



Reversing the Null: Regulation, Deregulation, and the Power of Ideas

David Moss

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David Moss
Harvard Business School

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Abstract

It has been said that deregulation was an important source of the recent financial crisis. It may be more accurate, however, to say that a *deregulatory mindset* was an important source of the crisis – a mindset that, to a very significant extent, grew out of profound changes in academic thinking about the role of government. As scholars of political economy quietly shifted their focus from market failure to government failure over the second half of the twentieth century, they set the stage for a revolution in both government and markets, the full ramifications of which are still only beginning to be understood. This intellectual sea-change generated some positive effects, but also some negative ones, including (it seems) an excessively negative impression of the capacity of government to address problems in the marketplace. Today, as we consider the need for new regulation, particularly in the wake of the financial crisis, another fundamental shift in academic thinking about the role of government may be required – involving nothing less than a reversal of the prevailing null hypothesis in the study of political economy.

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It has been said that deregulation was an important source of the recent financial crisis.² It may be more accurate, however, to say that a *deregulatory mindset* was an important source of the crisis – a mindset that, to a very significant extent, grew out of profound changes in academic thinking about the role of government.

The influence of academic ideas in shaping public policy is often underestimated. John Maynard Keynes famously declared that the “ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else.”³ Although perhaps exaggerated, Keynes’s dictum nonetheless contains an important element of truth, and one that looms large in the story of regulation and deregulation in America.

As scholars of political economy quietly shifted their focus from market failure to government failure over the second half of the twentieth century, they set the stage for a revolution in both government and markets, the full ramifications of which are still only beginning to be understood. This intellectual sea-change generated some positive effects, but also (it seems) some negative ones. Today, as we consider the need for new regulation, particularly in the wake of the financial crisis, another fundamental shift in academic thinking about the role of government may be required.

The paper starts with two stories – one about events (including financial crises and regulation) and the other about ideas (especially the shift in focus from market failure to government failure). Ultimately, it suggests that understanding the interplay between these two stories is essential for understanding not only the recent crisis but also what needs to be done, both politically and intellectually, to prevent another one. Meaningful policy reform is essential, but so too is a new orientation in scholarly research, which will require nothing less than a reversal of the prevailing null hypothesis in the study of political economy. What this “prevailing null” is – and what it needs to be – should become clear over the second half of the paper. First, though, the next two sections present two stories that lay the foundation for what comes next.

¹ This paper was prepared for the American Academy of Arts and Sciences and first presented at an Academy conference, “Challenges to Business in the Twenty-First Century,” November 30, 2009. I am grateful to the conference chairs, Gerald Rosenfeld, Jay Lorsch, and Rakesh Khurana, for inviting me to present the paper, and to Julio Rotemberg, Mitch Weiss, and Charlie Ledley for their advice and counsel along the way.

² See e.g. James Crotty, “Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture,’” *Cambridge Journal of Economics*, Vol. 33 (2009), pp. 563-580.

³ John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace Jovanovich 1964 [1936]), p. 383.

The Rise and Fall of Financial Regulation in the United States

The first story – about events – begins with a long series of financial crises, which punctuated American history up through 1933.⁴ Starting when George Washington was president, major panics struck in 1792, 1797, 1819, 1837, 1857, 1873, 1893, 1907, and 1929-33. Although lawmakers responded with a broad range of policies, from state banking and insurance regulation across the nineteenth century to the creation of the Federal Reserve in the early twentieth, none of these reforms succeeded in eliminating financial panics.

Only with the adoption of New Deal financial regulation (including the Banking Acts of 1933 and 1935, the Securities and Exchange Act of 1934, and the Investment Company Act of 1940), did the United States enjoy a long respite from further panics. In fact, Americans did not face another significant financial crisis for about 50 years, which represented by far the longest stretch of financial stability in the nation’s history (see figure below). Importantly, this was also a period of significant financial innovation, with U.S. financial institutions – from investment banks to venture capital firms – quickly becoming the envy of the world.

