

MIXED AGENDAS AND GOVERNMENT REGULATION OF BUSINESS: CAN WE CLEAN UP THE MESS?

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I. INTRODUCTION

The history of regulation in the U.S. economy shows a cumulative growth of government involvement in private enterprise that has helped business at times and has been at odds with business at other times.¹ The wavering views on how much regulation is warranted change over time and cut across political and philosophical ideologies.² For example, in the first two years of President Barack Obama's administration there was a push for new and large increases in regulation of healthcare and financial markets along with intervention into public markets with massive spending to bailout automakers³ and financial institutions.⁴ Now, in the second half of the Obama term we are seeing a call

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1. Government regulation of business has a constitutional framework at both the federal and state level. Mark C. Christie, *Economic Regulation in the United States: The Constitutional Framework*, 40 U. RICH. L. REV. 949, 959, 972-79 (2006).

2. For example, deregulation of business in the late nineteenth century led to President Theodore Roosevelt's trust busting in the Progressive Era from 1901 to 1909. John Wyzalek, *Government Regulation of Business*, in 4 DICTIONARY OF AMERICAN HISTORY 25, 26 (3d ed. 2003). Deregulation then became common in the "Roaring Twenties," followed by aggressive regulation and intervention under President Franklin Roosevelt in the New Deal period following the Great Depression. *Id.* at 27. Deregulation returned in the 1950s, followed by increased regulation throughout the 1960s and 1970s. *Id.* Finally, a wave of deregulation began in the 1980s along with an economic boom. *Id.*

3. Brady Dennis, *President Obama Plans To Pitch Reform on Wall Street*, WASH. POST, Sept. 14, 2009, at A1.

4. Jim Puzzanghera & Janet Hook, *Obama Presses for Showdown on Financial Reform*, L.A. TIMES, Apr. 20, 2010, at A1.

for regulatory review with an eye on reducing regulatory burdens on economic growth and job creation.⁵

The purpose of this article is first to navigate through various perspectives on government regulation in an effort to develop a reasonable and consistent view for regulatory proposals. Parts II and III of this article provide a brief outline of our current regulatory environment and its evolution. Part IV presents arguments for an efficient regulation of business by using market based regulation with a separation of efficiency and equity issues, where feasible. Examples of this regulatory approach appear throughout the article along with suggested reforms.

II. THE EVOLVING HISTORY OF BUSINESS REGULATION IN THE U.S. ECONOMY

A. *Colonial Period*

Government regulation of business in the United States existed well before the American Revolution. The British Parliament passed laws, such as the Navigation Act of 1651, to regulate trade both with the colonies and within the colonies.⁶ While these acts benefitted England, they were not enforced until 1764 when the British Parliament decided to finance its war debts by imposing revenue generating acts on the colonies.⁷ The Currency Act of 1764, the Stamp Act of 1765, and the Townshend Acts of 1767 were all designed to raise money by regulating the economic activities of the colonies.⁸ Freedom from excessive government regu-

5. In his State of the Union Address on January 18, 2011, President Obama ordered a review of federal regulations with an eye toward getting rid of regulations that hurt job creation and economic growth. 112 CONG. REC. H457, 460 (daily ed. Jan. 25, 2011) (statement of Pres. Barack Obama). In a Wall Street Journal opinion column, the President noted that the review will help straighten out the current patchwork of overlapping rules and allow more transparent cost-benefit analysis of regulation. Barack Obama, Op-Ed., *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17.

6. An Act for Increase of Shipping and Encouragement of the Navigation of This Nation, (1651) 11 ACTS & ORDS. INTERREGNUM 559, 559-62 (Eng.); see LAWRENCE A. HARPER, THE ENGLISH NAVIGATION LAWS: A SEVENTEENTH-CENTURY EXPERIMENT IN SOCIAL ENGINEERING, at ix-x (Octagon Books 1964) (1939).

7. Wyzalek, *supra* note 2, at 25.

8. Stamp Act, 1765, 5 Geo. 3, c. 12 (Eng.); Currency Act, 1764, 4 Geo. 3, c. 34 (Eng.); Revenue Act, 1767, 7 Geo. 3, c. 46 (Eng.); see also GARY B. NASH, THE URBAN CRUCIBLE: THE NORTHERN SEAPORTS AND THE ORIGINS OF THE AMERICAN REVOLUTION 162 (1986); Wyzalek, *supra* note 2, at 25.

lation played a significant role in the American Revolution, but replacement of the British Parliament by the Articles of Confederation soon made it clear that responsive and effective regulation of commerce was both necessary and controversial.⁹

B. *Regulation in the Nineteenth Century—Building the Economy*

At the start of the nineteenth century the federal government promoted business by backing a uniform national currency, securing the legal status of contracts and private property, creating tariff policies, providing a system of due process of law, providing national defense, and making land gifts.¹⁰ States also “actively began to promote business.”¹¹ Incorporation was relatively easy and state courts gave corporations the benefit of limited liability.¹² “With its 1824 decision in *Gibbons v. Ogden*, the Supreme Court strengthened the federal government’s power to regulate interstate [b]y giving Congress the sole authority to regulate interstate transportation.”¹³ This landmark case cleared the way for a national transportation system that was critical to business development.

9. ROBERT SINGH, *AMERICAN GOVERNMENT & POLITICS* 27 (2003) (“Without the power to regulate interstate commerce or to levy taxes the national government found itself unable to provide for its citizens or pay its war debts.”). Shay’s Rebellion in 1786-1787 illustrated the inability of the Articles of Confederation to provide a government strong enough to maintain an orderly society. Paul Finkelman, “A Well Regulated Militia”: *The Second Amendment in Historical Perspective*, 76 CHI-KENT L. REV. 195, 195–96 (2000). In general, Americans realized that stronger powers were needed to raise taxes, establish a judicial system, empower executive agencies, and regulate commerce. Wyzalek, *supra* note 2, at 25–26. See generally Jack N. Rakove, *The Collapse of the Articles of Confederation*, in *AMERICAN FOUNDING: ESSAYS ON THE FORMATION OF THE CONSTITUTION* 225 (1988) (discussing the historical establishment of the Constitution in 1789).

10. Wyzalek, *supra* note 2, at 25–26.

11. *Id.*

12. *Id.* In *Dartmouth College v. Woodward*, the Supreme Court of the United States limited the power of states to interfere with private charters, including those of commercial enterprises. 17 U.S. (1 Wheat.) 518, 656–57, 659, 661–62, 666 (1819).

13. Wyzalek, *supra* note 2, at 26; *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 196–97 (1824) (holding that the power to regulate commerce is vested solely in Congress).

1. Regulation as an Anticompetitive Tool

By 1860, business regulation was used more often to prevent competition than to promote free markets.¹⁴ As travel from state to state became easier, state regulations to protect the interests of local businesses became common.¹⁵ State licensing laws protected local businesses by preventing out-of-state doctors, lawyers, barbers, and tradesmen from practicing across state lines.¹⁶ Following the Civil War, the federal government gained increased power to regulate business based on the Commerce Clause and police powers granted in the Constitution. In 1877, the Supreme Court upheld the use of states' police power to regulate business in *Munn v. Illinois*.¹⁷ Nevertheless, the Supreme Court often used the Due Process Clause of the Fourteenth Amendment to strike down state laws regulating business.¹⁸ Due process with respect to property required judicial review of the substance of law, which decreased the effectiveness of state regulation of national business. Business thrived in this new regulatory environment as the United States became an industrial giant. The Interstate Commerce Act created the Interstate Commerce Commission ("ICC") to regulate railroads and transportation.¹⁹ By the end of the nineteenth century, the ICC evolved into a protective regulatory agent for railroads, promoting the growing power of big business.²⁰

14. A classic example is the creation of the Interstate Commerce Commission to protect railroads. See, e.g., MILTON FRIEDMAN & ROSE FRIEDMAN, *FREE TO CHOOSE: A PERSONAL STATEMENT* 194–97 (1980); RICHARD D. STONE, *THE INTERSTATE COMMERCE COMMISSION AND THE RAILROAD INDUSTRY* 5–7 (1991).

15. Wyzalek, *supra* note 2, at 26.

16. *Id.*

17. See 94 U.S. 113, 135 (1877).

18. See, e.g., *Lochner v. New York*, 198 U.S. 45, 63–64 (1905).

19. Interstate Commerce Act of 1887, ch. 104, 24 Stat. 379, 383 (1887). The Act was the first federal law to regulate private industry in the United States. See Paul Stephen Dempsey, *Rate Regulation and Antitrust Immunity in Transportation: The Genesis and Evolution of this Endangered Species*, 32 AM. U. L. REV. 335, 336 (1983).

