficulties of translating conservative values into effective regulatory restraint. The vigor of American democracy has depended on a continuous tension between liberalism and conservatism. The liberal viewpoint is activist, comfortable with government power, and eager to reform society and launch new projects to address social ills and redress injustices. The conservative viewpoint is cautious, alert to the dangers and corruptions of power and the advantages of private ordering, and desirous of maintaining established arrangements and institutions. The liberal-conservative argument, as we have noted, has worked to the disadvantage of the full-blooded conservative vision over time. But it has presumably had some moderating effect on the growth of government and the enthusiasms of power, and some improving effect on the substance of individual policies.

The worry today must be that the big-government activism of the Bush administration was not an episode but a trend. In the presidential primary elections of 2008, the Republican electorate's choices included a traditional economic conservative (Mitt Romney), a social conservative (Mike Huckabee), and a libertarian (Ron Paul). Its choice, John McCain, was a conservative moralist exactly in the Bush mold—an adherent of the ethics of conviction with a strong populist streak who saw even the most complex economic issues in terms of good people needing protection and bad people needing punishment. The more recent tea party movement may signal a return to traditional conservatism, but so far it is also populist movement, and concerned primarily with government spending and debt. As we have seen, regulation is a substitute for spending, and American populism has as often favored as opposed regulation.

If the wariness of government power has disappeared from our politics, then the natural constrains on power arising from international policy competition may be critical. Indeed we may speculate that growing intergovernmental policy competition could be a *cause* of the decline of limited-government values in domestic politics. The principle of limited government may have been appealing, in times when governments held much greater effective power over citizens than they do today, as a constitutional self-denying ordinance—an assurance that those in authority would exercise power with restraint and within generally accepted limits. Globalization may be a substitute for that principle. In a world where government power is being naturally eroded—and especially one where that power is minutely distributed among a multitude of specialized government bureaus, each one operating in a tiny ambit of the economy or society—it may be more realistic to conceive of government as a holding company for numerous small firms operating in competitive markets. Business firms do not talk about limits on their ambitions or seek to reassure investors or consumers that they do not intend to grow or to seek new markets; in general, they do just the opposite. U.S. governors, to take a closer analogy, are state boosters because they have to be. National governments that are feeling the competitive heat and sensing their effective power slipping away may behave increasingly in this manner. Bold political talk and anemic policy action may be the wave of the future.

APPENDIX

Did Deregulation Cause the Financial Collapse of 2008?

The financial collapse of 2008 prompted extensive debate over its causes and lessons for policy. Some arguments were sweeping and ideological, such as the claim that the collapse amounted to a collapse of capitalism itself as a viable economic system. At the other extreme were indiscriminate lists of antecedent events and failures large and small, such as the final report of the official Financial Crisis Inquiry Commission which announced that "the collapse was the result of human action and inaction … [by] captains of finance and the public stewards of our financial system."[109] But other arguments were more robust, including the contention that the collapse was caused by "financial deregulation."

President Obama's charge, in his 2008 election campaign, that the financial crisis was the result of "Republican deregulation," was false. Financial deregulation, like many other recent acts of deregulation and new regulation related in Section II of this paper, was essentially nonpartisan. Every president from Jimmy Carter to Bill Clinton signed an important financial deregulation statute that enjoyed bipartisan support, and the concurrent wave of state deregulation was thoroughly pragmatic.[110] But the deregulation charge itself seemed plausible and was widely accepted, simply because the collapse involved so many bad decisions (and a smattering of criminality) on the part of so many highly paid financial executives.

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[109] *The Financial Crisis Inquiry Report*, National Commission on the Causes of the Financial and Economic Crisis in the United States, p. xvii, Jan. 2011.

[110] State financial deregulation was often motivated by interstate policy competition of the sort lauded in Section V. The dynamics of state abolition of usury laws (interest-rate ceilings on consumer loans), where these ubiquitous and longstanding laws were suddenly lifted in a majority of states in the 1980s, are described in Christopher DeMuth, "The Case Against Credit Card Interest Rate Regulation," 3 *Yale Journal on Regulation* 201 (Apr. 1986). But branching deregulation appears to have been driven by interest-group jockeying within states—see Randall S. Kroszner and Philip E. Strahan, "What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions," 114 *Quarterly Journal of Economics* 1437 (Nov. 1999).

