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Edward Rubin
Vanderbilt University Law School

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Can The Obama Administration Renew American Regulatory Policy?

EDWARD RUBIN*

In THE ONION's version of George W. Bush's inauguration speech, Bush intones: "Our long national nightmare of peace and prosperity is finally over."¹ Written on January 17, 2001, the satire is so prescient that it merits quotation at length, and thus appears below (what are footnotes for, after all?).² By the end of his two terms in office, Bush had not only wrecked the nation, but also wrecked the model of government that had dominated national politics for 28 years. The purpose of this essay is to explore the possibility that the Obama Administration will develop a new model, a new approach to governing America. It focuses exclusively on regulatory policy, and uses the regulation of financial derivatives as its example. This essay proceeds as follows: Part I discusses models of governance generally (Section A) and their application to the regulatory process (Section B). Part II explores the theory of a new approach to governance descriptively, if unimaginatively, named New Public Governance (Section A), that might serve as a model for the Obama Administration, and describes the way that approach applies to regulatory policy (Section B). Part III uses the example of the 2007–08 financial crisis, in particular the case of mortgage-backed securities, to assess the causes of the crisis (Section A) and the cures that the New Public Governance suggests (Section B).

* University Professor of Law and Political Science, Vanderbilt University.

¹ *Bush: 'Our Long National Nightmare of Peace And Prosperity is Finally Over,'* THE ONION (Jan. 17, 2001), <http://www.theonion.com/articles/bush-our-long-national-nightmare-of-peace-and-pros,464/>.

² Bush swore to do "everything in [his] power" to undo the damage wrought by Clinton's two terms in office, including . . . going into massive debt to develop expensive and impractical weapons technologies . . . Bush also promised to bring an end to the severe war drought that plagued the nation under Clinton, assuring citizens that the U.S. will engage in at least one Gulf War-level armed conflict in the next four years. . . .

....

On the economic side, Bush vowed to bring back economic stagnation by implementing substantial tax cuts, which would lead to a recession . . .

....

Turning to the subject of the environment, Bush said he will do whatever it takes to undo the tremendous damage not done by the Clinton Administration to the Arctic National Wildlife Refuge. He assured citizens that he will follow through on his campaign promise to open the 1.5 million acre refuge's coastal plain to oil drilling.

Id.

I. MODELS OF POLITICS AND GOVERNANCE FROM ROOSEVELT TO REAGAN

A. *Politics: Skowronek's Theory of Presidential Leadership*

Stephen Skowronek's theory of presidential leadership provides a framework that can be used to understand models of governance in general, and thus of the regulatory policy that constitutes such an important part of modern government.³ This will in turn provide insight into the meaning of Barak Obama's election and the possibility that his administration will develop a new approach to governance and regulation.

Skowronek begins from the somewhat counterintuitive position that the president's greatest power resides in negation rather than creation. As the leader of a government with divided powers and of a nation with a robust, pluralist and interventionist public discourse, he generally cannot take control of affairs and systematically implement his ideological vision. What he can do is change direction, altering what has gone before. The presidency, Skowronek writes, "has functioned best when it has been directed toward dislodging established elites, destroying the institutional arrangements that support them, and clearing the way for something entirely new."⁴

The principal determinant of a president's ability to achieve something new by using this "battering ram"⁵ is, according to Skowronek, his position in history. One group of presidents takes office as opponents of previously established regimes that have "become vulnerable to direct repudiation as failed or irrelevant responses to the problems of the day."⁶ As a result, these presidents have the unusual opportunity to "reformulate the nation's political agenda altogether, to galvanize support for the release of governmental power on new terms, and to move the nation past the old problems, eyeing a different set of possibilities altogether."⁷ Skowronek refers to this group as "reconstructive" presidents, and its members have come down to us with the reputation of being great leaders: Jefferson, Jackson, Lincoln and Franklin Roosevelt.⁸

A second group of presidents comes to power when the regime established by a prior reconstruction remains relevant and resilient, and strives "to fit the existing parts of the regime together in a new and more relevant way."⁹ Skowronek calls this the politics of articulation. "[T]hese presidents shake things up largely by blasting away at the obstacles to completing the work and exhorting their followers to continue the fight."¹⁰ Most obviously, this group includes direct followers of a reconstructive president who are close colleagues of that president and are specifically elected as his successor: Madison,

³ STEPHEN SKOWRONEK, *THE POLITICS PRESIDENTS MAKE: LEADERSHIP FROM JOHN ADAMS TO GEORGE BUSH* (1993).

⁴ *Id.* at 27.

⁵ *Id.* at 28.

⁶ *Id.* at 36; *see generally id.* at 36–39.

⁷ *Id.* at 38.

⁸ *Id.* at 36; *see id.* at 62–85 (Skowronek does not discuss Washington, who is in some sense *sui generis*, but it would not be difficult to view him as the ultimate reconstructive President, coming to power after the Articles of Confederation government that was widely believed to be a failure in its entirety).

⁹ *Id.* at 41; *see generally id.* at 41–43.

¹⁰ *Id.* at 42.

Van Buren, and Truman.¹¹ It also includes presidents who follow the reconstructive president after a period of time, but remain committed to the same values and consciously identify themselves as such, regardless of any direct personal connection. Skowronek provides an extended discussion of four such presidents—Monroe, Polk, Theodore Roosevelt and Lyndon Johnson¹²—whom he calls orthodox innovators.

Skowronek's third category consists of presidents who are "affiliated with a set of established commitments that have in the course of events been called into question as failed or irrelevant responses to the problems of the day."¹³ These presidents, whom Skowronek labels "disjunctive," are not necessarily "do-nothing" leaders, as their historical reputations sometimes suggest; rather, their efforts possess a desperate quality as they struggle to meet contemporary demands with an approach that only alienates their followers, while energizing their opponents. Skowronek considers four such presidents at length: John Quincy Adams, Pierce, Hoover and Carter.¹⁴ A significant feature of disjunctive presidencies, as this list indicates, is that they prepare the way for a new reconstruction.¹⁵

Among the interesting aspects of Skowronek's theory is that it replaces the linear approach typical of Western historical accounts with a cyclical account more typical of Chinese historiography.¹⁶ Presidents are grouped in patterns that resemble Chinese dynasties, each one with its vigorous youth, its stable maturity, and its decrepit old age that is soon swept away by a new, invigorating successor.¹⁷ Skowronek does not entirely abandon the linear approach¹⁸ that characterizes other accounts of presidential politics, however;¹⁹ perhaps a better analogy is to Vico's theory that history moves in a spiral

¹¹ Thus, each of the reconstructive presidents was followed by an articulating president, with the exception of Lincoln, whose successor, Andrew Johnson, was actually a member of the opposing party, chosen because of the secession crisis. Lincoln's real successor was Grant; he was certainly an articulating president although, like Van Buren, not a particularly good one.

¹² *Id.* at 86–109, 155–76, 228–59, 325–60. These are clearly among the most successful presidents in this category.

¹³ *Id.* at 39; *see generally id.* at 39–41.

¹⁴ *Id.* at 110–27, 177–96, 260–86, 361–406.

¹⁵ *Id.* at 40.

¹⁶ *See* EDWIN REISCHAUER & JOHN FAIRBANK, *EAST ASIA: THE GREAT TRADITION* 111–18 (1960). For modern interpretations, *see* C.Y. Cyrus & Ronald Lee, *Famine, Revolt and the Dynastic Cycle: Population Dynamics in Historic China*, 7 *J. POPULATION ECON.* 351 (1994); Dan Usher, *The Dynastic Cycle and the Stationary State*, 79 *AM ECON. REV.* 1031 (1989). This mode of thought was also common in Ancient Greece. *See* HESIOD, *THEOGONY & WORKS AND DAYS* (M.L. West, trans., 1988).

¹⁷ In the Chinese account, each new dynasty is said to possess the Mandate of Heaven, which it loses as it declines. I will avoid any effort to analogize this aspect of Chinese historiography to an account of American presidents.

¹⁸ *See* SKOWRONEK, *supra* note 3, at 52–58, 409–46.

¹⁹ *See, e.g.,* RICHARD E. NEUSTADT, *PRESIDENTIAL POWER AND THE MODERN PRESIDENTS: THE POLITICS OF LEADERSHIP FROM ROOSEVELT TO REAGAN* (Free Press 1990) (1960) (post-World War II presidency represents a new phase of leadership);

pattern, with each cycle building on the prior one.²⁰ Even better, although admittedly overused these days, may be the analogy with Thomas Kuhn's theory of scientific revolutions.²¹ A revolution in scientific thought, according to Kuhn, produces a new paradigm that then serves as a conceptual structure for subsequent research, which Kuhn describes as normal science. After a while, however, contradictory data begins to accumulate and the paradigm is placed under increasing stress as its devotees struggle to accommodate this data within the confines of the paradigm. The situation persists until someone develops a new paradigm that more adequately explains the data and displaces the preceding one.