20. STONE, *supra* note 14, at 8–9.

2. Trusts and Holding Companies

Business entities concentrated wealth and power in the 1880s through the creation of trusts.²¹ While there are arguments to justify trusts on the basis of economies of scale and access to capital, the key purpose of a trust soon became limiting competition.²² Trusts were monopolies that prevented competition, extracted monopoly rents, exploited labor, and controlled prices.²³ The success of trusts and holding companies such as Standard Oil soon led to a long list of trusts exercising monopoly power in product markets under the protection of the legal trust structure.²⁴ The Sherman Act of 1890 aimed to promote competition by breaking up trusts.²⁵ Initially, the law was not enforced effectively due to decisions of the Supreme Court such as *United States v. E.C. Knight Co.*, in which the Court deemed the power of the federal government to regulate interstate commerce an insufficient cause for breaking up a trust.²⁶

C. *Business and Anti-Business Sentiment in the Twentieth Century*

1. Enforcing the Sherman Act—Creating Competitive Markets

One turning point in the history of regulation took place early in the 1900s as the Progressive movement sought to use business regulation as a mechanism for larger social reform. Progressives helped elect Theodore Roosevelt as president in 1904.²⁷ The agen-

21. HANS B. THORELLI, *THE FEDERAL ANTITRUST POLICY: ORIGINATION OF AN AMERICAN TRADITION* 71–76 (1954).

22. *Id.* at 71.

23. *See id.* at 147, 161.

24. *Id.* at 76, 78.

25. Sherman Antitrust Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1–4 (2006)). The Sherman Act of 1890 requires the United States federal government to investigate and prosecute trusts, companies, and organizations suspected of violating the Act. 15 U.S.C. § 4. It was the first federal statute to limit cartels and monopolies and continues to form the basis for most antitrust litigation by the federal government. THORELLI, *supra* note 21, at 166; Meredith E.B. Bell & Elena Laskin, *Antitrust Violations*, 36 AM. CRIM. L. REV. 357, 382 (1999).

26. *See* 156 U.S. 1, 12, 16–17 (1895) (holding that manufacturing was not interstate commerce).

27. *See* MICHAEL MCGERR, *A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA, 1870–1920*, at 155–59, 169 (2003).

da for regulation of business then clearly shifted to a position of hostility toward big business.²⁸ Following the Civil War, business concentration through trusts and holding companies led to abuses and excess that provided easy targets for regulation.²⁹ Holding companies were legalized structures in a number of states, including New Jersey and Delaware.³⁰ The Supreme Court upheld the authority of the Sherman Act in the breakup of the Northern Securities Company in 1904.³¹ With this precedent, Standard Oil and American Tobacco were dissolved in 1911 on the basis that they placed unreasonable restraints on trade.³²

2. The Clayton Act—Controlling Anticompetitive Methods of Competition

Victories under the Sherman Act were important in shaping more competitive business structures, but less obvious restraints of trade continued. In 1914, Congress passed the Clayton Act to strengthen control over business practices and to prevent “unfair” methods of competition.³³ The Federal Trade Commission was created to enforce the legislation.³⁴ Now, regulations attacked anticompetitive conditions due to either a concentrated market structure or unfair practices.³⁵ The notion of a free market meant a regulated market where competitors were free of unfair practices and disadvantages linked to market concentration.³⁶ The concept of “market failure” emerged as outcomes from unregulated

28. *Id.* at 153.

29. See THORELLI, *supra* note 21, at 161.

30. JAMES C. BONBRIGHT & GARDINER C. MEANS, *THE HOLDING COMPANY: ITS PUBLIC SIGNIFICANCE AND ITS REGULATION* 56–57 (1932). Early holding companies had charters granted by state legislatures that explicitly permitted controlling stock of other corporations. *Id.* Holding companies grew as some states like New Jersey, and later Delaware, offered favorable tax treatment. Ajay K. Mehrotra, *Mergers, Taxes, and Historical Materialism*, 83 *IND. L.J.* 881, 898, 905–06 (2008).

31. *United States v. N. Sec. Co.*, 193 U.S. 197, 357, 357–58 (1904).

32. *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1, 45, 79 (1911); *United States v. Am. Tobacco Co.*, 221 U.S. 106, 184, 187 (1911).

33. Clayton Act, ch. 323, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12-27, 29 U.S.C. §§ 52-53 (2006)).

34. 15 U.S.C. § 21; Wyzalek, *supra* note 2, at 27.

35. 15 U.S.C. §§ 12-27; 29 U.S.C. §§ 52-53.

36. Elbert L. Robertson, *A Corrective Justice Theory of Antitrust Regulation*, 49 *CATH. U. L. REV.* 741, 752–53, 766 (2000).

markets deviated from the ideal world of perfect competition and full pricing of all production costs.³⁷

For every regulatory action there tends to be a market reaction. Competition in the Sherman and Clayton Acts is generally defined along a single line of business and a domestic market.³⁸ Big business reacted to this regulatory environment by creating conglomerates across business lines and industries without heavy concentration in a single line of business.³⁹ Conglomerates existed before World War II, but they became increasingly popular during the late 1950s and early 1960s as a means of growth that would not elicit antitrust scrutiny.⁴⁰ While there was some interest in expanding antitrust laws to regulate conglomerates in the late 1960s and 1970s, the trend toward conglomerates ended in the 1980s and 1990s when large diverse firms became too complex to manage effectively.⁴¹ While the view was not universal, the law generally did not view big business as bad per se, as long as product markets remained competitive and business practices were fair.⁴² Still, elements of a bias against business remained in effect in the tax laws, much as it does today. For example, the in-

37. Francis M. Bator, *The Anatomy of Market Failure*, 72 Q.J. ECON. 351, 351 (1958).

38. See *Am. Tobacco Co. v. United States*, 328 U.S. 781, 797-98 (1946) (utilizing the domestic market share of the corporation in a single industry to determine whether or not a monopoly or conspiracy to monopolize the industry existed for purposes of proving a violation of the Sherman Act); *United States v. Grinnell Corp.*, 384 U.S. 563, 573, 588 (1966) (stating that there should be no differentiation between defining the competitive market under § 7 of the Clayton Act and § 2 of the Sherman Act).

39. Carlos D. Ramirez, *The Clayton Act*, in 2 THE ENCYCLOPEDIA OF PUBLIC CHOICE 75, 77 (2004); Wyzalek, *supra* note 2, at 27.

40. See Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 165 (1999) (discussing the use of vertically integrated conglomerates after the Civil War as a means of controlling other corporations); John T. Miller, Jr., *Conglomerates, Conglomerate Mergers and the Federal Antitrust Laws*, 44 ST. JOHN'S L. REV. 613, 614-15 (1970) (discussing the use of conglomerates during the 1960s and 1970s to avoid antitrust scrutiny); William J. Kolasky, Deputy Assistant Attorney General, U.S. Dep't of Justice, Address Before the George Mason University Symposium: Conglomerate Mergers and Range Effects: It's a Long Way from Chicago to Brussels (Nov. 9, 2001), available at <http://www.justice.gov/atr/public/speeches/9536.pdf> (discussing the use of conglomerate mergers to avoid antitrust scrutiny).

41. See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 905 (1992). In the late 1960s the Attorney General took an aggressive approach to applying antitrust law to conglomerates. *Antitrust: Scourge of the Conglomerates*, TIME, May 23, 1969, at 100. Today there is little interest in conglomerate mergers unless they represent a merger of potential competitors. See, e.g., *United States v. SBC Commc'ns Inc.*, 142 F. Supp. 2d 26, 31 (D.D.C. 2000).