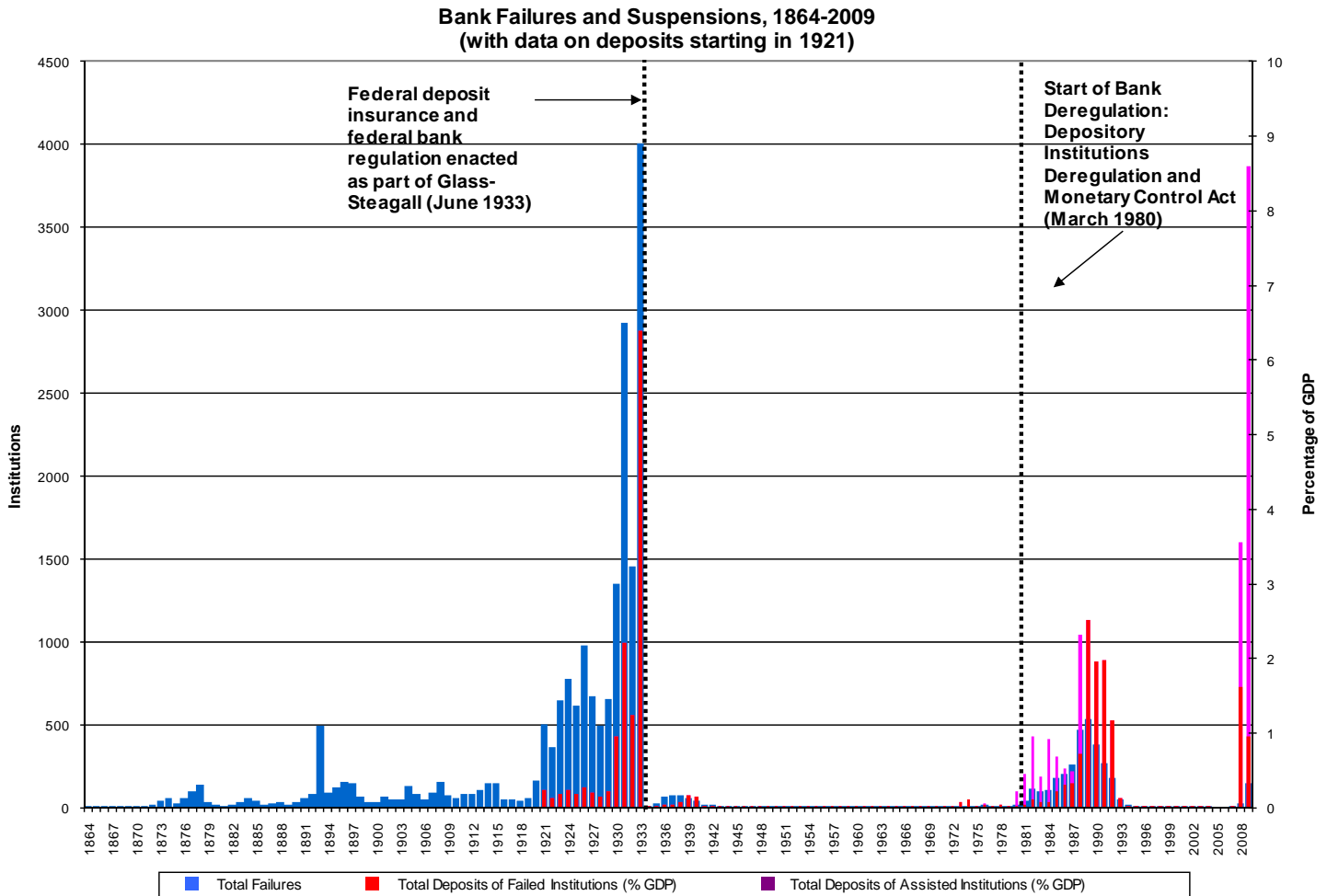
One reason that the American financial system performed so well over these years is that financial regulators were guided by a smart regulatory strategy, which focused aggressively on the greatest systemic threat of the time, the commercial banks, while allowing a relatively lighter regulatory touch elsewhere. This made sense because most financial crises back then were essentially banking crises. As a result, the dual strategy of tough regulation (and insurance) of the commercial banks along with lighter (more disclosure-based) regulation of the rest of the financial system helped to ensure both stability and innovation – a precious combination. Interestingly, this strategy did not arise out of the mind of any one person or group, but rather out of the workings of the American political system itself, which required continual compromise and accommodation. In the end, the regulatory strategy appears to have worked, helping to produce a long “golden era” of financial stability and innovation in America through the middle of the twentieth century.

This unprecedented period was dramatically interrupted following a new experiment in financial deregulation, which commenced with passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982. Before long, the nation faced a sharp increase in failures at federally insured depository institutions, including both commercial banks and savings and loans, commonly known as the S&L crisis. Although a degree of re-regulation, enacted as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), proved useful in putting out the S&L fire, the broader movement for financial deregulation continued through the early years of the 21st century. Particularly notable were passage of the Gramm-Leach-Bliley Act of 1999, which repealed the Glass-

⁴ This section draws on David Moss, “An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of ‘Too Big to Fail’,” *Harvard Magazine*, September – October 2009.

Steagall separation of commercial from investment banking; the Commodities Futures Modernization Act of 2000, which prohibited the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) from regulating most over-the-counter derivatives; and the SEC's 2004 decision, driven in large part by Gramm-Leach-Bliley, to allow the largest investment banks to submit to voluntary regulation with regard to leverage and other prudential requirements.⁵

Figure: A Unique Period of Calm Amidst the Storm⁶



Sources: *Historical Statistics of the United States: Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1975), Series X-741.8 (p. 1038); "Federal Deposit Insurance Corporation Failures and Assistance Transactions United States and Other Areas," Table BF01, FDIC website (<http://www2.fdic.gov/hsob>); Sutch, Richard, "Gross domestic product: 1790–2002," Table Ca9-19 in *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition*, eds. Susan B. Carter et al. (New York: Cambridge University Press, 2006); Bureau of Economic Analysis, "Gross Domestic Product," NIPA Table 1.1.5. (<http://www.bea.gov/national/nipaweb/SelectTable.asp>).