It also, of course, involved many bad decisions on the part of government officials and legislators—but it was they who held the biggest megaphones, and they naturally emphasized the business errors and frauds rather than their own. The collapse occurred in the private sector; obviously something was seriously amiss. It would not have happened if government regulators had prevented it—and regulation *had* been relaxed in recent years, in ways that were only vaguely explained or understood.

This simple narrative dominated the media and political accounts of the collapse. While the explanation was usually loose and polemical, it was also advanced systematically by some academic economists; the treatment here draws on the writings of three of the most eminent—Judge Richard A. Posner and Nobel laureates Paul Krugman and Joseph E. Stiglitz.[111]

Financial deregulation had consisted of the progressive removal, during the 1980s and 1990s, of controls on deposit-taking commercial banks, many of them imposed in the 1930s following the widespread bank failures of 1930–1933. Beginning in the 1970s, advances in information and communications technologies, augmented by innovative techniques for managing financial risk through abstract measurement and diversification, fostered new institutions and methods that were effective substitutes for the traditional "intermediation" function[112] of

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[111] In particular from Richard A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009), chaps. 1, 3, 9, 10, and *The Crisis of Capitalist Democracy* (2010), chaps. 2, 5, 7; Paul Krugman, *The Return of Depression Economics and the Crisis of 2008* (2009), chaps. 8–10; and Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* (2010), chaps. 1, 3, 6. There are many differences in emphasis among the three but they are unimportant here. None of them identified deregulation as the *only* cause of the collapse—all pointed to additional causes, such as lax monetary policy or failure to control international financial flows—but all regarded deregulation as a primary cause.

[112] That is, the business of borrowing funds from savers and investors in order to lend funds to producers and consumers, financed by the spread between borrowing rates and lending rates. The riskiness of commercial banking is that the borrowing is in the form of demand deposits which may be withdrawn at any time, while the lending is generally for periods of months or years and cannot be called (withdrawn) before the term is up. Many but not all of the "shadow bank" commercial banking involve similar disparities in the time patterns of borrowing and lending.

commercial banks. These included money market funds, hedge funds, finance companies, mass-market credit cards, and new and greatly expanded uses of corporate commercial paper and derivative securities, often underwritten and marketed by investment banks. The upstart "shadow banking" industry was far less regulated than commercial banking, and grew rapidly.

The government response was to remove many of the controls on commercial banks in order to permit them to make use of the new technologies and compete with the less regulated products and services. Thus, interest-rate controls on bank deposits and consumer loans were abolished or greatly relaxed, as were prohibitions on banks operating through branches, across state lines, and in affiliation with other kinds of financial firms such as investment banks and insurance companies.[113] Banking was not really "deregulated"—it remained among the most heavily regulated sectors of the economy, with commercial and investment banks and other institutions such as stock exchanges subject to a multitude of capital standards, prudential-management controls, disclosure requirements, investment limitations, and much else, enforced by a fleet of federal and state agencies. But some of the most important controls, affecting the size and scope of firms and the terms of competition among them, were abolished or greatly relaxed.

The combination of new technology, new management techniques, and deregulation transformed banking and finance. As late as the 1970s, a "bank" was typically a single building, solidly red brick or neoclassical, that offered savings and checking accounts, safety deposit boxes, and loans to local businesses and homebuyers, and that genteelly evaded interest-rate controls by offering new depositors free toasters.[114]

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[113] Much of the deregulation consisted of states removing their longstanding controls on branch banking, interest rates on consumer loans, and other matters. But federal law played a part, and the decontrol of interstate and branch banking was sealed by the national Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Federal controls on interest rates on deposits were phased out beginning with the Depository Institutions and Monetary Control Act of 1980. The Gramm-Leach-Bliley Act of 1999, partially repealing the Glass-Steagall Act of 1933, permitted commercial banks, investment banks, and insurance companies to affiliate under a common holding company (although not to merge operations).