42. See, e.g., 15 U.S.C. § 13(a) (2006).

terest paid to debt holders of a corporation is tax deductible,⁴³ while corporate income is taxed at a corporate rate⁴⁴ and then again at the shareholder's tax rate on dividends.⁴⁵ This bias leads to increased use of leverage, which makes markets riskier.⁴⁶

3. Social Issues Linked to Regulating Business

The regulation of business took another important turn at the start of the twentieth century. The need to "protect the public" became a prime justification for additional regulation of business standards and practices.⁴⁷ Social activists took a larger view of business responsibilities to include public health and safety concerns.⁴⁸ The common phrase "buyer beware" was sufficient warning if the producer and consumer had equal and adequate information.⁴⁹ But, consumers seldom have adequate information to protect themselves from many business practices. For example, Upton Sinclair's book, *The Jungle*, exposed unsanitary conditions in the meatpacking industry, arousing public support for greater regulation of business practices.⁵⁰ The Pure Food and Drug Act of 1906 provided the legal structure for regulating product standards⁵¹ and Congress continued to strengthen these regulations over most of the twentieth century.⁵²

Social activists had a harder time gaining regulation of child labor and various forms of labor practices that were deemed unfair. The Supreme Court failed to support child labor laws passed

43. I.R.C. § 163 (2010).

44. I.R.C. § 11.

45. I.R.C. §§ 61, 301, 316.

46. See, e.g., David Leonhardt, *Heading Off the Next Financial Crisis*, N.Y. TIMES MAG., Mar. 28, 2010, at 36, available at <http://www.nytimes.com/2010/03/28/magazine/28Reform-t.html>.

47. See, e.g., Pure Food and Drug Act, ch. 3915, 34 Stat. 768 (1906) (codified as amended in scattered sections of 21 U.S.C.).

48. See *id.*

49. See, e.g., *Pine River Logging Co. v. United States*, 186 U.S. 279, 293–94 (1902).

50. UPTON SINCLAIR, *THE JUNGLE* 39, 131–32 (1906). Upton Sinclair was part of a famous "muckraking" group seeking social change during the early part of the twentieth century. Erik Ugland, *Demarcating the Right to Gather News: A Sequential Interpretation of the First Amendment*, 3 DUKE J. CONST. L. & PUB. POL'Y 113, 176 (2008).

51. Pure Food and Drug Act, ch. 3915.

52. E.g., Food Quality Protection Act of 1996, Pub. L. No. 104-170, 110 Stat. 1489 (codified as amended at 7 U.S.C. § 136 (2006)); Wholesome Meat Act of 1967, Pub. L. No. 90-201, 81 Stat. 584 (codified as amended at 21 U.S.C. § 671 (2006)).

by Congress from 1913 to 1935 on the grounds that direct controls of state and local commerce were beyond the powers of Congress.⁵³ It was not until 1941 that the Supreme Court upheld the Fair Labor Standards Act of 1938, which regulated child labor and provided worker protection.⁵⁴

The progressive movement for increased regulation of business and direct intervention in the economy gained momentum during the administration of Franklin D. Roosevelt.⁵⁵ New Deal legislation was in part a reaction to the stock market crash of 1929 and the subsequent depression.⁵⁶ Poor macroeconomic performance was now added to the list of market failures, allowing another opening for government intervention.⁵⁷ New Deal legislation was extensive, and court battles were inevitable as a new and larger role of government pushed the boundaries of the U.S. Constitution.⁵⁸ Government regulation made important inroads in banking and securities markets, while expanded government programs and agencies sought to jump-start the economy through direct spending.⁵⁹

53. See *Morehead v. New York ex rel. Tipaldo*, 298 U.S. 587, 618 (1936); *Adkins v. Children's Hospital*, 261 U.S. 525, 561–62 (1923); *Hammer v. Dagenhart*, 247 U.S. 251, 276–77 (1918). Thus, the Supreme Court was one of the major obstacles to wage-hour and child-labor laws prior to the Fair Labor Standards Act of 1938.

54. Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended at 29 U.S.C. §§ 201, 202, 212 (2006)); *United States v. Darby*, 312 U.S. 100, 108, 125 (1941).

55. See Patrick M. Garry, *The Unannounced Revolution: How the Court Has Indirectly Effected a Shift in the Separation of Powers*, 57 ALA. L. REV. 689, 699–700 (2006).

56. *Id.* at 699.

57. *Id.*

58. See, e.g., *W. Coast Hotel Co. v. Parrish*, 300 U.S. 379, 400 (1937) (discussing the validity of minimum wage laws for women); *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 550 (1935) (discussing the validity of wage and hours laws that applied to businesses engaged in intrastate commerce); see also BASIL ROUCH, *THE HISTORY OF THE NEW DEAL 1933–1938*, at 192 (2d ed. 1980) (explaining how the Supreme Court faced the task of determining the constitutionality of the new legislation); Achim Steiner, *Focusing on the Good or the Bad: What Can International Environmental Law Do To Accelerate the Transition Towards a Green Economy?*, 25 AM. U. INT'L L. REV. 843, 848–49 (2010) (discussing the wide ranging series of programs created by New Deal legislation).

59. ROUCH, *supra* note 58, at 71, 83. Some programs were declared unconstitutional and others were repealed during World War II. See, e.g., Labor-Federal Security Appropriation Act, ch. 475, 56 Stat. 562, 569 (1942) (repealing the Civil Service Corps during World War II). The New Deal had two stages. The first stage in 1933 dealt with groups that needed help to recover, such as banking, railroads, manufacturing, and farming. ROUCH, *supra* note 58, at 57, 61–62, 65–68, 72. The second stage from 1934 through 1936 addressed larger social issues including promotion of labor unions, relief programs, the Social Security Act, and fair labor standards. *Id.* at 156, 161.

The role of government intervention in the economy expanded to include the “spender of last resort” in the wake of the Great Depression, and both political parties slowly accepted the view that free markets were not self-correcting.⁶⁰ Nevertheless, the forms of government intervention remained controversial. The “tax and spend” approach to government intervention largely displaces private market investing and spending decisions in favor of government spending decisions.⁶¹ Government spending, not guided by relative prices and market signals, is designed to directly boost demand and creates a deficit as a byproduct.⁶² As a result, resource allocation takes place outside market signals and may not offer optimal job creation or growth.⁶³ To finance the deficit, the government then competes with the private sector for credit, crowding out private investment.⁶⁴ As a practical matter, there is also the concern that once a government program for spending is created, it is difficult to reverse course when the economy improves, ultimately leading to bigger and more inefficient government at the expense of the private sector.⁶⁵

Proponents of regulation tend to favor government intervention for structural issues, arguing that the economy will not self-correct due to fundamental market imbalances.⁶⁶ A more market-oriented form of macroeconomic intervention creates a climate for private spending and investing to allocate resources efficiently to the greatest needs.⁶⁷ Rather than large and direct government

60. INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK APRIL 2009: CRISIS AND RECOVERY 126 (2009), available at www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf. It is reported that even Republican Richard Nixon once proclaimed that “we are all Keynesians now.” “We Are All Keynesians Now”, TIME, Dec. 31, 1965, at 64.

61. Roger W. Spencer & William P. Yohe, *The “Crowding Out” of Private Expenditures by Fiscal Policy Actions*, FED. RES. BANK OF ST. LOUIS REV., Oct. 1970, at 12, 12–21, available at http://research.stlouisfed.org/publications/review/70/10/Expenditures_Oct1970.pdf.

62. See WILLIAM J. BAUMOL, ROBERT E. LITAN & CARL J. SCHRAMM, GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY 36–37 (2007).

63. See Benjamin A. Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127, 1163–64 (2010). According to “Keynesian theory,” there is no strong automatic market mechanism to move output and employment toward full employment levels. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 25–26 (1936). This market failure can be addressed with increased government spending and/or lower tax policies to increase aggregate demand, resulting in increasing economic activity and reducing unemployment and deflation. *Id.* at 374–81.

64. Spencer & Yohe, *supra* note 61, at 13–14.

65. See Templin, *supra* note 63, at 1140.

66. *Id.* at 1149–50.

67. See Spencer & Yohe, *supra* note 61, at 15.

spending, regulations use market incentives through lower taxes and targeted spending to encourage investment consistent with a market solution to poor macroeconomic performance.⁶⁸

4. Growth of Government Agencies in Place of Judicial Review

The regulatory environment in the twentieth century evolved in another important way. The costs of regulation, uncertainty of regulation enforcement, and the time it takes to adjust to a regulatory change are all relevant to economic stability.⁶⁹ The early history of regulation introduced the cumbersome process of regulation by passing federal or state acts, and waiting for subsequent judicial interpretations, which might or might not enforce the regulation.⁷⁰ This approach was largely replaced by the use of administrative orders issued by commissions.⁷¹ A plethora of commissions and boards were created at both the state and federal levels to cover a wide range of business and labor activities.⁷² While there are exceptions, businesses prefer this change in the regulatory process because commissions tend to be staffed by people familiar with the needs of business.⁷³ Nobel laureate economist George Stigler advanced a “capture theory of regulation” where businesses seek regulation to limit competition and form friendly relationships with regulators.⁷⁴ Such regulation is not all bad from a public perspective. Regulators often come with work experience in the industries they regulate and understand the problems faced by business.⁷⁵ From a cost perspective, appearances before a commission lead to a quicker resolution of prob-

68. VICTOR A. CANTO, DOUGLAS H. JOINES & ARTHUR B. LAFFER, FOUNDATIONS OF SUPPLY-SIDE ECONOMICS: THEORY AND EVIDENCE 267–70 (1983).