⁵ On the 2004 SEC decision, see "Chairman Cox Announces End of Consolidated Supervised Entities Program" (Securities and Exchange Commission press release, 2008-230), <http://www.sec.gov/news/press/2008/2008-230.htm>, accessed 11/22/09.

⁶ This chart, based on an earlier version in Moss, "Ounce of Prevention," was prepared with the assistance of Darin Christensen.

Although certain deregulatory initiatives may have contributed to the financial crisis of 2007-2009, more important (in my view) was a broader *deregulatory mindset* that impeded the development of effective regulatory responses to changing financial conditions. In particular, the explosive growth of major financial institutions, including many outside of the commercial banking sector, appears to have generated dangerous new sources of systemic risk.

Among the nation's security brokers and dealers, for example, total assets increased from \$45 billion (1.6 percent of GDP) in 1980 to \$262 billion (4.5 percent of GDP) in 1990 to more than \$3 trillion (22 percent of GDP) in 2007.⁷ Many individual institutions followed the same pattern, including the first major investment bank to collapse in the crisis, Bear Stearns, whose assets surged more than 10 fold from about \$35 billion in 1990 to nearly \$400 billion at the start of 2007.⁸

There can be little doubt that the nation's supersized financial institutions – from Bear and Lehman to Citigroup and AIG – played a central role in the crisis. They proved pivotal not only in inflating the bubble on the way up but also in driving the panic on the way down. As asset prices started to fall as a result of the subprime mess, many of these huge (and hugely leveraged) financial firms had no choice but to liquidate assets on a massive scale to keep their already thin capital base from vanishing altogether. Unfortunately, their selling only intensified the crisis and, in turn, their balance-sheet problems. Had the terrifying downward spiral not been stabilized through aggressive federal action, the nation's financial system might have collapsed altogether.

Because of the enormous systemic risk posed by the supersized financial institutions, federal officials felt they had little choice but to bail out many of them – ironically, the very firms that had helped to cause the crisis in the first place. The failure of Lehman in September 2008, and the severe financial turmoil that ensued, demonstrated just how much systemic damage one of these financial behemoths could inflict if it were allowed to go down.

Clearly, the nation's largest and most interconnected financial institutions had become major sources of systemic risk, even though many of them (including Bear, Lehman, Fannie Mae, and so forth) operated entirely outside of commercial banking. Had our original regulatory strategy from the 1933-40 period been updated in the 1990s or early 2000s to account for these new sources of systemic risk, meaningful regulation of the largest and most systemically significant financial institutions (including potentially tough leverage and liquidity requirements) would have been forthcoming. Indeed, had such regulation been developed and enforced, the worst of the crisis might well have been avoided. But, regrettably, there was simply no appetite for devising new financial regulation back then because of a pervasive belief that private actors could most

⁷ Federal Reserve Board, "FRB: Z.1 Release--Flow of Funds Accounts of the United States, Historical," <http://www.federalreserve.gov/releases/z1/Current/data.htm>.

⁸ Data, courtesy of New York Federal Reserve, drawn from company 10-Qs.

effectively manage financial risks on their own, without interference from government regulators.⁹

The problem, therefore, was not so much deregulation *per se*, but rather a deregulatory mindset that hampered the development of new regulation, which, in retrospect, was desperately needed to address the emergence of new systemic threats in the financial sector. The intellectual sources of this deregulatory mindset long predated the crisis. Indeed, they are part of a second story – on the development and transformation of ideas – which is the subject of the next section.

From Market Failure to Government Failure: Reversing the Null

Within the academy, ideas about the proper role of government in the economy were turned almost completely upside down over the course of the twentieth century. Until at least the 1960s, economists devoted particular attention to the problem of market failure, rejecting the notion that free markets always optimized social welfare, and believing that well-conceived government intervention could generally fix these failures in the private marketplace. By the 1970s, however, cutting-edge scholarship in both economics and political science was increasingly spotlighting the problem of government failure, suggesting that even if markets sometimes failed, public intervention was unlikely to remedy these deficiencies since government failure (it was often claimed) was far more common.