[114] At the depths of the financial collapse in autumn 2008, a popular Internet joke was the slogan, "Buy a toaster and get a free bank."

By 2000, many banks had become extended national (or international) networks of storefront branch offices and automated teller machines and computer websites in customers' homes and offices, elaborately interconnected with other banks and financial firms of all kinds, which offered not only deposit accounts but credit and debit cards, investment accounts, and insurance, and which spent heavily on promoting their prices and services. For both consumers and businesses, borrowing and investing had become cheaper, easier, and more abundant than ever before. The transformation of mortgage finance described in Section IV—with extended markets in mortgage-backed securities replacing local banks' making and holding individual mortgages—was one important part of this phenomenon.

According to the deregulation explanation, deregulating commercial banking rather than extending regulation to shadow banking had been a profound mistake that set the stage for the financial collapse. This was because banking is inherently very risky and, without regulation, banks will take on too much risk in pursuit of higher profits. Finance involves extensive "interconnection" and risk-sharing among independent firms, and the financial system as a whole is a critical input to the wider commercial economy—so one firm's borrowing and lending decisions can impose risks on other firms and the wider economy. But individual firms, left to themselves, will consider only their own risk/return tradeoffs, ignoring the external, "systemic" risks of their decisions. It is the responsibility of government to internalize the external risks, just as government internalizes the external costs of industrial pollution, and it failed that responsibility. The failure consisted, first, of deregulating commercial banks rather than regulating shadow-bank substitutes—for example, lifting interest-rate controls on bank deposits rather than imposing them on money-market funds. It also involved refusing to corral new financial markets and instruments; a prime example was the decision, enacted in a 2000 statute, not to require that credit-default swaps and other novel derivative contracts be traded through clearing-houses, in the manner of traditional derivatives such as commodity futures, to insure that trades were adequately collateralized. The growing systemic risks of lightly regulated, high-rolling commercial and shadow banks and exotic securities markets were exacerbated in the 2000s by the laissez-faire ideology of Republican regulatory officials, who were lax in enforcing the controls that remained. As a result, the financial sector spun out of control, crashed, and took the rest of the economy down with it.

The deregulation argument was correct in its premise that the financial system had become massively over-leveraged and excessively risky in the years preceding the financial collapse. But the argument itself was mostly incorrect. It was not the operating freedoms given to commercial banks (over pricing, branching, and corporate structure), nor the failure to restrict shadow banking operations and markets, that caused the excessive risk-taking that led to the collapse. One form of deregulation, however, had contributed directly to excessive leverage and risk: the relaxation of already loose capital standards for commercial and investment banks.

Consider the proposition that when commercial banks were permitted to pay interest on demand deposits (checking accounts), so that they could compete with the interest-paying money-market funds, they were thereby obliged to seek higher profits to cover the costs of their new interest expenses, which led them to make riskier loans.[115] This is an odd argument because changes in input costs should not affect the pursuit of profit: profit-maximizing firms attempt to increase profits when and where they can, regardless of whether their costs are rising, falling, or standing still.[116] Put another way, it is arbitrary to assume that when bank deposits were subject to price controls (with interest rates on checking accounts fixed at zero and those on savings accounts fixed at rates lower than market rates—effectively a monopsony cartel), banks realized the cartel profits in the form of less-risky loans rather than higher returns to owners.[117] Commercial banks did indeed make

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[115] See Posner, note 111 above, *Failure of Capitalism* at 22-23, 130-131, and *Crisis of Capitalist Democracy* at 261–264.

[116] For some empirical evidence on the point, see George J. Benston, "Interest Payments on Demand Deposits and Bank Investment," 72 *Journal of Political Economy* 431 (Oct. 1964); cf. R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," Federal Reserve Bank of St. Louis (Feb. 1986).