A truly convincing model of institutions or human behavior is one that, like the Chinese model of dynastic cycles, predicts future events.²² Skowronek ends his book with a preliminary discussion of Reagan and George Bush (henceforth "Bush I").²³ Nearly twenty years later, and thirty years after Carter's defeat, it is apparent that the intervening period follows his model quite well. Reagan represented a reconstruction, a reformulation of the nation's policy agenda and a repudiation of many of the policies and politics that had dominated the nation, despite Republican interludes, for nearly fifty years. Bush I was an articulation of Reagan's policies, a loyal former colleague who followed him—very much in the mode of Madison, Van Buren and Truman—and strove to adapt his policies and perspectives to a changing situation. George W. Bush (henceforth "Bush II") clearly represented a disjunction, an effort to continue or revive the same policies after they had ceased to be relevant to contemporary conditions or appealing to their former supporters. The result was a series of severe or catastrophic failures, spanning a wide range of policy areas: foreign affairs, the economy, disaster relief, environmental protection and human rights.²⁴

ARTHUR M. SCHLESINGER, JR., *THE IMPERIAL PRESIDENCY* (1973) (linear increase in presidential power).

²⁰ GIAMBATTISTA VICO, *THE FIRST NEW SCIENCE* (Leon Pompa ed., trans., 2002); see BENEDETTO CROCE, *THE PHILOSOPHY OF GIAMBATTISTA VICO* 131–32 (R. G. Collingwood trans., Transaction Publishers 2002) (1913).

²¹ THOMAS S. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* (2d ed. 1970); see also IMRE LAKATOS, *THE METHODOLOGY OF SCIENTIFIC RESEARCH PROGRAMMES* (John Worrall & Gregory Currie eds., 1978).

²² As Reischauer and Fairbank report, see *supra* note 16, the model was developed during the Han Dynasty on the basis of prior regimes that were largely mythological in nature. A period of warring states that did not conform to the model followed, and the next dynasty did not arise for another four hundred years. After that, however, came 1300 years of Chinese history that largely conformed to that model, with the T'ang, Sung, Ming and Ch'ing Dynasties following the pattern that the Han historians had articulated. The so-called Yuan Dynasty, between the Sung and the Ming, was in fact the Mongols, and was possibly an exception to the pattern.

²³ See SKOWRONEK, *supra* note 3, at 409–46.

²⁴ For general assessments of the Bush II presidency, see JACK GOLDSMITH, *THE TERROR PRESIDENCY: LAW AND JUDGMENT INSIDE THE BUSH ADMINISTRATION* (2007); SCOTT MCCLELLAN, *WHAT HAPPENED: INSIDE THE BUSH WHITE HOUSE AND WASHINGTON'S CULTURE OF DECEPTION* (2008); CHARLIE SAVAGE, *TAKEOVER: THE RETURN OF THE*

B. Regulatory Policy

Skowronek's theory focuses on political leadership and electoral success, those being the metrics by which he determines whether a president is reconstructive, articulating or disjunctive; but it can be readily adapted to modes of governance, which are intimately related to politics. The topic of this essay is regulatory policy, a crucial component of governance in a modern administrative state. It was certainly crucial to Franklin Roosevelt's reconstruction, which centered on the idea that government could take an active role in solving people's economic woes. Roosevelt's first attempt to do so, subsequently known as the First New Deal, was the National Industrial Recovery Act (NRA).²⁵ The NRA adopted a corporatist strategy, under which the Administration induced businesses, workers and consumers in each industry to join together in developing industry codes to control prices and stimulate consumption. While the immediate motivation for its passage was to counteract Senator Hugo Black's proposal for a mandatory thirty-hour work week,²⁶ its more general, albeit vaguer, inspiration probably came from Mussolini,²⁷ who was much admired at the time.²⁸ Within a few years, however, the NRA was revealed as unmanageable, Hitler had given fascism a bad name,²⁹ and the Supreme Court was emboldened to strike down the entire act as an

IMPERIAL PRESIDENCY AND THE SUBVERSION OF AMERICAN DEMOCRACY (2007); CRAIG UNGER, *THE FALL OF THE HOUSE OF BUSH* (2007); JACOB WEISBERG, *THE BUSH TRAGEDY* (2008); BOB WOODWARD, *BUSH AT WAR* (2003); BOB WOODWARD, *PLAN OF ATTACK* (2004); BOB WOODWARD, *STATE OF DENIAL* (2006). Not every account of George W. Bush's presidency is negative, however. *See* GEORGE W. BUSH, *A CHARGE KEPT: THE RECORD OF THE BUSH PRESIDENCY 2001–2009* (Marc A. Thiessen ed., 2009).

²⁵ For general descriptions, *see* CONRAD BLACK, *FRANKLIN DELANO ROOSEVELT: CHAMPION OF FREEDOM* 285–89, 303–06 (2003); DONALD R. BRAND, *CORPORATISM AND THE RULE OF LAW: A STUDY OF THE NATIONAL RECOVERY ADMINISTRATION* (1988); JAMES MACGREGOR BURNS, *ROOSEVELT: THE LION AND THE FOX* 180–81, 191–93 (1956).

²⁶ BLACK, *supra* note 25, at 285; SKOWRONEK, *supra* note 3, at 305–06.

²⁷ *See* R.J.B. BOSWORTH, *MUSSOLINI'S ITALY: LIFE UNDER THE FASCIST DICTATORSHIP 1915–1945* 308–12 (2006); ERNST NOLTE, *THREE FACES OF FASCISM* 261 (Leila Vennewitz trans., 1965) (1963).

²⁸ BOSWORTH, *supra* note 27, at 285. Roosevelt corresponded with Mussolini on friendly terms from the time of his first inauguration until 1936, addressing him as “My Dear Duce.” BLACK, *supra* note 25, at 273, 423–24.

²⁹ Italy was still an ally of Britain and France in 1932, as it had been in World War I, BOSWORTH, *supra* note 27, at 277–306, and Mussolini was neither overtly anti-Semitic, *id.* at 415–21, nor particularly savage in punishing dissenters, *id.* at 241–42, until his alliance with Hitler in the mid-1930s. *See also* NOLTE, *supra* note 27, at 228–31. It was this alliance that generated the first feelings of hostility toward Mussolini in the U.S. BOSWORTH, *supra* note 27, at 396–414. Both Bosworth and Nolte caution us against adopting too benign a view of Mussolini, a temptation because of the inevitable comparison with Hitler; but the need for this warning underscores the rather positive attitude toward Mussolini that prevailed through the early 1930s.

unconstitutional delegation of power,³⁰ a rationale that it had never invoked before and has never invoked since.³¹

Roosevelt, ever the pragmatist, then shifted gears and moved forward with a number of statutes, which instituted a more adversarial, command and control model of regulation that focused on disciplining corporations for specified misbehavior rather than on making efforts to obtain their cooperation.³² That model of regulation, sometimes called the “Second New Deal,” became the standard approach, and extensive reliance on it was a hallmark of the Democratic administrations that followed, as well as of the Nixon Administration. The two great bursts of regulatory activity during this period were in the mid to late 1930s, when the command and control approach was applied to economic issues, and in the mid to late 1960s, when it was applied to consumer issues, environmental issues, and civil rights.³³ As might have been expected and is now well known, the size of the national government grew steadily throughout this period.³⁴

The Reagan reconstruction involved a broad attack on the model of regulation that had prevailed since Franklin Roosevelt and the development of a new approach. Reagan campaigned in 1980 against the extent of federal regulation and the scope of the federal government in general. The mood of his campaign was captured by his subsequent remark that “the nine most terrifying words in the English language are ‘I’m from the government and I’m here to help.’”³⁵ This represented a dramatic change; Roosevelt, Truman, Kennedy, Johnson, and Carter all based their campaigns and administrations on federal initiatives. Eisenhower, as Skowronek notes, “demonstrated extraordinary sensitivity to the resilience of the previously established regime . . . [and] refused to take on New Deal liberalism or Fair Deal foreign policy directly.”³⁶ Nixon was the ultimate

³⁰ A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 541–42 (1935) (striking down the NRA in its entirety on delegation grounds); Panama Ref. Co. v. Ryan, 293 U.S. 388, 430 (1935) (striking down one provision of the NRA on delegation grounds).

³¹ See, e.g., Whitman v. Am. Trucking Ass’n, 531 U.S. 457, 472–76 (2001) (unanimously reversing a D.C. Circuit decision that struck down EPA regulations on delegation grounds); Mistretta v. United States, 488 U.S. 361, 371–74 (1989) (upholding broad delegation to U.S. Sentencing Commission over a single dissent by Justice Scalia); Indus. Union Dep’t v. Am. Petroleum Inst., 448 U.S. 607, 611, 661–62, 683–89 (1980) (upholding broad delegation to the Secretary of Labor; the Court was unanimous on the delegation issue, with only Justice Rehnquist expressing reservations).