In a sense, what had changed was the prevailing null hypothesis in the study of government and markets.¹⁰ If students of market failure were responding to (and rejecting) the null that markets are perfect, students of government failure had adopted a new null – that *government* is perfect – and were doing their very best to reject it. This transformation (or, loosely, reversal) of the prevailing null would fundamentally reshape academic research on the role of the state, encouraging scholars over the last third of the twentieth century to focus relentlessly on both the theory and practice of government dysfunction.¹¹ When Ronald Reagan announced in his first inaugural address in 1981

⁹ Alan Greenspan, the former chairman of the Federal Reserve, acknowledged one aspect of this perspective in his now famous testimony of October 2008 before the House Committee on Oversight and Government Reform: “[T]hose of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.” See Testimony of Alan Greenspan, House Committee on Oversight and Government Reform, U.S. Congress, October 23, 2008, <http://oversight.house.gov/images/stories/documents/20081023100438.pdf>.

¹⁰ I am deeply indebted to Julio Rotemberg for encouraging me to think about the notion of a prevailing null in political economy.

¹¹ It has long been recognized that it is advantageous to “own” the null hypothesis. “As any empirical social scientist can attest,” one scholar has written, “it is extremely difficult to accumulate enough acceptable evidence to reject, or overturn, the null hypothesis, given the limited power of social science theory and our inability to identify adequate methods and techniques that can be applied to complex social situations. Therefore, whoever controls, or ‘owns,’ the definition of the null is apt to preserve it against attacks based on existing evidence.” See Jonathan R. Cole, “Balancing Acts: Dilemmas of Choice Facing Research Universities,” *Daedalus*, vol. 122, no. 4 (Fall 1993), p. 12. See also Harrison C. White, Review

that “government is not the solution to our problem; government is the problem,” his approach was entirely consistent with a new generation of scholarship on government failure.

Market Failure

Although the first relevant use of the term “market failure” dates to 1958, when Francis Bator published “The Anatomy of Market Failure” in the *Quarterly Journal of Economics*, the broader notion that private market activity might not always be welfare maximizing goes back considerably further. Perhaps the earliest expression of the externality concept should be credited to Henry Sidgwick, who observed in *The Principles of Political Economy* (1887) that individual and social utility could potentially diverge. A generation later, another British economist, Arthur Cecil Pigou, developed the idea further, first in *Wealth and Welfare* (1912) and subsequently in *The Economics of Welfare* (1920, 1932). Indeed, because Pigou was the first to suggest that a well targeted tax could be used to internalize an externality, such an instrument is still known among economists as a Pigouvian tax.¹²

Market failure theory continued to develop over the course of the twentieth century. In addition to externalities and public goods, economists identified and formalized numerous other potential sources of market failure, including asymmetric information (especially adverse selection and moral hazard) and imperfect competition (such as monopoly, oligopoly, and monopsony).¹³

of *Fair Science* by Jonathan R. Cole, in *American Journal of Sociology*, vol. 87, no. 4 (January 1982), pp. 951-956. In this paper, however, I come at the null (and what it means to “own the null”) from the opposite direction – that is, viewing the prevailing null as punching bag rather than fortress. With respect to market failure and government failure, I would characterize the prevailing null hypotheses not as difficult or impossible to reject but rather as intentionally very easy to reject, because they were implicitly framed as absolutes. The implicit null against which the market failure school did battle – that markets are perfect – proved relatively easy to reject, since any exception (say, to Pareto optimality) would justify rejection. Similarly, the implicit null that the government failure school has attacked – that government is perfect – is rather easy to reject for much the same reason. Although neither is a well-formed null from a statistical standpoint, both ended up facilitating successful and longstanding research efforts. And in both cases, repeated “rejection of the null” vaguely left the impression that the object of study (i.e., markets or government) was *very far* from perfect, when in fact such an interpretation would be nearly impossible to confirm or disconfirm empirically.

¹² Francis M. Bator, “The Anatomy of Market Failure,” *Quarterly Journal of Economics*, Vol. 72, No. 3 (August 1958), pp. 351-379; Henry Sidgwick, *The Principles of Political Economy* (London: Macmillan, 1887); A. C. Pigou, *Wealth and Welfare* (London: Macmillan, 1912); A. C. Pigou, *The Economics of Welfare*, 4th edition (London: Macmillan, 1932).

¹³ In addition to Pigou on externalities, some of the classic texts on market failure include Paul A. Samuelson, “The Pure Theory of Public Expenditure,” *Review of Economics and Statistics*, Vol. 36, No. 4 (November 1954), pp. 387-389; William J. Baumol, “On Taxation and the Control of Externalities,” *American Economic Review*, Vol. 62, No. 3 (June 1972), pp. 307-322; George A. Akerlof, “The Market for Lemons: Quality, Uncertainty, and the Market Mechanism,” *Quarterly Journal of Economics*, Vol. 84, No. 3 (August 1970), pp. 488-500; Michael Spence, “Job Market Signaling,” *Quarterly Journal of Economics*, Vol. 87, No. 3 (August 1973), pp. 355-374; Michael Rothschild and Joseph Stiglitz, “Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information,” *Quarterly Journal*