[117] One is reminded of John R. Hicks's observation that "the best of all monopoly profits is a quiet life" (and "quiet life" could be translated to "bankers' hours"). But Hicks's dictum is best understood as a propensity of the monopolist *whose pecuniary monopoly returns are limited* so that he substitutes non-pecuniary returns. See Armen A. Alchian and Reuben A. Kessel, "Competition, Monopoly, and the Pursuit of Pecuniary Gain," in National Bureau of Economic Research, *Aspects of*

increasingly risky loans in the years following interest-rate decontrol, but this was because their traditional customers, business borrowers, were finding less costly ways to borrow, and the banks' next alternative was real estate lending (residential and commercial, both directly and through MBSs and other securities). But real estate loans, although for longer time periods than the business loans they replaced, were not generally regarded as highly risky. They were revealed to be so only when the housing bubble burst (and commercial real estate values plummeted shortly afterwards). And the never-regulated money-market funds never made risky investments in the first place—they specialized in low-risk, very-short-term commercial paper.[118]

Most of the other deregulation arguments were variations on the rate-decontrol theme: abolishing interest-rate ceilings on consumer loans and restrictions on branch and interstate banking had led to greater competition among banks which in turn led to greater risk taking; investment banking was highly risky and profit-seeking from the start; the relaxation of Glass-Steagall restrictions permitted the high-rolling culture of investment banking to penetrate and undermine the prudence culture of commercial banks.[119] The arguments echoed those of the 1930s—that the bank failures of 1930–1933 had been the result of excess competition in the 1920s; it was this perception that had led to the various New Deal bank controls that were lifted in the 1980s and

Labor Economics (1962). So restricting banks' interest payments on deposits would lead to safer, lower-risk loans only if their profits were also controlled.

118 The money-market funds were victims, not perpetrators, of the financial collapse. In the panic following the Lehman Brothers collapse in September 2008, a run on money-market funds was imminent until the Treasury Department provided for temporary extension of deposit insurance to the funds.

119 Many of the deregulation arguments in the media assumed or asserted that the Gramm-Leach-Bliley Act had permitted commercial banks to engage in securities trading and other investment banking activities. That was incorrect—as former President Clinton, who had signed the statute, was among the first to point out. See Maria Bartiromo, "Bill Clinton on the Banking Crisis, McCain and Hillary," *Bloomberg Businessweek*, Sept. 24, 2008. Peter Wallison, "Deregulation and the Financial Crisis: Another Urban Myth," *AEI Financial Services Outlook*, Oct. 2009, notes that the growth of the nonprime MBS market was accomplished primarily through contracting among independent firms, and that most of the firms that failed were not part of investment bank-commercial bank combinations. Krugman, Posner, and Stiglitz offer the milder "cultural transmission" argument in criticizing Gramm-Leach-Bliley.

1990s.[120] But we have better empirical evidence on the point today, and the evidence is that competition leads banks to make less risky rather than more risky loans, and to improve operating efficiency in ways that produce greater systemic stability.[121]

In retrospect, one may think that bankers in the years before 2008 were deluding themselves in thinking that it was not highly risky to replace short-term business loans with long-term mortgage loans and MBSs that were themselves highly leveraged (and some bankers did see the risks). There are several plausible explanations for the delusion: complacency about rising housing values, misapplication of economic theories about risk diversification, the reassurance of massive government participation in the MBS market, herd behavior reinforced by the belief that a general collapse would prompt a government rescue.[122] Deregulation of banking operations is not on the list: the subprime MBS mania was not inspired by the lifting of controls on interest rates, interstate banking, and the like, or by any loss of banks' market power.

To be sure, bank deregulation both accommodated and facilitated the growing scope, interconnection, and efficiency of financial markets, which made it possible for the MBS virus to spread further and faster than it otherwise would have and eventually to do vastly more harm. But this is not an argument for reversing the extensions of financial markets (which were for the most part highly beneficial) through re-abolition of price competition and interstate and branch banking. That would be like containing the risks of influenza pandemics by reregulat-

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[120] The perception was backwards. For example, "unit banking" under statutory prohibitions of branch banking in many states produced too little, not too much, competition, and contributed significantly to the fragility of the banking system and the bank failures of the early 1930s. Charles W. Calomiris plumbs these and other fallacies in the 1930s banking laws in "The Political Lessons of Depression Era Banking Reform," 26 *Oxford Review of Economic Policy* 540 (Autumn 2010).