69. See, e.g., Sal Iannuzzi, *Politics Is Hurting Certainty, Which Is Hurting Hiring*, FORBES.COM (Sept. 13, 2010, 7:30 PM), http://www.forbes.com/2010/09/13/job-growth-hiring-markets-economy-monster-worldwide_3.html.

70. See RICHARD H. K. VIETOR, CONTRIVED COMPETITION: REGULATION AND DEREGULATION IN AMERICA 3 (1994); Wyzalek, *supra* note 2, at 27.

71. See MARC ALLEN EISNER, REGULATORY POLITICS IN TRANSITION 42–44 (2d ed. 2000) (discussing the benefits of and motivation for creating commissions to administer regulations); Wyzalek, *supra* note 2, at 27.

72. See VIETOR, *supra* note 70, at 8–9, 16–17; Wyzalek, *supra* note 2, at 27.

73. EISNER, *supra* note 71, at 15–17; Wyzalek, *supra* note 2, at 27.

74. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI., Spring 1971, at 3, 5–6, 9–13.

75. EISNER, *supra* note 71, at 15–16.

lems with more attention to details than legal proceedings, which are much slower and more costly.⁷⁶

5. Regulatory Excess Leads to Deregulation

Events in the 1970s increased government regulation and intervention. A number of agencies were created to protect the public, including the Occupational Safety and Health Administration, the Environmental Protection Agency, and the Consumer Protection Agency.⁷⁷ Inflationary pressures led to dramatic government intervention into the private sector with a series of wage and price controls during the Nixon administration that disrupted the role competitive prices played in allocating resources.⁷⁸ The cumulative weight of business regulation along with a large federal budget deficit prompted support for a different approach.⁷⁹ Deregulation became the mantra for proponents of a reduced role of government in business and a return to more private market based solutions.⁸⁰ By the end of the 1970s, the Civil Aeronautics Board was abolished, followed by the ICC in 1995, and deregulation took place in the airline, telecommunications, railroad, trucking, television, and radio broadcasting industries.⁸¹

6. Government Enters the Mortgage Market—Moral Hazard and Unintended Consequences

While consumers and business benefitted from many of the reversals in business regulation, the failures of government regulation and deregulation in the 1980s had a dramatic effect on the

76. Wyzalek, *supra* note 2, at 27.

77. EISNER, *supra* note 71, at 119.

78. Michael Mussa, *Monetary Policy*, in AMERICAN ECONOMIC POLICY IN THE 1980S 81, 86–87 (1994).

79. EISNER, *supra* note 71, at 177–79.

80. See Paul L. Joskow & Roger G. Noll, *Deregulation and Regulatory Reform During the 1980s*, in AMERICAN ECONOMIC POLICY IN THE 1980S, *supra* note 78, at 367, 371–72.

81. ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (codified as amended at 49 U.S.C. § 701 note (2006)); Joskow & Noll, *supra* note 80, at 378–81 (discussing how the Airline Deregulation Act of 1978 led to the dismantling of the Civil Aeronautics Board). Joskow and Noll note that many of the significant changes in economic regulation began during the Carter administration and a deregulation movement should not be confused with Reaganomics. *Id.* at 371.

economy in 2007 and 2008.⁸² Deregulation of financial institutions led to failures, especially in the savings and loan firms, when interest rates spiked, and the declining values of long term mortgages erased the equity in lender balance sheets.⁸³ The interest rate and credit risks of holding interest sensitive assets had not been adequately managed. One response to this failure was the creation of government sponsored secondary markets (e.g., Fannie Mae, Ginnie Mae, and Freddie Mac) with securitization of mortgages into mortgage-backed securities.⁸⁴ In 1995, Freddie Mac began receiving affordable housing credit for buying subprime securities.⁸⁵ In 2004, Freddie Mac came under added pressure from the Department of Housing and Urban Development to increase its financing of low income housing, building a large base of high risk “subprime” securities that were securitized and spread throughout the financial system.⁸⁶

The combined effects of government sponsored agencies, attempts to promote low income housing, easy money policies that helped keep real estate prices rising, and mortgage securitization

82. See, e.g., Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1 (discussing deregulation in the context of credit-rating agencies).

83. See Robert E. Litan, *U.S. Financial Markets and Institutions in the 1980s: A Decade of Turbulence*, in AMERICAN ECONOMIC POLICY IN THE 1980S, *supra* note 78, at 519, 526–28. Financial institutions held short term interest sensitive assets. See *id.* at 526–27. When interest rates increased, the mismatch in maturities resulted in declining values of assets and a decline in equity. See *id.* at 526–28. Many financial institutions had no equity when the balance sheet was market to market, leading to “zombie” banks and ultimate failure. See *id.* at 535–36.

84. *Id.* at 542. As of 2008, Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac) owned or guaranteed 56.8% of the United State’s \$12 trillion mortgage market. Charles Duhigg, *Loan-Agency Woes Swell from a Trickle to a Torrent*, N.Y. TIMES, July 11, 2008, at C1. In 1968 Fannie Mae split into a private corporation and a publicly financed institution. DAVID H. CARPENTER & M. MAUREEN MURPHY, CONG. RESEARCH SERV., RL 34657, FINANCIAL INSTITUTION INSOLVENCY: FEDERAL AUTHORITY OVER FANNIE MAE, FREDDIE MAC, AND DEPOSITORY INSTITUTIONS 2 (2008). The private corporation was still called Fannie Mae, and the publicly financed institution was named the Government National Mortgage Association (Ginnie Mae). *Id.* Only Ginnie Mae had an explicit insurance policy to guarantee the value of mortgages. See Ken Belson, *Finding a Refuge in Ginnie Mae Funds*, N.Y. TIMES, July 11, 2010, at BU14. Congress then established Freddie Mac through the Emergency Home Finance Act of 1970. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450 (codified as amended at 12 U.S.C. §§ 1451-1459 (2006)).

85. Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 20, 2008, at A1.

86. *Id.*

created a serious moral hazard.⁸⁷ The loan originator collected fees and sold the mortgage, which was securitized with all of the risks passed to the owner of the associated mortgage-backed security.⁸⁸ The mortgage-backed securities were in turn reconfigured into more complex structures such as collateralized debt obligations (“CDO”s) with another transfer of the risk.⁸⁹ Finally, reinsurers entered into credit default swaps for these securities, accepting the risk for a predetermined fee based on historical mortgage default rates.⁹⁰ Oddly, current regulatory acts to address the financial market problems revealed in the 2008 recession do not deal with the role of government sponsored agencies or government induced moral hazards.⁹¹ The experience with government sponsored agencies and moral hazard illustrates the danger of mixing economic intervention with a social agenda.

7. Sarbanes-Oxley—A Few Crooks Lead to High Compliance Costs

The regulation of business gained a new impetus when the 2001 bankruptcy of Enron uncovered deceptive accounting practices and overstated earnings, which then resulted in an inflated stock price.⁹² A number of other bankruptcies based on fraudulent

87. See Kevin Dowd, *Moral Hazard and the Financial Crisis*, 29 CATO J. 141, 142–43, 155 (2009), available at <http://www.cato.org/pubs/journal/cj29n1/cj29n1-12.pdf>. A moral hazard creates a situation where a decision-maker has an incentive to do the wrong thing. *Id.* at 142–43. In this case, the decision is to make high risk loans that would not have been made if it were not for the ability to pass the risk through the secondary market to a government security agency to then be securitized and passed on in the financial markets. *See id.* at 143.

88. *Id.*

89. *See id.* at 146–47.

90. See Gretchen Morgenson, *Arcane Market Is Next To Face Big Credit Test*, N.Y. TIMES, Feb. 17, 2008, at A1.

91. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of the U.S.C.). The Act introduces wide ranging new regulations but fails to address the role government security agencies played in the great recession. *See generally id.* Just recently, the Obama administration released a surprising housing finance policy report with a process to replace Fannie Mae and Freddie Mac with three alternatives for conducting housing finance policy. DEP’T OF THE TREASURY & U.S. DEP’T OF HOUS. & URBAN DEV., REFORMING AMERICA’S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 1–2, 11, 27–30 (2011).