Across nearly all of this work on market failure was the underlying idea that good public policy could remedy market deficiencies and thus improve upon market outcomes, enhancing efficiency and, in turn, overall social welfare. At about the same time that Pigou was conceiving of his internalizing tax in Britain, reform-minded economists in America were claiming that social insurance could be used to minimize industrial hazards (such as workplace accidents and even unemployment) by internalizing the cost on employers. As John Commons explained in 1919 regarding newly enacted workers' compensation laws (which required employers to compensate the victims of workplace accidents), "We tax [the employer's] accidents, and he puts his best abilities in to get rid of them."¹⁴ Pigou himself endorsed a tax on gasoline that covered the cost of wear and tear on the roads, and even the playwright George Bernard Shaw suggested in 1904 that the "drink trade" be "debited with what it costs in disablement, inefficiency, illness, and crime..."¹⁵

Beyond Pigouvian taxes, the identification of market failures has been used to justify a wide range of economic policies. These include, among many other examples, public spending on education, national defense, and public parks (to support classic public goods); environmental regulation (to limit environmental externalities, such as pollution); and compulsory insurance, such as Medicare (to address the problem of adverse selection in private insurance markets). In fact, market failure theory is among the most powerful intellectual rationale – some would say, *the* most powerful rationale – for government intervention in the marketplace.

Government Failure

The problem, of course, is that there is no guarantee that government (and the political system that drives it) has the capacity to identify and fix market failures in anything close to an optimal manner. Beginning as far back as the late 1940s, a variety of strands of research began raising significant questions about the integrity and rationality of democratic decision making, about the legitimacy and efficacy of majoritarian politics, about the attentiveness and knowledge-base of voters, and about the public mindedness of lawmakers and civil servants. Methodologically, what nearly all of these strands of research had in common was the application of basic tools of economic analysis to the study of politics and public decision making.

of Economics, Vol. 95, No. 4 (November 1976), pp. 629-649; Mark V. Pauly, "The Economics of Moral Hazard: Comment," *American Economic Review*, Vol. 58, No. 3, Part 1 (June 1968), pp. 531-537; Joan Robinson, *The Economics of Imperfect Competition* (London: Macmillan, 1933); Michael Spence, "Product Selection, Fixed Costs, and Monopolistic Competition," *Review of Economic Studies*, Vol. 43, No. 2 (1976), pp. 217-235.

¹⁴ Cited in David Moss, *Socializing Security: Progressive-Era Economists and the Origins of American Social Policy* (Cambridge: Harvard University Press, 1996), p. 65.

¹⁵ *Ibid.* On Shaw's suggestion regarding alcohol (which was posed more as a something to imagine than as a true policy recommendation), see [George] Bernard Shaw, *The Commons Sense of Municipal Trading* (Westminster: Archibald Constable and Co., Ltd, 1904), p. 19.

Just two years after Duncan Black's landmark 1948 paper in the *Journal of Political Economy*, which introduced the median voter hypothesis, Kenneth Arrow published in the same journal a statement of his impossibility theorem, which proved that there exists no system of voting that can reflect ranked voter preferences while meeting even very basic rationality criteria (such as the requirement that if every voter prefers A to B, the electoral outcome will always favor A over B, regardless of the existence of alternative choice C). Seven years later, in 1957, Anthony Downs published *An Economic Theory of Democracy* which, among other things, pointed to the so-called rational ignorance of voters. James Buchanan and Gordon Tullock followed in 1962 with *The Calculus of Consent*, which offered a profound economic analysis of collective decision making, including a strong critique of majoritarianism. Rounding out the foundational texts of public choice theory, Mancur Olson published *The Logic of Collective Action* in 1965, highlighting in particular the power of special interests to exploit opportunities involving concentrated benefits and diffuse costs.¹⁶

Meanwhile, a closely related body of thought, which also tended to venerate the market, was beginning to take shape at the University of Chicago. In "The Problem of Social Cost," published in the *Journal of Law & Economics* in 1960, Ronald Coase (who was then at the University of Virginia but would soon move to Chicago) showed that externalities could be eliminated through trade in the absence of transaction costs. After apparently being the first to label Coase's contribution the "Coase Theorem," George Stigler launched a bold new approach to the study of regulation with his 1971 paper, "A Theory of Economic Regulation." Stigler's paper formalized the notion of regulatory capture (which grew out of rent-seeking on the part of both interest groups and regulators) and inaugurated what would ultimately become known as the Economic Theory of Regulation. Milton Friedman, meanwhile, had published *Capitalism and Freedom* in 1962, arguing that the best guarantee of political freedom lay in leaving private economic activity to the market and insulating it from government intervention. Government involvement in economic matters, he maintained, not only violated freedom through coercion but also generally spawned severe unintended consequences.¹⁷

By the mid to late 1970s, the study of government failure, in all its various forms, had come to rival – and, in terms of novelty and energy, perhaps had even overtaken – the

¹⁶ See Duncan Black, "On the Rationale of Group Decision Making," *Journal of Political Economy*, vol. 56, no. 1. (Feb., 1948), pp. 23-34; Kenneth J. Arrow, "A Difficulty in the Concept of Social Welfare," *Journal of Political Economy*, vol. 58, no. 4 (August 1950), pp. 328-346; Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957); James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962); Mancur Olson, Jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1965).