[121] See Allen N. Berger, Leora F. Klapper, and Tima Turk-Ariss, "Bank Competition and Financial Stability," 35 *Journal of Financial Services Research* 99 (2009); Mark Carlson and Kris James Mitchener, "Branch Banking as a Device for Discipline: Competition and Bank Survivorship During the Great Depression," NBER Working Paper 12938, Feb. 2007, and "Branch Banking, Bank Competition, and Financial Stability, 38 *Journal of Money, Credit, and Banking* 1293 (Aug. 2006); and John H. Boyd and Gianni De Nicoló, "The Theory of Bank Risk Taking and Competition Revisited," 60 *Journal of Finance* 1329 (June 2005).

[122] See the discussion in Section IV of the text at note 92 above.

ing airlines, so as to suppress the reach and efficiency of air transportation. And despite the widespread acceptance of the deregulation explanation among politicians, journalists, and academics, essentially no one seriously proposed resuscitating the New Deal banking controls; in Washington, the calls were instead for new forms of regulation that were unrelated to the idea that deregulation had caused the collapse.[123]

The deregulation argument did touch on one policy directly addressed to the excessive-risk problem: the regulation of bank capital. A bank's risk of insolvency (with possible systemic effects on others) depends in part on its assets—the degree of risk in its portfolio of loans and investments. But its risk also depends on its liabilities—in particular, the extent that it is financed by deposits and other fixed-rate borrowings as opposed to equity investments. Unlike creditors, equity investors (shareholders) have no fixed claims: they receive any excess of revenues over fixed expenses but absorb any loss (up to the total value of their equity) if revenues fall short of expenses. So the greater a bank's equity in proportion to its assets, the greater the cushion between losses in its asset portfolio and losses to creditors and to "interconnected" parties that depend on its business. Greater equity is a therefore a direct protection against the systemic risks of excessively risky loans and investments.[124]

Modern commercial and investment banks prefer to be very thinly capitalized. They like their equity to be highly leveraged with debt—which increases both the equity profits when investment revenues exceed debt expenses ("upside risk") and also the equity losses when

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[123] The three academic proponents of the deregulation argument cited in note 111 above did however favor reimposing the Glass-Steagall separation of commercial and investment banking, although only Stiglitz was emphatic (*Freefall* at 163–164) and Posner, after considering the question at length, said only that the idea "merits very serious consideration" (*Crisis of Capitalist Democracy* at 356–360, 358). Posner, whose articulation of the deregulation argument was the most thorough and detailed of the three, concluded that full reregulation of commercial banking, and the extension of similar controls to shadow banking, would present "profound and intractable issues"; he instead suggested more targeted (and highly sensible) policy reforms (*Failure of Capitalism* at 288–303 and *Crisis of Capitalist Democracy* at 335–362).

[124] Indeed the finding of Berger et al., at note 121 above, at 109–113, is that banks with greater market power tend to have riskier loan portfolios but to compensate for the risk by having more equity in their capital structures.

revenues fall short ("downside risk"). Banks may prefer higher risk because, as the deregulation argument posits, the financial system involves systemic downside risks that individual banks are not charged for and therefore ignore. But several government policies also promote leverage—indirectly, as an unintended consequence of promoting other goals. Deposits in commercial banks are insured by the Federal Deposit Insurance Corporation at premiums, paid by banks, which are well below actuarial cost; that subsidizes banks' cost of deposits and increases the advantages of leverage.[125] The "too big to fail" phenomenon—the expectation, grounded in long experience, that the government will rescue the creditors of large insolvent financial institutions—provides a further leverage subsidy for many investment and other shadow banks as well as commercial banks. And the tax deductibility of interest on loans (but not dividends on equity) works in the same direction for everyone.

These factors appear to have had a powerful effect on modern finance: during the past century, reported ratios of assets to capital (the standard measure of leverage) for commercial banks have grown from 4:1 and lower to 10:1 and higher; and those for large investment banks were typically higher than 30:1 at the time of the financial crisis.[126] So little equity relative to investment assets explains why returns on equity were so high in the financial sector in the heady years preceding the collapse—and why, when MBS investments soured, losses of only a few percent of investment portfolios led to the sudden insolvency of so many prominent firms. Regardless of whether the banks' incentives for excessive leverage were due to factors inherent to finance or to the influence of public policies, it was the responsibility of bank regulators to offset those incentives by requiring the greater equity capital necessary for financial stability.