³² WILLIAM E. LEUCHTENBURG, FRANKLIN ROOSEVELT AND THE NEW DEAL 1932–1940, 163–63 (Henry Steele Commager & Richard B. Morriseds., 1963); ARTHUR M. SCHLESINGER, JR., THE AGE OF ROOSEVELT: THE POLITICS OF UPHEAVAL 385–442 (1960). Briefer discussion can be found in BLACK, *supra* note 25, at 355–57; BURNS, *supra* note 25, at 223–26; SKOWRONEK, *supra* note 3, at 312–13.

³³ See Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189 (1986).

³⁴ DENNIS C. MUELLER, PUBLIC CHOICE III, 501–06 (2003).

³⁵ Spoken at a press conference in Chicago on Aug. 2, 1986. JULIA VITULLO-MARTIN & J. ROBERT MOSKIN, THE EXECUTIVE’S BOOK OF QUOTATIONS 130 (1994).

³⁶ SKOWRONEK, *supra* note 3, at 46.

Washington insider; perhaps the only President who had no home state at the time he ran for office,³⁷ he signed the far-reaching regulatory statutes written and passed by a liberal Democratic Congress.³⁸ Reagan's attack on federal regulation thus represented a genuine reconstruction in Skowronek's terms.

Once in office, Reagan attempted to advance his reconstruction along three overlapping lines: deregulation, privatization, and cost-benefit analysis. Deregulation could serve as a general term for Reagan's entire regulatory policy. If limited to the repeal of regulatory statutes and the refusal to enact new ones, however, the term is distinguishable from the other two policies, which will give some descriptive clarity. Deregulation, in this more limited sense, was actually an important part of Carter's administrative program, but it was directed to those industries where regulation was designed to control and limit competition.³⁹ Many economists rejected regulation of this sort as inefficient,⁴⁰ using a market failure model of efficiency, which Carter fully understood. Reagan's notion of deregulation was not program-specific in this way. He wanted to reduce the general scale of regulation on the theory that any regulation, whether intended to correct a market failure or not, interfered with the ability of businesses to create wealth and provide employment.⁴¹ In addition, he had both a political and emotional commitment to federalism and private property and saw national regulation as improperly intruding on their domains.⁴²

Privatization is a separate, although obviously related, policy. It refers to the process by which a formerly public task is contracted to a private firm; one famous example is the Reagan Administration's LOGCAP contract, in force to this day, through

³⁷ See CONRAD BLACK, RICHARD M. NIXON: A LIFE IN FULL 444–507 (2007). Nixon began as a California politician, and that was certainly his identity when he was elected Vice President in 1952. *Id.* at 75–267. When he ran for the presidency in 1968, however, he was a New York lawyer with no particular political base in any state, and he presented himself as someone with extensive Washington, D.C. experience.

³⁸ *Id.* at 642–702.

³⁹ See MARTHA DERTHICK & PAUL J. QUIRK, THE POLITICS OF DEREGULATION 147–206 (1985); THOMAS K. MCCRAW, PROPHETS OF REGULATION 57–79, 222–99 (1986) (discussing railroad regulation adopted to protect small shippers and deregulation of passenger air travel). Generally, this policy was adopted in order to achieve either economic planning or non-economic goals. See, e.g., NICK A. KOMONS, BONFIRES TO BEACONS: FEDERAL CIVIL AVIATION POLICY UNDER THE AIR COMMERCE ACT, 1926–1938, 91–92 (1978) (airline regulation adopted to encourage passenger air travel).

⁴⁰ See, e.g., ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 173–220 (1988); GORDON TULLOCK, TOWARD A MATHEMATICS OF POLITICS (1967); W. KIP VISCUSI, ET AL., ECONOMICS OF REGULATION AND ANTITRUST (4th ed. 2005).

⁴¹ See LOU CANNON, PRESIDENT REAGAN: THE ROLE OF A LIFETIME 736–40 (1991); STEPHEN F. HAYWARD, THE AGE OF REAGAN: THE CONSERVATIVE COUNTERREVOLUTION 1980–1989 214–18 (2009).

⁴² See, e.g., Exec. Order No. 12,612, 3 C.F.R. 252 (1987); Exec. Order No. 12,630, 3 C.F.R. 554 (1988). Executive orders are a particularly good indication of presidential policy because, unlike legislation or treaties, the President promulgates them unilaterally.

which several private companies have provided a broad range of logistical services to the U.S. military.⁴³ Unlike deregulation, privatization is not necessarily designed to end government regulation of a particular area, but rather to shrink the number of employees and the amount of funds under direct government control.⁴⁴ From an economic point of view, the purpose is to benefit from the presumed efficiency of private entrepreneurs, who generally function in a competitive environment.⁴⁵ Far from being something new, privatization is as old as government⁴⁶ and has been extensively utilized throughout American history.⁴⁷ The U.S. government, after all, has rarely manufactured the many military and civilian products that it uses. But, the Reagan Administration significantly increased the potential scope of privatization by issuing a Supplemental Handbook to the Office of Management and Budget directive, OMB Circular-76 providing guidelines for privatization⁴⁸ and an Executive Order that created a presumption in favor of this approach.⁴⁹

⁴³ The acronym stands for Logistics Civil Augmentation Program. The services provided include housing, sanitation, food, recreation and burial services to soldiers, and operations, information, personnel and maintenance services to the Army as a whole. *See* Logistics Civil Augmentation Program, Army Regulation 700-137 (Dec. 16, 1985), *available at* www.aschq.army.mil/gc/files/AR700-137.pdf. Four successive LOGCAP contracts have been awarded to three different contractors, KBR, DynCorp, and Fluor Corporation. *See* PRATAP CHATTERJEE, HALLIBURTON'S ARMY: HOW A WELL-CONNECTED TEXAS OIL COMPANY REVOLUTIONIZED THE WAY AMERICA MAKES WAR (2009); Nathan Vardi, *DynCorp Takes Afghanistan*, FORBES.COM, July 30, 2009, www.forbes.com/2009/07/30/dyncorp-kbr-afghanistan-business-logistics-dyncorp.html.

⁴⁴ *See* JOHN D. DONAHUE, THE PRIVATIZATION DECISION (1989); GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY (Jody Freeman & Martha Minow eds., 2009); DANIEL GUTTMAN & BARRY WILLNER, THE SHADOW GOVERNMENT: THE GOVERNMENT'S MULTI-BILLION-DOLLAR GIVEAWAY OF ITS DECISION-MAKING POWERS TO PRIVATE MANAGEMENT CONSULTANTS, "EXPERTS," AND THINK TANKS (1976); E.S. SAVAS, PRIVATIZATION: THE KEY TO BETTER GOVERNMENT (1987); PAUL VERKUIL, OUTSOURCING SOVEREIGNTY: WHY PRIVATIZATION OF GOVERNMENT FUNCTIONS THREATENS DEMOCRACY AND WHAT WE CAN DO ABOUT IT (2007); Martha Minow, *Outsourcing Power: How Privatizing Military Efforts Challenges Accountability, Professionalization and Democracy*, 46 B.C. L. Rev. 989 (2005).

⁴⁵ For an extreme version of this claim, *see* Michael J. Trebilcock & Edward M. Iacobucci, *Privatization and Accountability*, 116 HARV. L. REV. 1422, 1424-31 (2003).

⁴⁶ Feudalism, after all, is a form of privatization. *See* MARC BLOCH, FEUDAL SOCIETY 123-279 (L.A. Manyon trans., 1961); F.L. GANSHOF, FEUDALISM (Philip Grierson, trans., 3d. ed. 1996) (1950).

⁴⁷ WILLIAM J. NOVAK, THE PEOPLE'S WELFARE: LAW AND REGULATION IN NINETEENTH CENTURY AMERICA (1996).

⁴⁸ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR NO. A-76 (Revised Supplemental Handbook 1996).

⁴⁹ Exec. Order No. 12,615, 3 C.F.R. 259 (1987). Section 1(a) instructed each agency head to "[e]nsure that new Federal Government requirements for commercial activities are

The third element in Reagan's regulatory reconstruction was cost-benefit analysis, which was also instituted by executive order.⁵⁰ In essence, the order required that every executive agency calculate the monetized costs and benefits of proposed regulations and submit their calculations to the Office of Management and Budget (OMB).⁵¹ A unit within the OMB would then review the agency calculations and inform the agency whether it could proceed with the proposed regulation.⁵² The goal was to determine whether the regulation was economically justified—that is, whether the measurable benefits that would result from the regulation exceeded the costs that would be incurred by the government and imposed on private parties. Being established by executive order, the scheme could not serve as deregulation per se; that is, it could not repeal a congressionally enacted statute.⁵³ Nor was it closely allied to privatization; privatization might reduce the cost of the program somewhat but for cost-benefit purposes, the money paid to a private contractor counts to the exact same extent as the money directly expended by the agency.⁵⁴ Rather, cost-benefit analysis was a separate initiative to subject the regulatory process to economic discipline.⁵⁵ Policy makers have always understood that they should not spend more money solving a problem than the problem itself costs. One distinctive feature, as a policy device, is that it counts the costs imposed on private firms by regulation equally with the direct costs of governmental action. Although much discussed during the 1970s, and adumbrated by several initiatives during the Nixon, Ford, and Carter Administrations, Reagan's cost-benefit regimes represented a distinct departure from prior practice.

provided by private industry, except where statute or national security requires government performance or where private industry costs are unreasonable.”