¹⁷ R. H. Coase, "The Problem of Social Cost," *Journal of Law & Economics*, Vol. 3 (October 1960), pp. 1-44; George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2, no. 1 (Spring 1971), pp. 3-21; Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962). On Stigler's use of the term "Coase Theorem," see e.g. Richard A. Posner, Nobel Laureate: Ronald Coase and Methodology," *Journal of Economic Perspectives*, Vol. 7, No. 4 (Autumn 1993), p. 200.

study of market failure in the social sciences. Indeed, Charles Wolf's synthesis, "A Theory of Nonmarket Failure," published in the *Journal of Law & Economics* in 1979, reflected the field's coming of age.¹⁸ "The principal rationale for public policy intervention," Wolf wrote, "lies in the inadequacies of market outcomes. Yet this rationale is really only a necessary, not a sufficient, condition for policy formulation. Policy formulation properly requires that the realized inadequacies of market outcomes be compared with the potential inadequacies of nonmarket efforts to ameliorate them."¹⁹ Ironically, as Wolf points out in a footnote, one of the earliest articulations of this insight about the potential for government failure belongs to Henry Sidgwick, who was also perhaps the earliest contributor to the theory of market failure. "It does not follow," Sidgwick wrote in his 1887 *Principles of Political Economy*, "that whenever *laissez faire* falls short government interference is expedient; since the inevitable drawbacks of the latter may, in any particular case, be worse than the shortcomings of private enterprise."²⁰

A Distorted Picture of Government?

There can be little doubt that the study of governmental failure has advanced our understanding of both the logic and limits of government involvement in the economy, including government efforts to remedy market failure. But just as the study of market failure, in isolation, may produce a distorted picture of government's capacity to solve problems, so too may an excessively narrow focus on government failure produce an exaggerated picture of government's incapacity to do almost anything constructive at all.

As studies of government dysfunction and democratic deficiency have piled up over the past several decades, cataloguing unending theories and examples of capture and rent-seeking and voter deficiencies, consumers of this literature could be forgiven for arriving at the conclusion that democratic governance can do nothing right. It would be as if health researchers studied nothing but medical failure, including medical accidents, negligence, and fraud. Even if every individual study were entirely accurate, the sum total of this work would be dangerously misleading, conveying the mistaken impression that one should never go to the doctor or the hospital. Unfortunately, the same may be true of social science research on government failure. When carried to an extreme, it may leave the mistaken impression that we should never turn to the government to help address societal problems.

Such an impression is obviously difficult to reconcile with practical experience. While no one would say that government regulation is perfect, who among us would prefer to live without many of the key regulatory agencies, such as the FDA, the EPA, the Federal

¹⁸ Charles Wolf, Jr., "A Theory of Nonmarket Failure: Framework for Implementation Analysis," *Journal of Law & Economics*, Vol. 22, No. 1 (Apr., 1979), pp. 107-139.

¹⁹ *Ibid.*, p. 107.

²⁰ Quoted in *Ibid.*, p. 107n1.

Reserve, the FDIC, the FAA, or the NTSB?²¹ Naturally, all of these agencies falter from time to time and could be improved in countless ways; but what proportion of Americans would seriously say that the nation would be better off if they were dismantled altogether? To take just one example, imagine how it would feel getting on an airplane if there were no FAA or NTSB, and the responsibility for air safety were left entirely to the airlines themselves.

The bottom line is that government failure is likely very far from absolute. Most of us probably appreciate that government regulators inspect our meat, check the safety and efficacy of our prescription drugs, and vigorously search for threats to the safety of our major modes of transportation. And yet, in the social sciences – and especially in economics and related fields – the appeal of continuing to bludgeon the government-is-perfect null remains remarkably strong, as does the influence of the resulting research.

While a good understanding of government failure is essential, it now seems that the original effort to correct the excessively rosy view of government associated with market failure theory has itself ended in overcorrection and distortion. In the face of the financial crisis of 2007-2009, the earlier drive to deregulate the financial markets, which was so profoundly influenced by the weight of academic opinion and the study of government failure, appears to stand as “Exhibit A” of just such an overcorrection and its tragic real world consequences.²²

The Case for Reversing the Null, Once Again

Today, in the wake of the most perilous financial crisis since 1933, there have been widespread calls for new regulation. I myself have put forward a proposal for identifying

²¹ The initials stand for the Food and Drug Administration (FDA), the Environmental Protection Agency (EPA), the Federal Deposit Insurance Corporation (FDIC), the Federal Aviation Administration (FAA), and the National Transportation Safety Board (NTSB).