92. See Kathleen F. Brickey, *Enron’s Legacy*, 8 BUFF. CRIM. L. REV. 221, 228–37 (2004) (explaining the plethora of regulations introduced following the bankruptcy of Enron); Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, J. OF ECON. PERSPECTIVES, Spring 2003, at 3, 11–12 (discussing Enron’s false accounting).

accounting practices soon followed, leading to a general concern for valuations based on reported data.⁹³ Congress responded by passing the Sarbanes-Oxley Act, which emphasized greater oversight and assignment of legal responsibilities to all managers.⁹⁴ Compliance costs and red tape imposed on business in response to Sarbanes-Oxley significantly increased the costs of regulation over the last decade.⁹⁵

III. THE POLITICS OF REGULATION—MIXED AGENDAS

A. *Agency Theory Applied to Government—Perverse Incentives of the Regulators*

Regulation of private enterprise is the result of a political process where the public elects representative agents to govern, and the elected agents appoint heads of other government agencies. Much like agency problems in corporations, where the manager is not the owner, government also has inherent agency problems.⁹⁶ The public has little control over the actions of elected agents and virtually no control over the bureaucrats who are outside of the election process. There is no systematic alignment of the incentive structures for government agents to achieve effi-

93. See Daniel Kadlek, Bernard Baumohl & Unmesh Kher, *Under the Microscope*, TIME, Feb. 4, 2002, at 28–29 (discussing the financial world shaking post-Enron).

94. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

95. Floyd Norris, *Top Regulator Says Sarbanes-Oxley Act Audits Are Too Costly and Inefficient*, N.Y. TIMES, Dec. 1, 2005, at C4. A McKinsey & Company study commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer (D-N.Y.) cites Sarbanes-Oxley as one reason America's financial sector is losing market share to other financial centers worldwide. MCKINSEY & CO. & N.Y. ECON. DEV. CORP., SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 97 (2007). Recent estimates of the costs of rules and restrictions on business reached \$1.75 trillion. NICOLE V. CRAIN & W. MARK CRAIN, SMALL BUS. ADMIN. OFFICE OF ADVOCACY, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS, IV (2010), available at <http://archive.sba.gov/advo/research/rs371tot.pdf>.

96. Agency theory rests on the conflict of interest when one party has discretion in making decisions on behalf of another party. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). In the private sector, various mechanisms are used to align the interests of the agent with those of the principal, including piece rates/commissions, profit sharing, efficiency wages, the agent posting a bond, or fear of firing. *Id.*

cient use of the public's resources.⁹⁷ Either in anticipation of or as a reaction to a regulation, a need is created for parallel bureaucracies of special interest groups organized to counter and influence government intervention. Businesses become as interested in satisfying and influencing their regulators and lawmakers as they are in producing and selling products and services. Lobbyists play an important role in presenting views of special interest groups, offering data, and providing funding for campaigns of elected officials.⁹⁸

B. *Capture Theory in Action—Where Is Objective Market-Based Regulation?*

Capture theory predicts that appointed regulators will tend to come from within the industry or special interest groups directly related or sympathetic to what is to be regulated.⁹⁹ For example, prior to being the Secretary of Treasury, Henry Paulson was the former chairman and chief executive officer of Goldman Sachs.¹⁰⁰ Paulson was a key figure in the design and direction of the government's rescue of the financial industry.¹⁰¹ Critics of the rescue point to this conflicting interest with respect to recipients of government bailout money, such as Goldman Sachs.¹⁰² On a different front, Secretary of Labor Hilda L. Solis is a recognized leader of environmental justice issues, with a background in the Office of Hispanic Affairs during the Carter Administration, and as an analyst with the Office of Management and Budget in the Civil Rights Division.¹⁰³ As a chairwoman of the California Senate Industrial Relations Committee, she was a leader in the effort to raise the state minimum wage from \$4.25 to \$5.75 an hour, while the majority of economists argued that higher minimum wages

97. See André Hampton, *Markets, Myths, and a Man on the Moon: Aiding and Abetting America's Flight From Health Insurance*, 53 RUTGERS L. REV. 987, 988–94 (2000).

98. Lloyd Hiteshi Meyer, *What is This "Lobbying" That We Are So Worried About?*, 26 YALE L. & POL'Y REV. 485, 486–87, 539–41 (2008).

99. Stigler, *supra* note 74, at 3–7.

100. Chris Isidore, *Goldman's Chief To Take on Treasury*, CNNMONEY.COM (May 30, 2006, 1:36 PM), http://money.cnn.com/2006/BO/news/economy/snow_replacement.

101. Bob Herbert, Op-Ed., *A Second Opinion?*, N.Y. TIMES, Sept. 23, 2008, at A29.

102. See *id.*

103. *Meet Secretary of Labor Hilda L. Solis*, U.S. DEP'T OF LABOR, <http://www.dol.gov/sec/welcome.htm> (last visited Apr. 15, 2011).

result in higher unemployment.¹⁰⁴ The background of Secretary Solis is more in line with a social progressive than a labor market economist.

C. *Intended Versus Unintended Consequences of Regulation—
Will Things Be Better?*

It is no surprise that the system does not follow a consistent philosophical approach to regulation and often moves in waves from regulation to deregulation. Even if regulations were crafted consistently without special interests, the intended consequences of government regulation are often dwarfed in importance by the unintended consequences of moral hazard, the excessive cost of red tape, fraud, and the need to replace one set of regulations with another.

The Dodd-Frank Act now seeks to address perceived flaws in the financial system with more regulatory constraints that will have intended and unintended consequences that we can only imagine.¹⁰⁵ Like the Dodd-Frank Act, most regulations from our political system tend to be a mixture of economic and social agendas, making it difficult to evaluate the costs and benefits of the changes made to the allocation of resources, relative price distortions, income redistribution, hiring equality, risks, and performance of the economy.¹⁰⁶

104. *Id.*; see also Mark Kelman, *Progressive Vacuums*, 48 STAN. L. REV. 975, 981 (1996) (reviewing MICHAEL J. PIORE, *BEYOND INDIVIDUALISM* (1995) (“Mainstream economists are, with very few exceptions, quite hostile to minimum wage laws Framed narrowly, the critique of such legislation is that it causes involuntary unemployment.”)).

105. See *supra* note 91 and accompanying text.

106. See Martha T. McClusky, *The Illusion of Efficiency in Workers’ Compensation Reform*, 50 RUTGERS L. REV. 657, 672 (1998). An example of mixing regulation with social fairness concerns is found in § 342 of the Dodd-Frank Act where twenty new offices are created for Minority and Women Inclusion at the various regulatory agencies. Dodd-Frank Wall Street Reform and Consumer Protection Act § 342, 12 U.S.C.A. § 5452 (West 2011). This section was proposed by Representative Maxine Waters as a means of correcting racial and gender imbalances at Wall Street firms and subcontractors. Kevin Roose, *Seeking Guidance on Dodd-Frank’s Diversity Clause*, N.Y. TIMES, Nov. 11, 2010, <http://dealbook.nytimes.com/2010/11/11/seeking-income-on-dodd-franks-diversity-clause>.

IV. ECONOMIC EFFICIENCY AND SOCIAL GOALS—MUSINGS ON REFORMS

A. *Neoclassical Economics—The Idealistic Benchmark*

Neoclassical economics, largely based on Adam Smith, provides the framework for the ideal free market economy and offers a model for economic growth and employment.¹⁰⁷ Competition results in efficient production and rapid innovation.¹⁰⁸ A consumer allocates income and savings based on relative prices to make optimal consumption choices so that the marginal utility per dollar spent is equalized across all products consumed.¹⁰⁹ Firms employ resources up to the point where the marginal revenue product is equalized for all inputs and only normal profits are achieved.¹¹⁰ A business is motivated to act in the best interest of its owners by focusing on profit maximization, forcing efficient resource use, and innovating without biases that detract from efficiency.¹¹¹ Investments are geared to balance risk and return and are generally risk averse.¹¹²

Without government intervention, a competitive market determines what is to be produced, how it is to be produced, and to whom the production will be distributed.¹¹³ On this last point, attempts to redistribute income for social purposes is a political issue, but for optimal growth it should be achieved with lump sum redistributions that do not distort market signals, incentives, and economic growth. Equality of opportunity is consistent with the

107. See generally ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (Edwin Cannan ed., Mathuan & Co. 1930) (1776).

108. Stephen G. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CALIF. L. REV. 1005, 1006 (1987).

109. *Equilibrium of the Consumer*, THE MICROECONOMICS.COM, http://www.themicroeconomics.com/equilibrium_of_the_consumer.html (last visited Apr. 15, 2011).