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125 An excellent account of the economic structure of federal deposit insurance is George G. Pennacchi, "Deposit Insurance," paper prepared for a conference on Private Markets and Public Insurance Programs, American Enterprise Institute, Jan. 2009.

126 Niall Ferguson, "The Descent of Finance," *Harvard Business Review* (July-Aug. 2009) at 3–4. "Assets-to-capital" ratios include forms of capital other than equity (such as subordinated debt), so "assets-to-equity" ratios would be even higher.

Yet the federal government *relaxed* its capital standards in the years leading to the crisis of 2008. We noted in Section IV that the commercial bank regulatory agencies liberalized capital requirements for investments in private-label MBS securities in 2001. Then, in 2004, the SEC revised its net capital rules in ways that permitted the largest investment banks to significantly increase their leverage—a misstep noted by proponents of the deregulation argument and many others.[127] These actions were followed by substantial increases in leverage and MBS exposure.[128] One may quibble over whether they were acts of "deregulation," prompted by undiscriminating free-market ideology, as opposed to earnest but benighted efforts to micromanage bank capital.[129] In either event they were deregulatory in the sense that their effect was to give private firms greater managerial leeway, and unfortunate in that they gave greater leeway to exploit the abundant public subsidies of higher bank leverage.

We need not decide whether the somewhat lower bank leverage prior to the 2001 and 2004 relaxations of capital standards would have been sufficient to prevent the financial collapse of 2008. Certainly *some* increase in bank's equity capital would have done so by absorbing the losses on MBS investments within the institutions that held them. So it seriously distracts from the importance of bank capital to lump it together, as one alternative means of countering excessive leverage, with the regulation of pricing, branching, and other incidents of business competition. Would one address the pollution externality by restricting business competition, on grounds that firms with market power restrict output and therefore pollution? The solution to pollution is pollution controls and the solution to inadequate capital is capital controls. If inadequate capital is the result of risk externalities that are intrinsic to financial markets, then the analogy with pollution is complete. If it is a byproduct of other government policies that are politically embedded and cannot be reformed directly, then capitol

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127 See the astute essay of John C. Coffee Jr., "Analyzing the Credit Crisis: Was the SEC Missing in Action?" *New York Law Journal* (Dec. 5, 2008).

128 As documented in Friedman and Kraus, note 85 above, and in Coffee, note 127 above.

129 Posner and Stiglitz take the former position, Friedman-Kraus and Coffee the latter.

controls are a second-best solution. But actually better than second best. Adequate capital would not only compensate for the leverage subsidy of deposit insurance but also *substitute* for deposit insurance, at least in part, as a means of preventing bank runs. It would not only compensate for the leverage subsidy of prospective government bailouts but *reduce* that subsidy by reducing the likelihood of systemic financial crises. Sufficiently robust capital standards could thereby increase the political feasibility of reforming deposit insurance and too-big-to-fail policies.

To be sure, capital regulation involves problems similar to those that plague other kinds of regulation (discussed in Section I). The overarching problem, analogous to that of calibrating pollution emissions standards, is determining the equity level that correctly internalizes systemic risks. But this problem is hypothetical for the time being, because it is likely that bank equity should be *much* higher than it currently is and that the economic costs of much higher equity would be small.[130] The problem of compensating adjustments presents more immediate issues. Capital standards create incentives for firms to engage in "regulatory arbitrage" transactions with other institutions with lower standards, and to place highly leveraged investment projects into special accounts poorly revealed (or not at all) on their balance sheets. Maneuvers such as these were widely in use in the years before the financial collapse, even when capital standards were already lax[131]; but the collapse has prompted many straightforward proposals for greater uniformity and simplicity in capital standards and greater transparency and disclosure in financial accounting. More serious is the problem of perverse managerial incentives within highly capitalized

[130] These are the findings of David Miles, Jing Yang, and Gilberto Marcheggiano, "Optimal Bank Capital," Bank of England, External MPC Unit, Discussion Paper No. 31 (revised and expanded version Apr. 2011); and Anat R. Admati, Peter M. DeMarzo, Martin R. Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," Working Paper No. 86, Rock Center for Corporate Governance, Stanford University, Mar. 18, 2011. These studies suggest that the ratio of unweighted assets to equity capital should be at most 5:1, which is much lower than anything being officially contemplated as a corrective to the 2008 financial collapse (for example in the "Basil III" global regulatory standards).