²² To be sure, academic ideas about government failure (and market efficiency) are not the only – nor even necessarily the primary – drivers of deregulatory sentiment in American politics. Suspicion about the state has always played a large (and often very constructive) role in American life, from the earliest days of the republic; and there have always been plenty of special interests lobbying aggressively to limit or dismantle regulation. What academics have brought to the table is the legitimacy of expert opinion. If Citigroup and a handful of other large financial firms had stood alone in the late 1990s calling for the repeal of Glass-Steagall restrictions on universal banking, many lawmakers may well have dismissed their appeals as empty expressions of self-interest, with little bearing on the public interest. But when the banks’ case was vigorously supported by many of the leading scholars in the country, from all of the most prestigious academic institutions, the argument naturally became far more difficult to dismiss. Confirming the existence of a remarkably broad academic consensus on this issue (and related ones) at the time of repeal, Charles Calomiris wrote in 2000 that “[n]o prominent banking historians or economists have defended unit (single-office) banking or the historical restrictions on bank activities in underwriting or insurance...” He wrote further of a “remarkable degree of agreement among banking scholars – supported by an extensive body of research – that historic limitations on U.S. banks’ locations and activities are inefficient. Furthermore, that literature not only argues that historical restrictions on banks are currently inefficient, but also that they were undesirable at the time of their passage” [Charles W. Calomiris, *U.S. Bank Deregulation in Historical Perspective* (Cambridge: Cambridge University Press, 2000), pp. xi-xii].

and regulating the most systemically dangerous financial institutions – those large and interconnected firms that are commonly characterized as “too big to fail.”²³ A basic premise of my proposal is that New Deal financial regulatory reform worked, paving the way for a highly dynamic financial system that remained virtually crisis free for a half-century. The essential strategy of those New Deal reforms was to aggressively regulate the greatest systemic threats of the time (especially those associated with commercial banking) while exercising a relatively lighter touch elsewhere. In this way, the regulatory reforms helped to ensure both stability *and* innovation in the financial system.

Unfortunately, somewhere along the way, many observers (including many academics) came to take that stability for granted. Financial crises were now just a distant memory, and the link between their disappearance and the rise of New Deal regulation was largely forgotten. From there, it became all too easy to see financial regulation as a costly exercise with few if any benefits. Many existing regulations were soon weakened or removed and, even more troubling, policymakers often refrained from introducing new regulations even as new systemic threats began to take shape.

One of the main goals of financial regulation going forward, therefore, must be to update our financial regulatory system to address these new systemic threats – especially the systemically dangerous financial institutions that played such a large role in driving the crisis.

Policy proposals like this one, however, will not be sufficient by themselves. If the post-crisis push for better regulation is to succeed over the long term, I believe it must become rooted in a new generation of research on the role of government. Our predecessors have taught us a great deal about market failure and government failure. Now the goal must be to figure out when government works best and why – that is, what distinguishes success from failure.

Take the problem of regulatory capture, for example. George Stigler and his successors modeled the phenomenon and have highlighted numerous cases in which regulators (and legislators) appear to have been captured by special interests. This marks a very important contribution. The question now is what comes next. Unless one believes that capture is absolute and immutable, affecting all policymakers equally in all contexts, the next logical step would be to try to identify additional cases in which capture was relatively mild or non-existent, and then to use the variance across cases to generate testable hypotheses about why some public policies, agencies, and officials are more vulnerable to capture than others.²⁴ If we could gain a better understanding of what accounts for high versus low vulnerability, it might become possible to design public policies and regulatory structures with a relatively high degree of immunity to capture.

²³ See esp. Moss, “Ounce of Prevention.”

²⁴ For a first cut at this strategy, see David Moss and Mary Oey, “The Paranoid Style in the Study of American Politics,” in Edward J. Balleisen and David A. Moss, eds., *Government and Markets: Toward a New Theory of Regulation* (Cambridge: Cambridge University Press, 2010). See also David A. Moss and Jonathan B. Lackow, “Rethinking the Role of History in Law & Economics: The Case of the Federal Radio Commission in 1927,” Harvard Business School Working Paper, No. 09-008, August 2008.

Such an approach would imply the need for a new null hypothesis in the study of government. If market failure theory grew out of a markets-are-perfect null, and the exploration of government failure grew out of a government-is-perfect null, then perhaps what is required now is a government-always-fails null. This would push researchers to examine whether (as some students of government failure seem to believe) government always fails and to look hard for cases of success to reject the null. The goal would not simply be to create a catalog of government successes, but ultimately to identify, with as much precision as possible, the essential conditions that separate success from failure.

Fortunately, some scholars have already begun moving in this direction. Dan Carpenter's work on market-constituting regulation and Steven Croley's on regulatory rule making in the public interest are valuable cases in point.²⁵ But much more is needed. To complement the rich work on government failure that has emerged over the past several decades, we need a similarly broad-based effort exploring what works in government, and why. It is time, in short, to reverse the null once again.