⁵⁰ Exec. Order No. 12,291 3 C.F.R. 127 (1981) [hereinafter EO 12,291].

⁵¹ The order excluded rules whose economic impact was less than \$100 million per year.

⁵² That unit is the Office of Regulatory Affairs (OIRA). It was created to implement the provisions of the Paperwork Reduction Act, 44 U.S.C. § 3501 *et seq.*, and then given authority over the cost-benefit process by Executive Order 12,615, thus transforming a fairly minor agency into one of the most important ones in the federal government.

⁵³ For the same reason, the Executive Order does not apply to independent agencies, over which the President does not exercise direct control. *See* EO 12,291 § 1(d).

⁵⁴ In fact, cost-benefit analysis is specifically designed to count private costs equally. One of its underlying concepts is the regulatory budget, a mode of analysis by which all the costs of a government program, including costs imposed on or incurred by private parties, are computed when deciding on the overall size of government. *See* Jim Tozzi, *Towards a Regulatory Budget: A Working Paper on the Cost of Federal Regulation* (Office of Mgmt. & Budget 1979), available at <http://www.thecre.com/ombpapers/regbudget.html>; B. Ward White, *Proposals for a Regulatory Budget*, PUB. BUDGETING & FIN. 46 (Autumn 1981).

⁵⁵ For general discussions of cost-benefit analysis, see MATTHEW ADLER & ERIC POSNER, *NEW FOUNDATIONS OF COST BENEFIT ANALYSIS* (2006); E.J. MISHAN & EUSTON QUAH, *COST BENEFIT ANALYSIS* (5th ed. 2007); TEVFIK NAS, *COST-BENEFIT ANALYSIS: THEORY AND APPLICATIONS* (1996); W. KIP VISCUSI, *FATAL TRADEOFFS: PUBLIC AND PRIVATE RESPONSIBILITIES FOR RISK* (1992).

Because Reagan's regulatory reconstruction is primarily a model of governance rather than a political position, it is helpful to add Kuhn's theory of paradigms to Skowronek's theory of leadership cycles. Of course, Reagan's regulatory policy was motivated by political considerations, and of course he used it to express his support for politically charged notions like free enterprise, self-reliance, private property, and smaller government.⁵⁶ But the policy itself lies well below the public radar screen; it is too technical and recondite to be a factor in political debate. Instead, it can be viewed as a paradigm for decisions involving regulation. Its conceptual, as opposed to its political, center is belief in the efficiency of a competitive market, an idea that is too abstract to possess much independent political appeal but really gets professional economists excited.

The essential claim is that a market where goods and services are voluntarily exchanged is inherently efficient, more so than any alternative mode of governing economic activities. From this claim, it follows that the task of government is to facilitate the market, not to control it or alter its results. Thus, the government should establish and protect property rights and enforce contractual agreements, but it should not undertake any further regulatory action.⁵⁷ The exception, of course, is in a case of market failure due to monopoly, externality, or information asymmetry.⁵⁸ In that case, regulation has the potential to improve the efficiency of the market, but there are several caveats. One caveat is that the government should not conclude too quickly that a market failure has occurred; in many cases, the market itself will "clear" the apparent failure.⁵⁹

A more important caveat for present purposes is that the government will not necessarily be able to correct the market failure because it does not behave in the efficient manner of a private firm that is subject to competitive market forces. Its best chance of acting efficiently is to contract out its functions to a private firm that is subject to such

⁵⁶ He also used it, as have all other presidents since its promulgation, as a means of controlling the administrative apparatus. See Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001).

⁵⁷ The radio legislation that preceded Roosevelt's presidency can be taken as an example of such governmental action. Individual entrepreneurs who started broadcasting companies—perhaps the classic image of anti-regulatory Republicans—begged Congress to pass a statute governing their business, and Coolidge—perhaps the classic image of an anti-regulatory Republican president—agreed. What they wanted, and what they got, was a statute that established property rights to specific portions of the electromagnetic spectrum. Radio Act of 1927, ch. 169, 44 Stat. 1162, 1166 (1927).

⁵⁸ See WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICIES* 255–324 (6th ed. 1979); STEPHEN BREYER, *REGULATION AND ITS REFORM* (1982); N. GREGORY MANKIW, *PRINCIPLES OF MICROECONOMICS* 201–20, 311–38 (3d ed. 2004); ANTHONY OGUS, *REGULATION: LEGAL FORM AND ECONOMIC THEORY* (1994); DANIEL RUBINFELD & ROBERT PINDYCK *MICROECONOMICS* 327–52, 561–619 (7th ed. 2008).

⁵⁹ The presence of only one seller does not necessarily indicate that a monopoly exists because the market may be readily contestable; that is, barriers of entry may be sufficiently low that another seller could enter if the existing seller were selling goods above the competitive price. Externalities can sometimes be bargained away and information asymmetries can be resolved by the sale of information, such as ratings or consumer guides.

forces; thus, the government has a better chance of correcting the market failure of public goods by hiring a private firm to provide services to the national defense forces rather than providing these services directly. Whether the government subcontracts out or not, it must take care that its inherent inefficiency does not result in its doing more harm than good. Cost-benefit analysis is a means of making this determination. It adopts a skeptical stance toward the government's ability to solve problems; rather than taking the problem itself as a justification for action, the way the previous New Deal paradigm of regulation did, it requires an affirmative demonstration that the action is justified in economic terms.

Reagan's model of regulatory governance, consisting of deregulation, privatization, and cost-benefit analysis, was continued by Bush I with relatively little change. This is hardly surprising and is consistent with Skowronek's model of political leadership; as Reagan's Vice President and the successor to a reconstructive president, Bush I fits into the classic mode of an articulating president, like Madison, Van Buren and Truman. What is perhaps more interesting is that the same model, with some modification, was also continued by Clinton. Skowronek proposes a fourth category of leadership, which he calls preemptive, for presidents who are members of a different party from their predecessor, but do not lead a reconstruction of their own. These are "opposition leaders in resilient regimes. . . . Like all opposition leaders, these presidents have the freedom of their independence from established commitments, but . . . their repudiative authority is manifestly limited by the political, institutional and ideological supports that the old establishment maintains."⁶⁰ The term "preemptive" does not seem as intuitively accessible as the others in his model; in any event, it is a product of the essentially political focus of his work.

Focusing on governance instead of politics, and adding Kuhn's concept of paradigms to Skowronek's concept of leadership cycles, allows us to interpret Clinton's presidency in a somewhat different light. His regulatory policy, rather than being regarded as preemptive, can be seen as normal science—a continuation and elaboration of the paradigm established by Reagan. Like Reagan, Clinton was generally opposed to new regulatory initiatives, and joined him in championing the value of the market and the need to relieve businesses of burdensome regulation. In fact, he reached the Republican nirvana of a balanced federal budget and actually succeeded in repealing several major federal statutes, including the Glass-Steagall Act and Aid to Families with Dependent Children.⁶¹ Clinton was not a particular proponent of privatization, although he left OMB Circular-76 in place, but strongly supported a related policy that he described as "Reinventing Government." This involved an effort to alter the behavior of public agencies so that it resembled the presumed efficiency of private firms, specifically by being cost-conscious, client-centered, freed from unnecessary bureaucratic rules, and

⁶⁰ SKOWRONEK, *supra* note 3, at 43; *see generally id.* at 43–45.

⁶¹ Financial Services Modernization Act of 1999, 15 U.S.C. §§ 6801–09 (1999) (repealing the Glass-Steagall Act; Personal Responsibility and Work Opportunity Reconciliation Act of 1996 42 U.S.C. §§ 601–17) (1996) (repealing AFDC). To be sure, AFDC was social regulation, rather than being the economic regulation that is the focus of this study, but it is a product of the same Roosevelt governance paradigm and was repealed in favor of the Reaganesque policy of federalism and state control.

alert to their employee's incentives.⁶² It is related to privatization because it acknowledges the inherent inefficiency of government agencies and attempts to counteract it by relying on the private market, in this case as a model rather than directly. Most notably, perhaps, Clinton continued the OMB cost-benefit analysis that Reagan had initiated. He modified Reagan's Executive Order somewhat, substituting a new Order that made some secondary changes, but left the basic structure of Reagan's approach intact.⁶³

Bush II continued the normal science of regulatory policy under the Reagan paradigm. He too adopted a deregulatory stance, abjuring new efforts in the social or economic realm and disparaging existing environmental, consumer and safety legislation for its deleterious impact on American business. One of his first acts upon taking office was to encourage Congress to rescind the Occupational Safety and Health Administration's ergonomic regulations.⁶⁴ He abandoned the Reinventing Government initiative, which was ineradicably linked to his electoral opponent, but pushed privatization hard, issuing a new Circular-76 that required agencies to open everything they did to competition from private firms to perform the same function unless a specially designated agency officer could justify to the OMB that the activity in question was "inherently governmental;" if not, the agency had to contract out the function or demonstrate to the Government Accountability Office (GAO) that the agency could perform the function more cheaply than the private bidders.⁶⁵ Bush II saw no need to

⁶² For the underlying idea, see DAVID OSBORNE & TED GAEBLER, *REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR* (1993) (stating the views of advisors to the National Performance Review). The basic contours of the initiative itself are stated in ALBERT GORE, *FROM RED TAPE TO RESULTS: CREATING A GOVERNMENT THAT WORKS BETTER AND COSTS LESS, REPORT OF THE NAT'L PERFORMANCE REV.* (1993). Vice President Gore was specifically charged with implementing this initiative.