[131] Niall Ferguson reports that, in Sept. 2008, Bank of America had a reported assets-to-capital ratio of 73.7:1, but that inclusion of off-balance-sheet commitments raised the ratio to 134:1. See note 126 above at 4.

banks whose shares are publically traded. Substituting dispersed equity for fixed-obligation debt could reduce incentives for zealous management, or increase incentives for making risky investments, or both. The measurement of assets-to-capital ratios could become problematic in bad times as stock prices fall, and create incentives for manipulating earnings reports and for postponing rather than accelerating equity replenishment and other corrective measures. These problems argue for beefing up bank capital with a mix of common equity and "contingent convertible debt"—fixed-obligation debt that converts automatically to equity when the market value of outstanding equity declines to a certain level. Such a capital structure would preserve the management discipline of significant fixed debt obligations and create strong incentives for managers to issue additional equity on their own when stock prices fell toward the target level.[132]

In sum, the problems of bank capital regulation are relatively tractable. Unlike controls on prices and other incidents of business competition, capital standards can align managers' incentives with rather than against regulatory goals.[133] And they would render superfluous many other, far more problematic financial stability programs, such as the highly discretionary and almost certainly perverse "systematic risk regulation" program established by the Dodd-Frank Act.

The most serious deficiency of the deregulation argument was its neglect—or pooh-poohing—of the government's manifold contributions to the nonprime mortgage fiasco through Fannie Mae, Freddie Mac, the Community Reinvestment Act, and other means.[134] It was,

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[132] The substantial literature on the design and incentive properties of contingent convertible debt instruments is reviewed and extended in Charles W. Calomiris and Richard J. Herring, "Why and How to Design a Contingent Convertible Debt Requirement," Wharton Financial Institutions Working Paper 11-41, Apr. 2011; cf. Shadow Financial Regulatory Committee, "The Case for a Properly Structured Contingent Capital Requirement," Shadow Statement No. 303, Dec. 13, 2010. Further variations on the much-higher-equity idea are proposals that equity requirements increase with the size and complexity of financial institutions and/or during periods of economic expansion; see Charles W. Calomiris, "Financial Innovation, Regulation, and Reform, 29:1 *Cato Journal* 65, 79–84 (Winter 2009).

[133] See Calomiris, "An Incentive-Robust Program for Financial Reform," note 105 above.

[134] Krugman (note 111 above, *Return of Depression* Economics at 162), Posner (note 111 above, *Failure of Capitalism* at 214–242 and *Crisis of Capitalist Democracy* at 255–

indubitably, the existence of a large quantity of nonprime mortgages and MBSs in the asset portfolios of major financial institutions that transformed a precipitous fall in housing values into a multiple precipitate insolvencies (or near insolvencies) among those institutions. And the nonprime mortgage was a government project. The abolition of down-payment, income-documentation, good-credit-history, and other mortgage requirements was sponsored by government and government-backed agencies through targeted regulations and massive market participation. Those actions propelled nonprime mortgages to $4.6 trillion in loans—half the U.S. mortgage market—in a matter of about fifteen years.