Regulation, Deregulation, and the Power of Ideas

The financial crisis of 2007-2009 exposed severe weaknesses in American financial regulation and, in turn, in our *ideas* about financial regulation and the role of government more broadly.

With regard to the regulation itself, we had no meaningful mechanism for monitoring and controlling new forms of systemic risk. Massive financial firms – the failure of any one of which could pose grave danger to the financial system – were allowed to take extraordinary risks during the boom years, with leverage ratios rising into the stratosphere. There was also far too little protection of the consumer borrower; and a number of particularly strategic players in the financial system (including especially credit rating agencies) operated with virtually no oversight whatsoever. Some say the problem was deregulation itself, which dismantled critical protections. Others (including this author) have placed more emphasis on a deregulatory mindset that inhibited the development of new regulation – or the modernization of existing regulation – in response to changing financial conditions. Either way, it seems clear that our regulatory system failed us.

Looking forward, it is imperative that our policymakers devise and implement effective systemic regulation. I have suggested particularly vigorous regulation of the most systemically dangerous financial firms, with the dual goal of making them safer and encouraging them to slim down.

²⁵ See e.g. Daniel Carpenter, "Confidence Games: How Does Regulation Constitute Markets," in Balleisen and Moss, eds., *Government and Markets*; Steven P. Croley, *Regulation and Public Interests: The Possibility of Good Regulation Government* (Princeton: Princeton University Press, 2008).

But as we think about regulatory reform – including both enactment and implementation – it is important that we correctly diagnose the causes not only of the financial crisis itself but also of the regulatory failure that paved the way, both for the bubble and the subsequent crash. Ironically, part of the explanation for the latter may relate to the growing focus within the academy on government failure, which helped to convince policymakers that regulation was generally counterproductive. The influence of the leading scholars in the field – concentrated especially at Chicago and Virginia – appears to have been quite large. It was no coincidence, for example, that President Ronald Reagan chose as his lead official on deregulation Christopher DeMuth, who had studied under both George Stigler and Milton Friedman at the University of Chicago. Not long after Stigler won his Nobel Prize in Economics (in 1982), DeMuth characterized him as “the intellectual godfather of what we’re trying to do in the regulatory area.”²⁶

In the specific domain of financial deregulation, general academic work on government failure combined with two other influences, particularly in the 1990s and early 2000s, to help shape the worldview of numerous lawmakers and regulators: (1) a growing faith in the nearly perfect efficiency of financial markets (which was, by the way, the product of another very successful field of academic research that was taken perhaps to an unreasonable extreme) and (2) a fading memory of the many crises that had punctuated American history up until the adoption of New Deal financial regulation from 1933 to 1940. In tandem with these two factors, the relentless academic focus on failure in the study of government, especially within the discipline of economics, may have fostered a distorted picture in which public policy could almost never be expected to serve the public interest.

Finally, then, if we are to introduce, implement, and *sustain* effective regulation – in the financial sector and elsewhere – a new generation of academic research may be necessary, exploring the essential questions of when government works and why. Naturally, the question of what constitutes success within the policy arena will remain controversial. But at least it’s a question that takes us in the right direction.

Summary

After more than a quarter century since George Stigler’s Nobel Prize (and just under a quarter century since James Buchanan’s), the field of public choice, with its intense focus on government failure, has emerged as perhaps the closest thing to an orthodoxy that exists in political economy. It certainly succeeded in changing the prevailing null hypothesis in the study of government, from markets are perfect to government is perfect, leading throngs of researchers to search for signs of government failure in an effort to reject the government-is-perfect null. This work taught us a great deal about the potential limits of public policy. But just as early market failure theory may have left the mistaken

²⁶ Quoted in Felicity Barringer, “I Knew Him When: Recent Developments on the Regulatory Front,” *Washington Post*, October 25, 1982, p. A11. On DeMuth, see also Edward Cowan, “What’s New in Deregulation: The Man Who Will Direct Phase 2,” *New York Times*, October 10, 1982, Section 3, page 27.

impression that government could fix any market failure, the study of government failure may have left the equally mistaken impression that government can do nothing right.

If so, then it may be time to reverse the prevailing null hypothesis once again, adopting the most extreme conclusion of the government failure school – that government always fails – as the new null. From there, the goal would be to set about trying to reject this new null, and (most important) to try to identify conditions separating government success from failure. Although such a shift in academic focus could only take root gradually, it would eventually mark a vital complement to the new and more assertive regulatory policies that appear to be emerging in response to the crisis. Without an underlying change in ideas, new regulatory approaches will almost inevitably atrophy over time, leaving us in the same exposed position that got us into trouble in the lead-up to the recent crisis. Looking ahead, we can (and must) do better.