⁶³ Clinton issued a new Executive Order, see Exec. Order No. 12,866, 58 Fed. Reg. 5173 (Sept. 30, 1993), which revised, and in certain ways softened, EO 12,291 but left the basic approach intact. The continuity is emphasized by the fact that Bush II retained Clinton's Order, making only minor alterations. See Exec. Order No. 13,258, 67 Fed. Reg. 9385 (Feb. 26, 2002), which runs less than two pages. Regarding Clinton's continuation of cost-benefit analysis, see Kagan, *supra* note 56.

⁶⁴ See Rachel Michael, *Ergonomics: It's Here to Stay, Despite the OSHA Standard Repeal*, 10 ENVTL. QUALITY. MGMT. 57 (2001).

⁶⁵ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR NO. 76-A (Revised Supplemental Handbook 1996); see Matthew Blum, *The Federal Framework for Competing Commercial Work between the Public and Private Sectors*, in GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY 63, 63 (Jody Freeman & Martha Minow, eds., 2009). Some of the provisions regarding this process appeared in the President's Management Agenda of 2001. *Id.* at 65-67. The phrase "inherently governmental" appears in Circular No. 76-A, *supra* at 3. 76-A defines an inherently government activity as "an activity that is so intimately related to the public interest as to mandate performance by government personnel." *Id.* While the Circular

revise Clinton's Executive Order, which followed Reagan's Order so closely, to any significant extent, simply leaving it in place and making relatively minor changes.

By the time of Bush II's presidency, however, it had become apparent that the Reagan model of regulation, which seemed so fresh and invigorating when first introduced, actually achieved very little. While some important regulatory statutes were repealed, the great majority of economic, environmental, consumer and civil rights statutes remained in place. Despite Bush's determined efforts to create a presumption in favor of privatization, the number of functions that were actually transferred from agencies to private firms remained quite small.⁶⁶ This is not to suggest that there was little privatization; in fact there was a massive amount, but there always has been. The point, rather, is that new contracts were granted, particularly for homeland security and the wars in Iraq and Afghanistan, but relatively few existing functions were transferred away from the government and into private hands. Similarly, the OMB forestalled relatively few regulations through cost-benefit review. OMB "return letters" rejecting regulations were more often met by new submissions with revised cost-benefit calculations, rather than withdrawal of the regulations, so that the review came to be seen largely as a demand for additional paperwork.⁶⁷

This lack of progress in achieving the goals of Reagan's regulatory agenda can be seen as the sort of contradictory data that signals the disintegration of a Kuhnian paradigm. By itself, however, it did not represent a disjunction in Skowronek's terms. The reason that Reagan, Bush I and, in a slightly different way, Clinton made so little progress in dismantling the regulatory state was that there was no real popular support for this strategy, and people were not unhappy about its meager results. They liked the anti-regulatory rhetoric, but they liked the regulatory programs as well. Not only did the majority of Americans want to retain social security, which affects nearly all their lives, but they also wanted to retain the Arctic National Wildlife Refuge, which none of them will ever see.

Perhaps in frustration over his paradigm's impending demise, Bush II decided to fulfill it in a different way. If federal programs could not be eliminated through deregulation, privatization and cost-benefit analysis, they could be undermined by sabotaging the agencies that carried out these programs. Bush II accomplished this by appointing people to run federal agencies who were hostile to the agency's mission,

goes on to provide criteria, it never offers a definitive test, so the categorization is inevitably a matter of judgment.

⁶⁶ See Blum, *supra* note 65, at 80–85; Stan Soloway & Alan Chvotkin, *Federal Contracting in Context: What Drives It, How to Improve It*, in GOVERNMENT BY CONTRACT, *supra* note 65, at 204–07, 214–15.

⁶⁷ See Steven Croley, *White House Review of Agency Rulemaking: An Empirical Investigation*, 70 U. CHI. L. REV. 821, 823 (2003). This is not to say that the OMB has no effect; in fact it clearly serves as a means of Presidential control. See James Blumstein, *Regulatory Review by the Executive Office of the President: An Overview and Policy Analysis of Current Issues*, 51 DUKE L.J. 851 (2001); Lisa Schultz Bressman & Michael P. Vandenbergh, *Inside the Administrative State: A Critical Look at the Practice of Presidential Control*, 105 MICH. L. REV. 47 (2006); Kagan, *supra* note 56. But its cost-benefit review has not led to a significant roll back of regulatory activity.

motivated by political considerations, and technologically incompetent.⁶⁸ They proceeded in turn to undermine the morale of the civil servants who carried out agencies' tasks, redirect the agency away from its basic goals, and leave essential operational positions unfilled.⁶⁹ It is possible that Bush, who was nothing if not ideological and stubborn, genuinely believed that federal agencies really did not do anything useful. The results included Abu Ghraib, where unsupervised private contractors tortured Arab prisoners; the U.S. Attorney scandal, where federal prosecutors were illegally fired on ideological grounds; Hurricane Katrina, where the Federal Emergency Management Administration functioned at less than third world levels; and the 2007–8 financial crisis, where exotic financial instruments proliferated outside regulatory control. These disasters contributed to ensuring that Bush II's Administration would be a disjunctive one. It would be hard to think of a clearer case when, to re-quote Skowronek, a president was "affiliated with a set of established commitments that have in the course of events been called into question as failed or irrelevant responses to the problems of the day."

II. NEW PUBLIC GOVERNANCE AND ITS APPLICATION TO REGULATORY POLICY

A. *The Theory of New Public Governance*

The question that arises in the wake of Bush II's disjunction is whether Obama will be able to achieve a reconstruction. It is probably too early to tell. But even at this juncture, at least one reconstructive element is apparent: rejection of the pessimistic stance toward government intervention and reinvigoration of the belief that government can advance the collective goals of our society. This was, of course, an element of the Roosevelt reconstruction as well, which suggests a sort of cyclic historical process. But the process is probably better described by Vico than by the traditional Chinese historians. That is, rather than mere repetition, it is more likely to build upon the

⁶⁸ Maureen Dowd, *Neigh to Cronies*, N. Y. TIMES, Sept. 10, 2005, www.nytimes.com/2005/09/10/opinion/10dowd.html (appointment of an unqualified person, Michael Brown, as head of FEMA); R. Jeffrey Smith, *Political Briefings At Agencies Disclosed: White House Calls Meetings Lawful*, WASH. POST, Apr. 26, 2007, www.washingtonpost.com/wp-dyn/content/article/2007/04/25/AR2007042503046.html (agency officials briefed on Republican election prospects in violation of the Hatch Act); Adam Zagorina, *Why Were These U.S. Attorneys Fired?*, TIME, Mar. 7, 2007, <http://www.time.com/time/nation/article/0,8599,1597085,00.html> (dismissal of public prosecutors for political reasons in violation of federal law).

⁶⁹ Paul Krugman, *All the President's Friends*, N. Y. TIMES, Sept. 12, 2005, <http://www.nytimes.com/2005/09/12/opinion/12krugman.html> (EPA, FDA, Treasury and other agencies being demoralized, politicized and "hollowed out"); James Parks, *Bush Administration Strangling EEOC—Workers' Best Recourse Against Discrimination*, AFL-CIO NOW BLOG, June. 22, 2006, <http://blog.aflcio.org/2006/06/22/bush-administration-strangling-eoc—workers'-best-recourse-against-discrimination/>; Charlie Savage, *Report Examines Civil Rights During Bush Years*, N. Y. TIMES, Dec. 2, 2009, www.nytimes.com/2009/12/03/us/politics/03rights.html (GAO Report concludes that Bush Administration failed to enforce Civil Rights laws).

microeconomic insights that served as the basis of the Reagan reconstruction. We cannot return to the straightforward command and control model of regulation that characterized the second New Deal. We have learned too much about the counterproductive effects of that approach and the inefficiencies that inhere in it. If there is to be a reconstruction, and one that reinvigorates the role of government, it will need to be based on a new paradigm of regulation.