110. MARK HIRSCHEY, *MANAGERIAL ECONOMICS* 185 (12th ed. 2009) (explaining perfect competition).

111. See Jon C. Sonstelie & Paul R. Portney, *Profit Maximizing Communities and the Theory of Local Public Expenditure*, 5 J. URB. ECON. 263, 264 (1978).

112. R. Mark Williamson, *Regulatory Theory and Deposit Insurance Reform*, 42 CLEV. ST. L. REV. 105, 110 (1994).

113. See Paul Stephen Dempsey, *Market Failure and Regulatory Failure as Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition*, 46 WASH. & LEE L. REV. 1, 10–11 (1989) (discussing Adam Smith's market theory of economics).

free market paradigm,¹¹⁴ but equality of outcomes is a non-market issue to be addressed in a political process.¹¹⁵

B. *Market Failures, Public Goods, and Social Agendas*

The U.S. economy often deviates from the ideal conditions of Neoclassical economics, creating the potential for government regulation to improve market outcomes.¹¹⁶ Regulation of business can be divided into three primary categories: correction of market failures, provision of public goods, and regulation to achieve non-market social goals.¹¹⁷ Our view is that public goods and market failures represent broad classes of areas where government market intervention, under the right conditions, can be structured to approximate the desired results of free markets. Regulation aimed at achieving social goals should be conducted with lump sum transfers to minimize distortions to market pricing and resource allocation relationships. Unfortunately, this is not the approach of past or current regulatory initiatives.¹¹⁸

Isolation of regulatory issues in a single act allows the costs and benefits of a given regulatory initiative to be debated without mixed efficiency and equality issues, resulting in more transparent data and analysis. Lump sum distributions outside the market system address issues of inequality, leaving market signals for optimal resource allocation relatively unaffected. Public choice

114. See John Cirace, *A Synthesis of Law and Economics*, 44 SW. L.J. 1139, 1164 (1990) (arguing maximum social wealth will be achieved if government action establishes equality of opportunity consistent with the efficiency of competitive markets); Harvey R. Miller, *Chapter 11, in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 400 (2007) (defining the free market paradigm as the emergence of “economic growth and prosperity” when the government stands aside and allows the markets to work).

115. Outcomes in a market process are conditioned by factors such as risk taking, effort, inherent skill, and the starting endowment of resources. The outcome is uncertain. Guaranteed outcomes or entitlements may be in place outside the market system to create a social welfare net for those who lose out in the market process. Dempsey, *supra* note 113, at 23, 30. Our goal is to allow societal choice for such safety net provisions without distorting market incentives and relevant price signals for resource optimization.

116. See discussion *supra* Part IV.A.

117. See discussion *infra* Part IV.C–F.

118. See Robert Hockett, *What Kinds of Stock Ownership Plans Should There Be? Of ESOPs, Other SOPs, and “Ownership Societies,”* 92 CORNELL L. REV. 865, 935–38 (2007) (discussing how regulation intervention through the home and education finance programs distorted each respective market as well as the larger macroeconomy).

is also improved by allowing separate analysis of the costs and benefits of lump sum transfers. When there is a mixture of social and economic efficiency objectives, it is difficult, if not impossible, for the public to weigh the merits of each initiative, which leaves too much unmonitored discretion to agents in government.

C. *Correction of Market Failures*

Business regulations designed to maintain competitive market structure and business practices were first put in place with the Sherman and Clayton Acts.¹¹⁹ Overall, regulation to maintain the competitive structure and behaviors of a Neoclassical model is consistent with efficient regulation as long as the regulated outcome improves efficiency of resource allocation.

More complex market failures occur when free market prices do not reflect true costs and benefits, creating externalities.¹²⁰ Examples of externalities include the external costs of pollution, smoking, or drinking¹²¹ and the external benefits of saving for retirement.¹²² The external costs and benefits of consumption or production are not expressed in market prices, leading to under-allocation of goods with positive externalities and overproduction of goods with negative externalities.¹²³ Here, the key public issue is to objectively measure the extent of the externality and to follow up with a market-based system to adjust prices.¹²⁴ This approach is commonly known as internalizing the externality.¹²⁵ An

119. Sherman Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1-7 (2006)); Clayton Act, ch. 323, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12-27, 29 U.S.C. §§ 52-53 (2006)); *see also* Part II.C.1-2.

120. *See* Dennis W. Carlton & Alan S. Frankel, *Transaction Costs, Externalities, and "Two-Sided" Payment Markets*, 2005 COLUM. BUS. L. REV. 617, 622-23 (2005).

121. *See id.* at 622 (discussing the costs of "cleaning, healthcare, and a lower quality of life" that pollution imposes on society).

122. *Cf.* Hampton, *supra* note 97, at 997, 999-1000 (defining a positive externality as one in which a third party receives the benefit of a private party's consumption and providing healthcare as an example).

123. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 3-6 (1960).

124. *See id.* at 40-42; Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1535 (1984).

125. The Coase Theorem illustrates that the socially optimal solution is to have the cost of an externality paid through a bargaining process, without regard to who has the legal responsibility for damages. Coase, *supra* note 123, at 4.

example is the auction of pollution rights to set an efficient cost of pollution for producers.¹²⁶ Obstacles to effective regulation of externalities and adjustments of relative prices include a lack of precision in the adjustment to relative prices, either directly or with auctions of externality rights, and a mixture of efficiency and equity arguments in the process.¹²⁷ Once special interest groups and a host of unrelated compromises are added, the outcome is not likely to approximate market efficiency. We deal with reforms needed for these agency problems as part of our discussion of public goods.

D. *Market-Based Solutions for Credit Risk and “Too Big to Fail”*

The Neoclassical economics framework applied to risk-return tradeoffs demands that the probability of expected failure serves as a deterrent to excessive risk. A series of high risk investments increases the chance of losses and potential bankruptcy.¹²⁸ Pursuit of the profit incentive is not a problem when all the consequences of losses fall solely on the private decision maker. When externalities from poor risk decisions occur, a deviation from the ideal free market paradigm results.¹²⁹ Excess risk taking is often a function of agents making decisions for owners, government bailout policies, and government agency activities that shift risk taking from the private sector to the public sector.¹³⁰

The “too big to fail” issue occurs when losses and the potential failure of a firm impose serious consequences on the rest of the economy.¹³¹ To avoid the external consequences of a firm’s failure,

126. See Cooter, *supra* note 124, at 1535–36.

127. See Coase, *supra* note 123, at 41–42.

128. See, e.g., Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 301 (1991).

129. See *The Risk Externality*, ECONOMIST (Jan. 12, 2010, 6:11 PM), http://www.economist.com/blogs/freeexchange/2010/01/risk_externality (“The larger a bank gets, the less likely the government is to allow it to fail, and the more shielded it is from potential losses. Size therefore generates some significant social costs, particularly since the negative externality encourages firms to take on too much risk.”).

130. See 156 CONG. REC. S4034, 4038–39 (daily ed. May 20, 2010) (statement of Sen. John Ensign).

131. See Kenneth C. Kettering, *Securization and Its Discontents: The Dynamics of Financial Product Development*, 20 CARDOZO L. REV. 1553, 1633 (2008).

government bailouts of some fashion take place, and regulators take over all or part of the private institution.¹³² Risks are shifted from the private sector to the government sector, and the taxpayer ultimately stands to make the payment.¹³³ Two common regulatory proposals for “too big to fail” problems include stricter regulation to steer well clear of bankruptcy and limiting the size of firms to reduce the external costs of failure.¹³⁴ These solutions impose costs on efficient resource allocation due to over-capitalization, costs of regulation, and ultimate disruption of private market resource allocation decisions.¹³⁵

When agents of the firm have taken on too much risk and losses are pending, short run creditors pull out and leave only owner equity to cushion the falling asset values.¹³⁶ Agents making decisions on their own behalf, rather than for the best interest of equity owners, may take these risks in exchange for the potential of higher bonuses in riskier asset investments.¹³⁷ Even if no single bank is too big, failures occur, and a sufficient number of failures will have external costs prompting bailouts.¹³⁸ Even under higher requirements, owner equity will be insufficient to absorb losses resulting from the failure of a financial company that poses systemic risk, and equity owners have limited monitoring control over bank managers.¹³⁹

Expectations of government bailouts or government insurance programs funded by premiums contribute to the moral hazard of encouraging excessive risk taking. William Poole suggested a

132. See, e.g., *The Troubled Asset Relief Program (TARP)*, CENTER FOR FISCAL ACCOUNTABILITY, <http://www.fiscalaccountability.org/rusted-asset-relief-program-tarp-a-769> (last visited Apr. 15, 2011).