To say that private firms seized the government initiatives with alacrity, and profited handsomely from them for the time being, is not to gainsay the central fact: that the degradation of mortgage standards would not have occurred without government sponsorship. Banks were also providing credit to individuals of modest means and credit records in other fields such as automobile financing and credit cards, and were packaging and selling that credit through derivative securities similar to MBSs. In those markets, banks employed effective risk-management techniques, avoided the lackadaisical habits of the nonprime mortgage market, and encountered nothing like the MBS market collapse of 2008, even in the hard economic times following that collapse.[135] That was

257), and Stiglitz (note 111 above, *Freefall* at 9–10) all single out Fannie, Freddie, and the CRA as "conservative" obsessions that had little or nothing to do with the financial collapse. All three got important particulars wrong (not understanding Fannie and Freddie's promotion of nonprime lending and massive purchases of private-label MBSs), perhaps because they were mislead by Fannie/Freddie's obfuscated accounting or were unaware of the research by Pinto described in Section IV of this paper; but the vehemence and political cast of their dismissals is nonetheless remarkable. On Krugman's arguments absolving Fannie and Freddie, see Raghuram Rajan, "Many Are the Errors," *The American,* Sept. 19, 2010.

135 Credit-card credit, amounting to nearly $1 trillion in 2008, is inherently risky. It is unsecured, is offered with limited initial documentation to many people of modest means, is repaid largely at the discretion of the cardholder, and is widely dispersed through MBS-like derivative securities. But the government does not promote easy credit cards, and card issuers and securitizers have developed methods for dealing with the risks they face, such as calibrating credit limits to payment histories and requiring cash collateral in derivative markets. In 2008 there were many predictions that a credit-card crash would follow the MBS crash (see for example Jessica Silver-Greenberg, "The Next Meltdown: Credit-Card Debt,"

also the experience of the residential mortgage market before the government campaign began in the early 1990s (when some banks were experimenting with mortgage loans to individuals with little credit history—but with traditional down-payment requirements[136]) and of the commercial real estate market when, beginning in 2008, property values fell as steeply as in residential real estate.[137] Not that those markets were free of mistakes and losses, sometimes big ones. But of all of the credit markets that featured complex derivative instruments, credit-default swaps and similar insurance arrangements, reliance on credit-rating agencies, and highly leveraged, elaborately interconnected banks operating under similar regulatory regimes in the identical very-low interest-rate environment, the only one that was pathological—embracing ruinous risks—was the residential mortgage market.

It is a fair conclusion that the government's easy-homeownership policies, in league with the Federal Reserve's easy-money policies, were the sine qua nons of the financial crisis (which was then magnified by the Bush administration's responses).[138] But one need not accept this conclusion to see that the deregulation explanation is singularly inapt. By no stretch of the record did the government leave the financial markets to themselves, whereupon they spontaneously developed market failures and excesses that spawned the collapse. To the contrary, it purposefully intervened in those markets and used their power to promote noneconomic, political ends while evading fiscal accountabil-

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Business Week, Oct. 9, 2008. It didn't happen. Credit-card payment delinquencies and defaults climbed to very high levels in 2009 and 2010, but the losses were absorbed and the derivative markets continued to function, and payment rates began to improve in late 2010 and 2011. The experience in automobile loan and commercial real estate markets was similar.

136 See Pinto, "Forensic Study," note 70 above at 41–44.

137 See Alex J. Pollock, "It Wasn't a Bubble—It Was a Double Bubble," *The American*, Sept. 12, 2009.

138 This view is similar to those set forth in Peter J. Wallison's exhaustive Dissent from the Majority Report of the Financial Crisis Inquiry Commission (2011); Viral V. Acharya, Matthew Richardson, Stijn van Nieuwerburgh, and Lawrence J. White, *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance* (2011); Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (2010); Thomas Sowell, *The Housing Boom and Bust* (revised edition 2009); and John B. Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (2009).

ity. Financial leverage was a key component of this strategy: the government did not permit leverage to grow out of neglect or free-market ideology, but rather promoted it throughout the system, both in bank capital standards and in mortgage standards. Although it is possible that the striving, sprawling, interconnected markets made possible by bank deregulation feature serious "risk externalities" calling for government countermeasures, we cannot know this because these are not the markets we have had. Instead we have had financial markets suffused with the understanding that the government was underwriting risk and would cover systemic failures.

The most unfortunate consequence of the deregulation argument was that it suggested financial markets had gone awry because of an excess of private market ordering and an insufficiency of collective, political ordering. So the government needed to act. Which it did, in the form of the Dodd-Frank Act of 2010—a statute reflecting the same political impulses that fashioned pre-collapse financial policies, and seemed likely to further amplify government-induced systematic risk.

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