One candidate for such a paradigm is New Public Governance. The prior model, composed of deregulation, privatization, and cost-benefit analysis was originated by the scholars who had been working in the microeconomic field for several decades.⁷⁰ Their work merged these disparate elements into a coherent theory of governance. In addition, it transformed the apparently selfish desire of businesses to avoid regulation and make more money into a strategy to improve the nation's welfare, thus giving resistance to regulation a legitimacy that moved it from the squalid back rooms of political intrigue into the sunlit forum of public policy and social progress. New Public Governance is also the product of scholarship, and has now been several decades in gestation.⁷¹ It is not limited to regulatory policy, but that policy is certainly one of its principal subjects of inquiry. The question is whether this body of thought can provide a new regulatory paradigm for Obama's reconstruction of political leadership.

New Public Governance does not reject the microeconomic theory of human behavior and market failure that has proven so useful in the development of microeconomics, and that served as the basis for Reagan's regulatory paradigm, but it

⁷⁰ For some foundational works, see GARY S. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* (1976); JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1962); MANCUR OLSEN, *THE LOGIC OF COLLECTIVE ACTION* (1965); RICHARD POSNER, *THE ECONOMIC ANALYSIS OF LAW* (5th ed. 1998).

⁷¹ See, e.g., IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992); EUGENE BARDACH & ROBERT KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982); NEIL GUNNINGHAM ET AL., *SMART REGULATION: DESIGNING ENVIRONMENTAL POLICY* (1998); Gráinne de Búrca & Joanne Scott, *Narrowing the Gap: Law and New Approaches to Governance in the European Union*, 13 COLUM. J. EUR. L. 513, 513–18 (2007); Daniel A. Farber, *Taking Slippage Seriously: Noncompliance and Creative Compliance in Environmental Law*, 23 HARV. ENVTL. L. REV. 297, 297–326 (1999); Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1 (1997); Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1; Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1016; Joanne Scott & Susan Sturm, *Courts as Catalysts: Re-thinking the Judicial Role in New Governance*, 13 COLUM. J. EUR. L. 565 (2007); Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 458–568 (2001). For overviews, see Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004); Victoria Nourse & Gregory Shaffer, *Varieties of New Legal Realism: Can A New World Order Prompt a New Legal Theory?*, 95 CORNELL L. REV. 61 (2009).

locates this theory in a larger institutional and behavioral context. In the modern world, people's desire to maximize their self-interest often depends on their role in an institution, rather than their role with respect to the economy in general. That is, the material self-interest of a manager in the typical business firm will not be directly determined by the firm's market performance, but by three other factors. The first, her salary, is often determined by her ability to carry out assigned functions within the firm that will not be measurable by the firm's profits because of the specialization of labor that Adam Smith noted as the starting point of his economic theory.⁷² Thus, tasks such as strategic planning, personnel, public or government relations, and factory or service operations must be evaluated in terms of internally defined criteria, not firm profits. This will even be true for more purely economic functions: The task of an industrial firm's real estate department is not to acquire land most cheaply, but to acquire the land that will ultimately be most useful to the firm's overall performance. A second factor that determines managerial self-interest is advancement within the firm, which will depend even more on institutionally defined criteria since it will also include collegiality, loyalty, tractability and creativity. A third factor is advancement outside the firm, which is determined by fairly specific aspects of human capital such as portability of knowledge and reputation among those outside the firm. It is increasingly important in this era of high individual mobility, frequent business recombination, and fluid make or buy decisions. It remains important even for people with high levels of firm loyalty, since it feeds back into salary.

The essence of this important insight goes back at least as far as Berle and Means' observation that ownership and management are separated in the modern corporation.⁷³ It has spawned a significant economic literature on so-called agency problems within firms, and constitutes a major motivation for current executive compensation plans.⁷⁴ Nonetheless, the general importance of this insight has been somewhat obscured by the

⁷² ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 13–30 (R. H. Campbell et al., eds., Oxford at the Clarendon Press 1976) (1790); *see also* EMILE DURKHEIM, THE DIVISION OF LABOR IN SOCIETY (W.D. Halls trans., 1984) (1917).

⁷³ ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (photo. reprint 2002) (1991); *see* ANDREI SCHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000).

⁷⁴ *See, e.g.*, WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1959); LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); Alfi Kohn, *Rethinking Rewards*, in HARVARD BUSINESS REVIEW ON COMPENSATION 51 (Alfred Rappaport & Alfi Kohn, eds., 2002); Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance*, in HARVARD BUSINESS REVIEW ON COMPENSATION 1 (Alfred Rappaport & Alfi Kohn, eds., 2002). This conclusion has not gone unchallenged; many economists and legal scholars argue that the market for executive compensation operates with a reasonable level of efficiency. *See* IRA T. KAY & STEVEN VAN PUTTEN, MYTHS AND REALITIES OF EXECUTIVE PAY (2007); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1142–85 (2005) (reviewing BEBCHUCK & FRIED).

argument, often advanced on the basis of an a priori commitment to markets, that agency problems can be ignored because competition will eliminate irrational behavior through a Darwinian extermination of inefficient firms.⁷⁵ This substitutes a metaphor for serious analysis. It is plausible only when very small firms that can eliminate such problems, obviously a very rare occurrence, can contest a market dominated by large firms, as most modern markets are. In most modern business firms, agency issues will be endemic, as they are in any large organization. To some extent, transaction cost economists have been willing to confront this situation,⁷⁶ but the most direct consideration by economists has occurred within the sub-field of New Institutional Economics.⁷⁷ Perhaps more significantly, the study of institutions and their effects on individual behavior has migrated from economics in general to sociology, where modern organization theory tends to find its methodological home.⁷⁸

The shift from economics to sociology also allows for the expansion of the microeconomic theory of behavior to incorporate other motivations. Despite the impressive results that the rational actor model has achieved, most social scientists, particularly those outside the field of economics, do not accept it as a complete theory of human behavior. There is simply too much countervailing evidence that people are often

⁷⁵ See RICHARD NELSON & SIDNEY WINTER, *AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE* (1992); Armen Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL. ECON. 211, 211–21 (1950).

⁷⁶ See, e.g., OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985); Armen A. Alchian & Susan Woodward, *Reflections on the Theory of the Firm*, 143 J. INST. THEORETICAL ECON. 110 (1987).

⁷⁷ See, e.g., DANIEL W. BROMLEY, *ECONOMIC INTERESTS AND INSTITUTIONS: THE CONCEPTUAL FOUNDATIONS OF PUBLIC POLICY* (1989); DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (James Alt & Douglass North eds., 1990); ANDREW SCHOTTER, *THE ECONOMIC THEORY OF SOCIAL INSTITUTIONS* (1981). For a review of the field, see Douglass C. North, *The New Institutional Economics*, 142 J. INST. THEORETICAL ECON. 230 (1986).

⁷⁸ See, e.g., ERVING GOFFMAN, *ASYLUMS: ESSAYS ON THE SOCIAL SITUATION OF MENTAL PATIENTS AND OTHER INMATES* (1961); JAMES G. MARCH, *DECISIONS AND ORGANIZATIONS* (1988); JAMES MARCH & HERBERT SIMON, *ORGANIZATIONS* (1958); JOHN MEYER & W. RICHARD SCOTT, *ORGANIZATIONAL ENVIRONMENTS: RITUAL AND RATIONALITY* (updated ed. 1992) (1983); *THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS* (Walter W. Powell & Paul J. DiMaggio eds., 1991); W. RICHARD SCOTT, *ORGANIZATIONS: RATIONAL, NATURAL AND OPEN SYSTEMS* (2d ed. 1987); PHILIP SELZNICK, *TVA AND THE GRASS ROOTS: A STUDY OF POLITICS AND ORGANIZATION* (Cal. Libr. Reprint Series ed., 1980) (1949); *INSTITUTIONAL PATTERNS AND ORGANIZATIONS: CULTURE AND ORGANIZATIONS* (Lynne G. Zucker, ed. 1988). For a discussion of the intellectual connections between sociology and contemporary economics, see Oliver E. Williamson, *Transaction Cost Economics and Organization Theory*, in *ORGANIZATION THEORY: FROM CHESTER BARNARD TO THE PRESENT AND BEYOND* 207 (Oliver E. Williamson ed., 1995).

motivated by personal affection, group solidarity, altruism, ideology, and other drives that cannot be fit within the category of material self-interest.⁷⁹ In addition, there is mounting evidence from psychology that people do not think rationally, that they are not only subject to prejudices and preconceptions, but labor under a variety of cognitive illusions that systematically produce non-optimal results.⁸⁰ New Public Governance has been open to this evidence, in part because its proponents have no a priori commitment to the rational actor model, in part because they are willing to draw from social science fields where that model has not proven to be persuasive.