133. See, e.g., David Wessel, *Estimate of TARP's Cost to Taxpayers Increases*, WALL ST. J., Apr. 4, 2009, at A3.

134. See *Bank Regulation*, 28 BANKING & FIN. SERVS. POL'Y REP., Dec. 2009, at 21, 22.

135. 155 CONG. REC. H9875 (daily ed. Sept. 30, 2009) (statement of Rep. Akin) (“Through experience, just history and common sense tells [sic] us that when the government is trying to do something, there are some side effects. Sometimes it’s expressively expensive. Sometimes there is excessive bureaucracy and rationing, inefficient allocation of resources, and degraded quality.”).

136. Cory Dean Kandestin, Note, *The Duty to Creditors in Near-Insolvent Firms: Eliminating the “Near-Insolvency” Distinction*, 60 VAND. L. REV. 1235, 1244–46 (2007).

137. See, e.g., Robert C. Illig, *Hedge Funds: The Missing Link in Executive Pay Reform*, 28 BANKING & FIN. SERVICES POL'Y REP., Sept. 2009, at 10.

138. See Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 114–16 (2010).

139. See *id.* at 114–20.

market-based alternative form of regulation for this set of problems.¹⁴⁰ He proposed requiring financial institutions to hold substantial long term subordinate debt with staggered maturities in the financial structure to provide a long term cushion for falling asset values.¹⁴¹ The bond market would then offer an additional monitor of the firm's risk profile, and higher yields would be required on the firm's subordinate debt if the firm were to take on higher risk, offering an early warning device as well as imposing higher costs of capital on the firm.¹⁴² Market discipline of excess risk taking occurs as agents must account for the consequences of higher risk profiles and increased costs of capital.¹⁴³ The higher costs of capital also serve to take the edge off expected returns from risk, offering an automatic deterrent to excessive risk.¹⁴⁴ Additionally, agents are monitored because they must undergo the scrutiny of the market when they make new issues of subordinate securities to refinance subordinate debt that is coming due.¹⁴⁵

Poole's approach to regulation is consistent with improved efficiency and effective reduction of external costs in the private market. It does not rely on the federal government to put added constraints on free markets and offers a way to reduce moral hazard by putting a buffer between excessive risk taking behavior and reliance on public tax dollar support.

Many of the suggestions for financial market reform by the current administration move in the wrong direction. Breaking up financial institutions into smaller entities results in less competitive firms in the international market and loses economies of scale offered by size.¹⁴⁶ Ending proprietary trading activities of fi-

140. William Poole, *Moral Hazard: The Long-Lasting Legacy of Bailouts*, 65 FIN. ANALYSTS J., Nov./Dec. 2009, at 17, 21–23.

141. *Id.* at 22.

142. *Id.*

143. *Id.* at 22–23.

144. *See id.* at 22 (increasing the cost of capital by “eliminating the deductibility of interest would reduce the risk of failure of large companies.”).

145. *Id.*

146. Charles W. Calomiris, Op-Ed., *In the World of Banks, Bigger Can Be Better*, WALL ST. J., Oct. 20, 2009, at A21. The 109 American banks with more than \$10 billion of assets paid an average annual interest rate of around 0.8% to their depositors, while the 7,651 smaller banks' interest rate was 1.2%. Rob Cox & Fiona Maharg Bravo, “*Too Big to Fail*” *Still Here to Stay*, N.Y. TIMES, Nov. 24, 2010, at B2. As regulations on banks mount, along with the red tape already present under the Gramm-Leach-Bailey Act, the Patriot Act,

financial institutions misses the mark because financial market externality costs were induced by holding risky real estate-linked assets, not proprietary trading activities.¹⁴⁷ In fact, the activities of the bank are not the issue; rather, the issue is risk taking and risk monitoring backed by sufficient private capital. Unless compensation systems are regulated with an eye toward a better alignment of agent and owner, it is not clear why any one segment of society's compensation should be regulated, outside of envy or a sense of retribution.

E. *Public Goods—Transparency and Agency Theory Remedies*

Public goods represent a noted exception to the free market paradigm. No market exists for a public good, and consumption of a public good does not reduce the amount available to others.¹⁴⁸ There are “free rider” problems with public goods that also prevent private consumption, since it is not possible to exclude anyone who does not pay for it.¹⁴⁹ Public goods are consumed by society as a whole and are provided by the government.¹⁵⁰ Examples include national defense, law enforcement, national parks, statistics and information, homeland security, product safety standards, and environmental protection.¹⁵¹ The challenge with public goods is determining the correct amount of the good to provide and implementing the most cost-effective way to produce the public good.

The key problems with respect to public goods tend to be asymmetric information and agency problems. The voting public, scientific community, and agents of the government do not all

and the Bank Secrecy Act, smaller banks may find even bigger disadvantages in meeting all the compliance costs. *See id.*

147. *See Implications of the “Volcker Rules” for Financial Stability: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 11, 63–64 (2010) (statement of Barry L. Zubrow, Executive Vice President and Chief Risk Officer, JPMorgan Chase and Company). Ending proprietary trading for banks will limit their activities and reduce overall profitability and diversification of business lines. To enhance profits banks will either have to take more risk and/or find new ways to increase prices for their services.

148. *See* Renate Mayntz, *Common Goods and Governance*, in *COMMON GOODS* 15, 19 (Adrienne Héritier ed., 2002).

149. *Id.*

150. *Id.*

151. *See id.* (explaining that public goods are both non-rivalrous and non-excludable); *see also* Peter Drahos, *The Regulation of Public Goods*, 7 *J. INT'L ECON. L.* 321, 321 (providing examples of public goods including “peace, order, and good government”).

have the same information for most public goods. For example, military experts and intelligence agents may know more about the key threats to national security and the best way to deal with these threats. The relative costs and benefits of public goods are not fully presented to the public, and many public good initiatives are part of a more complex bundling of issues in government acts and laws.¹⁵² Compromises, amendments, and multiple line items in any given bill make it difficult to isolate cost and benefit data.

Agency problems occur as agents of the voting public are driven by different agendas that often lead to bigger budgets than necessary. “Pork barrel” politics is as much a matter of compromises to satisfy the needs of agents and special interest groups as it is about providing for the public good at the most efficient scale.¹⁵³ Environmental protection provides a good example of a public good where asymmetric information and agency theory make it very difficult to define the optimal amount of the public good.¹⁵⁴ Vested interests abound in the promotion of green technology interests at the sake of more traditional technology. Even so, it is very difficult to produce information and data that is objective and subject to a cost-benefit analysis.¹⁵⁵

F. *Fighting Agency Problems—Transparency, Watchdogs, Term Limits, and Re-Call*

Government information, along with line item budgets, should be more transparent, allowing less asymmetric information in the public debate on both the optimal amount of a public good and its efficient production. Incentives to deliver public goods at reasonable costs need to be integrated in all levels of government decisions. To help support this effort, public watchdog groups need to be organized. These groups should have no particular affiliation

152. Jennifer Nou, Note, *Regulating the Rulemakers: A Proposal for Deliberative Cost-Benefit Analysis*, 26 YALE L. & POL’Y REV. 601, 604, 606–07 (2008).

153. See Virginia A. Fitt, Note, *Honor at the Trough: The Ethics of Pork Politics*, 25 J.L. & POL. 467, 474 (2009).

154. See Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553, 559–63 (2001).

155. See *id.* at 561 (describing the problem of free-riders).

to either a political or business agenda. The public needs to know what public goods cost and that the budgets are kept in line with market prices.

Agent voting and administrative actions should be guided by cost-benefit data provided by public sources, not lobbyists. A major obstacle is the need of agents to be re-elected with funding from lobbyists and a need to provide “pork” (unrelated to meeting the public good goal in the most cost-efficient manner) to local voting constituents. Term limits and simple voter recall procedures would be steps in the direction of breaking some of the strings that pull agents away from the public interest. The information asymmetry issue is more complex. On this front there is a need for more independent and objective information and analysis. Transparent line item budgets are needed without mixing legislative issues in a given bill. For example, there should not be a compromise on a new bridge project in exchange for the location of a military base in a given area.