B. *Application of New Public Governance to Regulatory Policy*

The New Public Governance approach to regulation is based on this more comprehensive theory of behavior. If one believes that individuals and firms operate exclusively as rational self-interest maximizers, the natural regulatory approach to adopt is command and control. That is, the most obvious strategy for altering the behavior of a rationally self-interested entity is to impose sanctions for the undesired behavior that are sufficiently severe so that it is in the self-interest of that entity to avoid the sanction. This is the traditional model for law, and corresponds to the positivist conception of law as commands backed by sanctions.⁸¹ Criminal law, going back to Hammurabi's Code, is based on this model, in that the government tells an individual that he or she will be punished for performing a particular act. Thus, as Robert Kagan notes, the approach is largely adversarial in nature, treating the regulated firm as an opponent whose behavior must be controlled by threat.⁸²

According to New Public Governance, regulators have a wider set of options. Rather than taking an adversarial stance toward the firm as a whole, regulators can, in

⁷⁹ See, e.g., MAKING POLITICAL SCIENCE MATTER: DEBATING KNOWLEDGE, RESEARCH & METHOD (Sanford F. Schram & Brian Caterino eds., 2006); DONALD P. GREEN & IAN SHAPIRO, PATHOLOGIES OF RATIONAL CHOICE THEORY: A CRITIQUE OF APPLICATIONS IN POLITICAL SCIENCE (1994). More generally, on the need to move social science away from natural science models, see BENT FLYVBJERG, MAKING SOCIAL SCIENCE MATTER: WHY SOCIAL INQUIRY FAILS AND HOW IT CAN SUCCEED AGAIN (Steven Sampson trans., 2001); HANS-GEORG GADAMER, TRUTH AND METHOD (Joel Weinsheimer & Donald G. Marshall trans., 2d ed. 2004) (1988).

⁸⁰ See, e.g., CHOICES, VALUES, AND FRAMES (Daniel Kahneman & Amos Tversky eds., 2000); JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman, Paul Slovic & Amos Tversky, eds., 1982); RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE (Princeton Univ. Press 1994) (1992).

⁸¹ See, e.g., JOHN AUSTIN, THE PROVINCE OF JURISPRUDENCE DETERMINED AND THE USES OF THE STUDY OF JURISPRUDENCE 9–32 (Hackett Publ'g Co. 1998)(1832, 1836); HANS Kelsen, GENERAL THEORY OF LAW AND THE STATE 58–64 (Anders Wedberg trans., Russell & Russell, Inc. 1961) (1945); HANS Kelsen, PURE THEORY OF LAW (Max Knight trans., Univ. of Cal. Press 1967) (1934); JOSEPH RAZ, THE CONCEPT OF A LEGAL SYSTEM: AN INTRODUCTION TO THE THEORY OF LEGAL SYSTEM 111–12 (1978).

⁸² ROBERT A. KAGAN, ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW (2001); see also Robert A. Kagan & Lee Axelrad eds., *Regulatory Encounters: Multinational Corporations and American Adversarial Legalism*, in THE CAL. SERIES IN LAW, POLITICS, AND SOCIETY (Robert A. Kagan & Malcom Freely eds. 2000).

effect, get inside the regulated firm and craft regulations that operate on the incentive structure of its employees. This is based on an understanding of the institutional context of behavior. In addition, they can appeal to motivations other than material self-interest. Therefore, New Public Governance suggests a more flexible, cooperative and interactive mode of regulatory action. Regulators can explore ways in which they can work together with the regulated party to achieve the prevailing statute's underlying purposes, rather than adopting an adversarial stance, prohibiting prescribed behavior and threatening punishment for disobedience. In turn, the interaction calls upon the regulated party to act in a public-spirited manner, and induces it to do so by engaging in a dialogue that takes its needs and interests into account.

Consider, for example, Jody Freeman's discussion about the way that public agencies can make use of private standard setting.⁸³ As she points out, government has long relied on private standard setting, sometimes officially incorporating them into various legal requirements.⁸⁴ This approach is advantageous when compared to external regulations because it draws upon industry experience and avoids unintentional disruption of desirable or benign industry practices that external regulation can impose. However, the concern is that these rules are developed without public supervision, through opaque procedures, and under the control of the industry's dominant firms. However, according to the Reagan paradigm, this is not a serious concern because private firms are efficient. Furthermore, according to the Roosevelt paradigm, the proper response may be to subject private standard setting to uniform procedural requirements prior to adoption. New Public Governance recommends a more flexible approach. As Freeman notes, open and inclusive standard setting procedures "might best be encouraged through interaction with agency officials, and allowed to develop idiosyncratically, depending on the nature of the standard-setting group, rather than imposed uniformly by Congress."⁸⁵ In other words, the procedures for standard setting and their ultimate application might be developed cooperatively by the industry and the agency, relying on industry managers' motivation to act responsibly and on their self-interest in avoiding disruptive rules imposed without regard to industry practice. The cooperative relationship becomes a source of human capital for managers that they can use to obtain promotions

⁸³ Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 638–57 (2004).

⁸⁴ *E.g.*, Occupational Safety and Health Act of 1970, Pub. L. No. 91-596, 84 Stat. 1590 (1970) (codified as amended at 29 U.S.C. §§ 651-678 (1994)); National Technology Transfer and Advancement Act of 1995, Pub. L. No. 104-113, 110 Stat. 775 (1995) (codified in scattered sections of 15 U.S.C.); Uniform Commercial Code § 4A-501 (2002). *See also* MALCOLM FEELEY & EDWARD RUBIN, *JUDICIAL POLICY MAKING AND THE MODERN STATE: HOW THE COURTS REFORMED AMERICA'S PRISONS* 103–05, 162–66, 370–72 (1998) (federal judges' use of standards developed by the American Correctional Association in prisons conditions cases); Sidney A. Shapiro & Thomas O. McGarity, *Reorienting OSHA: Regulatory Alternatives and Legislative Reform*, 6 YALE J. REG. 1 (1982) (requirement that OSHA adopt private safety standards); Michael Vandenberg, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029 (2005) (role of private contracts in governance).

⁸⁵ Freeman, *supra* note 83, at 643.

or move elsewhere, thus inducing cooperation on the basis of their institutionally-generated self-interest.

A second example of the New Public Governance approach to regulation is Bardach and Kagan's proposal that safety and health inspectors under OSHA can obtain higher levels of compliance by adopting a cooperative stance toward the regulated parties.⁸⁶ Instead of "going by the book," they can overlook minor violations and address more serious violations by offering constructive suggestions to facilitate compliance. When the regulated party has ignored a direct suggestion from the agency or engaged in egregious behavior that could not possibly have been adopted in good faith, the safety and health inspectors can then reserve the effort to impose sanctions for cases of genuine recalcitrance. Higher levels of compliance can result from this approach because firm officers who can avoid the imposition of sanctions are likely to advance within the firm, and because their relationship with the regulator again becomes a form of human capital. In addition, the firm officers are less likely to disobey federal regulations if they have established affective ties with the regulators, something an adversarial stance will almost certainly preclude. All of this, moreover, can be achieved with fewer resources than adversarial enforcement, allowing more firms to be inspected.

John Scholz links this approach to the optimal strategy for the prisoner's dilemma game.⁸⁷ When the game is played only once, there is no optimal solution, but as Robert Axelrod determined in *The Evolution of Co-operation*,⁸⁸ when it is played repeatedly, between the same participants and with no definitive end point, an optimal strategy exists, which Axelrod calls "TIT FOR TAT."⁸⁹ According to Axelrod, "TIT FOR TAT is merely the strategy of starting with cooperation, and thereafter doing what the other player did on the previous move."⁹⁰ In other words, the first player begins by cooperating. If the second player continues to cooperate, the first player does so as well. But if the second player defects on one turn, the first player defects on the turn immediately following. If the second player then returns to cooperating, the first player does as well; if the second player defects in retaliation, however, then the first player continues to defect.⁹¹ Thus, the cooperative attitude of the inspecting agency can be viewed as the optimal strategy to adopt at the outset, and the imposition of sanctions on firms that disobey cooperative suggestions—"bad apples," in Scholz's terms—can be seen as the optimal response to a defection.

⁸⁶ BARDACH & KAGAN, *supra* note 71, at xvi.

⁸⁷ See John T. Scholz, *Cooperation, Deterrence and the Ecology of Regulatory Enforcement*, 18 LAW & SOC'Y REV. 179, 181 (1984); John T. Scholz, *Cooperative Regulatory Enforcement and the Politics of Administrative Effectiveness*, 85 AM. POL. SCI. REV. 115 (1991); John T. Scholz, *Voluntary Compliance and Regulatory Enforcement*, 6 LAW & POL'Y 385 (1984). See also ROBERT KAGAN & JOHN SCHOLZ, THE "CRIMINOLOGY OF THE CORPORATION" AND REGULATORY ENFORCEMENT STRATEGIES, as reprinted in ENFORCING REGULATION 67 (Keith Hawkins & John Thomas eds., 1984).

⁸⁸ ROBERT AXELROD, *THE EVOLUTION OF CO-OPERATION* (1984).

⁸⁹ *Id.* at xii.

⁹⁰ *Id.*

⁹¹ For an expanded discussion of the strategy and its advantages, see AYRES & BRAITHWAITE, *supra* note 71, at 19–53.