G. *Social Goals—Dealing with Social Issues of Equity Outside the Market System*

Government regulations are often structured to achieve a social agenda beyond correcting market failures or providing public goods. The view that greater access to low income housing or student loans are important social goals that prompted government sponsored agencies like Fannie Mae, Freddie Mac, Ginnie Mae, and Sallie Mae to enter the credit markets.¹⁵⁶ These interventions in the credit allocation market occurred for social purposes.¹⁵⁷ We saw the disaster in the mortgage market stem from the unintended consequences of non-market driven credit allocation due to the lack of market discipline in lending.¹⁵⁸ These issues have not been addressed. Instead, the government is preoccupied with tighter regulation of private financial markets.¹⁵⁹

The criticism of the regulatory approach taken for social issues should not be confused with a lack of empathy for the social

156. Leonnig, *supra* note 85.

157. *Id.*

158. *Id.*

159. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of the U.S.C.).

goal.¹⁶⁰ If the public is supportive of subsidies for a given segment of society, the solution is simply to follow a lump sum transfer approach that does not distort market signals and efficiency. The issue should be framed and presented to the public along with the costs of the necessary or intended transfer. The gain in transparency and focus on the issue at hand improves public choice and leaves credit allocation to the discipline of the market.

A list of examples where government regulation and direct intervention distorts market outcomes to achieve a social goal is lengthy, but a few examples of how we would separate social goal regulation from lump sum transfers should suffice.

1. Minimum Wage Laws

A straightforward example is the use of minimum wage laws to achieve a social goal of increasing income for low income workers. There is little controversy among economists that these laws increase unemployment and contribute to poorer economic performance overall by setting an artificial price above the market equilibrium price for labor.¹⁶¹ Yet, the minimum wage laws remain popular with the voting public seeking support for low income workers.¹⁶² Our view is that wages and prices should not be set for a social goal, since the disruption in markets leads to worse performance due to a combination of lower production, higher consumer prices, lower profit from investment, and higher unemployment. Rather, if relief for low income workers is desired, the government should make income transfers to low wage workers to bypass labor market distortions. The social issue is presented in a clearer fashion in this context, and the taxpaying public, without a background in economics, has a better chance of evaluating costs and benefits.

160. Capitalism and altruism are not inconsistent, even in Neoclassical economics. Adam Smith's "invisible hand" defense of capitalism was not without room for charity and social goals. See ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* 318–19 (Knud Haakonssen ed., 2002).

161. See Kelman, *supra* note 104, at 981 & n.12.

162. *Public Solidly Supports Increase in Minimum Wage*, GALLUP (Jan. 4, 2006), <http://www.gallup.com/poll/20710/public-solidly-supports-increase-minimum-wage.aspx>.

2. Tariffs

A protective tariff is a tax on an imported good or service motivated by a desire to subsidize domestic producers who are facing stiff competition from imports.¹⁶³ Such tariffs enhance profits of the domestic producer, but the domestic consumer pays a higher price for a lower market clearing amount of the good or service, resulting in deadweight loss to society.¹⁶⁴ Retaliation by foreign producers may occur, making all parties worse off in the process. A better solution for all parties is simply to offer a lump sum subsidy to protect industries, if that is the social goal.

3. Healthcare

Healthcare regulation has a massive set of provisions that are beyond the scope of this article. But we address some of the more salient issues as an example of how our view of regulation should work in this context. Regulation to lower the costs of healthcare and expand coverage is a worthy social goal. However, direct intervention with non-market determined pricing of insurance costs, pricing of healthcare services, and mandatory provisions for coverage introduces a host of resource allocation issues, selection bias problems, and moral hazards.¹⁶⁵ We would rather see more targeted market solutions to increase the supply of services and moderate the demand, resulting in lower market prices. For example, the current healthcare legislation does not focus on expanding the number of nurses, physician assistants, or doctors.¹⁶⁶ Subsidies could be used to promote larger medical and nursing

163. BLACK'S LAW DICTIONARY 1593 (9th ed. 2009); *see also* LUDWIG VON MISES, HUMAN ACTION: A TREATISE ON ECONOMICS 361–62 (1998).

164. The term “deadweight loss” in economics refers to a condition where the market equilibrium moves to a higher price at a lower market clearing quantity. The loss in welfare is a net loss to society. Causes of deadweight losses include tariffs, binding price ceilings or floors, taxes, and monopoly pricing. *See* VON MISES, *supra* note 163, at 361–62 (citing monopolistic pricing as a cause of deadweight loss); David Dudley, *The Coase Theorem as Applied to Trade Barriers and Optimal Adjustment Strategies*, 19 U. PA. J. INT'L ECON. L. 1029, 1036 (1998) (discussing how tariffs create deadweight loss).

165. *See, e.g.*, J. Paul Singleton, *Can You Really Have Too Much of a Good Thing?: How Benevolent Tax Policies Have Contributed to the Explosion of Health Care Costs and How New Policies Threaten To Do More of the Same*, 8 DEPAUL BUS. & COM. L.J. 305, 321–29 (2010).

166. *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010) (to be codified in scattered sections of 42 U.S.C.).

schools with attention to an expansion of preventive care practices and low cost local treatment centers.

The demand for healthcare services might also be reduced with lump sum expenditures to promote healthier diets and lifestyles. Healthcare education in public schools can be improved to promote the social goal of long term health. Households can be given access to online services to help deal with common healthcare needs and offer answers to lifestyle and diet habits for good health. A greater use of physician assistants should be encouraged to deal with most healthcare needs rather than using the more expensive time of doctors. Preventable healthcare issues can be minimized with subsidies for healthier life choices.

Cost of health insurance can be lowered by achieving the maximum number of exposures in the insurance pool, not allowing someone to self select out until they need care. Private insurance can be maintained, but a number of changes would help lower premiums. For example, the pool needs to be as large as possible, calling for elimination of restrictions on insurance across state lines. Allowing more competition in insurance markets would be an appropriate government response to bring insurance rates down. Coverage of pre-existing conditions, which makes private insurance premiums higher, can be achieved with a government lump sum transfer based on the social notion that these illnesses should be covered by the general public. If expanded coverage is a social goal and insurance costs remain too high for a segment of the economy with low income, a lump sum transfer would be appropriate. Again, this approach would put the social choice in perspective with transparent information for a public decision.

Other creative market approaches to health insurance are needed to lower premiums and expand coverage. For example, a national insurance market can be defined, and the rights to offer a basic common plan can be auctioned to competing insurers. These insurers would be much like a syndicate in investment banking, where each party takes a prorated share of the total pool to share risks. If the constitutionality of requiring everyone to participate in the plan is achieved, this approach would make sure both low risk exposures and high risk exposures are in the pool, lowering expected costs. For example, young people do not get insurance even though they are the lowest healthcare exposures, making premiums higher for the insured exposures. This approach allows competition and competitive pricing of health-

care insurance while moving to a lower cost premium. Much of what we have now in our healthcare regulation deludes voters into thinking “someone else” will pay for expanded costs of coverage and coverage of pre-existing conditions. A more transparent accounting of costs and market pricing would help put these issues in the correct perspective for public choice.

V. CONCLUSION

Government regulation of business is an evolving relationship that has dual goals of making markets more competitive and efficient by dealing with market failures, while also achieving a social agenda linked to equity concerns. Our review of the history of regulation illustrates changing public attitudes toward regulation with heavy influence of special interest groups on the final regulatory outcomes. Our political system makes it difficult to achieve transparency in separating appropriate regulatory approaches to specific market failures from non-market equity concerns. Agency problems in both government and private enterprise complicate the decision process leaving the public with little real understanding of the critical issues and likely consequences.

Government intervention along with a view that government should be a backstop for poor individual decisions has generated moral hazards that are capable of crippling the economy. Rather than being a source of stability and certainty, government regulation has often led to instability and uncertainty. A mixture of conflicting agendas in a lawmaking process, heavily influenced by special interest groups, has left us with an incoherent regulatory system where well-intended outcomes are often dwarfed by the unintended consequences.

In this article we proposed a regulatory approach and a series of changes in the way regulations are presented to the public for support. Our intention is to clarify public choice by separating issues of regulating market failure from issues of equity and social change. Many of our suggestions are aimed at greater transparency in government along with better monitoring of agents working in government. An important point is that the intention of a specific regulation must be articulated, and the proposed regulation must be more directly targeted to achieving that intention, without the distraction of other “add-on” issues that will be voted

2011]

GOVERNMENT REGULATION OF BUSINESS

1089

on at the same time. There needs to be tracking and accountability for the regulatory decision along with monitoring of the government costs involved. We realize that this leaves room for further discussion of a number of controversial issues, but the discussion needs to be framed in terms of how well the regulatory process achieves the stated objective without imposing other hidden costs on the public.