An interesting feature of both of these examples, and an indication of the complexity of the New Public Governance approach to regulation, is that its use of cooperation is both sincere and manipulative or, one might say, deontological and instrumental. On the one hand, it tries to foster a spirit of genuine cooperation between the regulatory agency and the regulated firm so that the two can develop a working relationship based on trust. To this extent, New Public Governance recognizes that people are often motivated to behave correctly, that they want to obey the law as long as they can feel that the law is reasonable or, alternatively, as long as the law is not being interpreted so unreasonably that it provides them with a justification for disobedience. At the same time, as described above, cooperative behavior is also used instrumentally as a device to ensure maximum compliance. It can function in this way for at least two reasons: first, because it is the optimal solution to a two-player, indefinitely repeated prisoner's dilemma game, and second, because a cooperative relationship with the regulator constitutes human capital for corporate executives that will be in their material self-interest to develop.

One important qualification regarding the application of New Public Governance to regulatory policy involves the specificity of goals. A different line of New Public Governance research has focused on governmental programs that are designed to help individuals, particularly disadvantaged individuals. These include welfare, education, community development, civil rights, and drug rehabilitation. Scholars who write about this approach sometimes argue that specific goals and strategies should be cooperatively developed between the public agency and the beneficiaries. In other words, the government officials should not simply assume that they can determine what is best for individuals.⁹² Regulatory policy is somewhat different, however, because, no matter how cooperative, it is ultimately intended to benefit society in general but not necessarily the regulated party. Although regulation does provide certain rewards, it would be unrealistically Panglossian for the agency to try to tell the regulated firm that "regulation is good for you." In addition, regulated firms, unlike disadvantaged individuals, are formidable opponents for a government agency, and need to be treated with some caution, no matter how positive the cooperative relationship may be. This suggests that the agency must keep its basic regulatory goals constant, and restrict its cooperative negotiations to the means by which those goals are to be achieved.

A regulatory policy based on New Public Governance could serve as a direct replacement for the deregulation, privatization, and cost-benefit components of the Reagan regulatory paradigm, and one element in a much-needed Obama Administration reconstruction. With respect to deregulation, the Reagan paradigm, it will be recalled, was a response to the adversarial, command and control paradigm that Roosevelt established in the Second New Deal. Rather than going back to that paradigm, New Public Governance suggests a different strategy that avoids the defects that rendered the Roosevelt paradigm vulnerable and ultimately led to its disjunction under Carter. In some sense, New Public Governance returns to the cooperative strategy of the First New Deal,

⁹² See, e.g., WILLIAM SIMON, *THE COMMUNITY ECONOMIC DEVELOPMENT MOVEMENT: LAW, BUSINESS AND THE NEW SOCIAL POLICY* 113–42 (2001); Martha Minow, *Public and Private Partnerships: Accounting for the New Religion* 116 HARV. L. REV. 1229, 1242–46 (2002); Sturm, *supra* note 71, at 564–66.

but without the corporatism that seemed so discordant in an American context. Instead of corporatism, it bases its cooperative strategy on the recently-developed understanding of individual motivation and firm behavior. It does not place unrestricted confidence in the public-spiritedness of regulated firms, or appeal directly to their sense of loyalty, as Mussolini did. Rather, it uses cooperation as a means of inducing the firm to behave in the desired way.

New Public Governance also provides an alternative to privatization, an aspect of the Reagan paradigm that is already under reconsideration by the new administration. OMB Circular A-76 was suspended for a year by the 2009 Omnibus Appropriations Act, which Obama signed this past March.⁹³ In that same month, he issued a Presidential Memorandum instructing the new director of the OMB to re-evaluate government outsourcing.⁹⁴ Obviously, however, the government's basic strategy of buying, rather than making, most of the physical products and many of the services it uses is not going to be replaced. This approach long pre-dates Reagan; in fact, it pre-dates Washington (in both senses). What will probably be replaced is Bush II's disjunctive effort to create a presumption of privatization for all governmental functions. The cooperative approach of New Public Governance suggests that the advantages of privatization—the superior efficiency of private firms that results from market discipline—can be achieved by the kinds of arrangements discussed by Jody Freeman and summarized briefly above. As she points out, it is not necessary to contract out a regulatory function in order to take advantage of private expertise in standard setting; flexibly designed cooperative relationships will often produce better results by combining that expertise with public accountability.⁹⁵

Finally, with respect to cost-benefit analysis—the third element of Reagan's reconstruction—New Public Governance also suggests an alternative approach.⁹⁶ A much less controversial management tool, called cost effectiveness analysis, preceded cost benefit analysis. This approach also monetizes the costs of a government program. The difference is that it holds the goal constant and does not try to determine whether that goal is worth the cost involved. It treats goal determination as a matter of morality, judgment and politics; one way of saying this is that cost effectiveness analysis treats the evaluation of goals as beyond the pay grade of a policy analyst. The value of cost effectiveness analysis is that it can compare two alternative regulatory strategies to each other. For example, suppose a hospital needs to decide how to allocate its resources. The goal of the hospital is a given—to cure as many people as possible. Cost effectiveness analysis does not attempt (or one might say presume) to determine whether curing people is more valuable than building highways, or, just as an example, bombing and torturing

⁹³, *See* Omnibus Appropriations Act of 2009, Pub. L. No. 111-8, 123 Stat. 524. (March 11, 2009).

⁹⁴ Government Contracting: Memorandum for the Heads of Exec. Dep'ts & Agencies, 74 Fed. Reg. 9755 (Mar. 4, 2009).

⁹⁵ *See supra* notes 83–85 and accompanying text.

⁹⁶ Obama immediately reversed Bush II's changes to Exec. Order No. 12,866. *See* Exec. Order No. 13,497, 74 Fed. Reg. 6113 (Jan. 30, 2009). This left the Clinton Order operative in its original form. Whether the Obama administration makes any changes of its own to Exec. Order No. 12,866 remains to be seen.

innocent people to sustain a mission undertaken for false purposes. Rather, it simply asks which policy alternative will cure the most people per unit cost. Is it buying more equipment, hiring more personnel, training the existing personnel, or building new facilities? As can be readily seen, these are very complex determinations that will involve multiple factors that will vary over time. Difficult as they are, they do not require the policy analyst to engage in highly controversial and perhaps impossible task of monetizing human health.

A regulatory policy shaped by New Public Governance would seem to have more use for cost effectiveness analysis than cost-benefit analysis. Cost-benefit analysis, because of its many methodological problems that include the undervaluation of social and moral concerns, has long been suspected of being a Trojan horse for deregulation.⁹⁷ If deregulation is no longer a policy objective, the evaluation of benefits may be shifted to a different decision making process. Under a New Public Governance approach, goals are either set by the public policy making process or, in the benefits context, developed by cooperative relationships between government and intended beneficiaries. Once the goal is established, implementation is generally a cooperative process. Cost effectiveness analysis is more useful than cost-benefit analysis in this context. Instead of being a presidential tool that little economic gnomes in the OMB can wield against the regulatory efforts of administrative agencies, as it was under the Reagan paradigm, it can be a way of structuring conversations between agencies and regulated parties. Cost-benefit analysis cannot be used in this way; a conversation about the value to attach to worker injuries or environmental degradation will so quickly become intertwined with basic value conflicts that cost-benefit analysis will provide more irritation than assistance. But a conversation about the best way to control environmental degradation—the way that produces a given goal at the lowest cost, all things considered—is one that may advance the decision making process along the lines that New Public Governance recommends.

III. CAUSES AND CURES OF THE CURRENT FINANCIAL CRISIS

A. Causes

As an illustration of what a new paradigm of regulation might look like “on the ground,” we can consider a situation that is on everyone’s mind these days—the current financial crisis and the efforts to avoid its repetition. The particular focus here will be on regulation of over-the-counter derivatives. These derivatives are widely regarded as responsible for the financial catastrophe of 2007–08, one of the most notable afflictions that Bush II has bequeathed to us.⁹⁸ Title VII of the Dodd-Frank Wall Street Reform and

⁹⁷ See, e.g., Alan B. Morrison, *OMB Interference with Agency Rulemaking: The Wrong Way to Write a Regulation*, 99 HARV. L. REV. 1059, 1064 (1986); Steven T. Kargman, Note, *OMB Intervention in Agency Rulemaking: The Case for Broadened Record Review*, 95 YALE L.J. 1789, 1791–96 (1986).

⁹⁸ See generally, GARY GORTON, SLAPPED BBY THE INVISIBLE HAND: THE PANIC OF 2007 2–3 (2010).

Consumer Protection Act is designed to control them.⁹⁹ This statute is over two thousand pages long, but, as has been widely noted, many of its provisions, including Title VII, grant broad authority to federal regulators. [On the URL, there is an underscore after dodd, and after Frank]¹⁰⁰ Given this authority and the importance of the issue it addresses, Title VII of Dodd-Frank is thus a good place to look for ways in which a new model of governance might emerge and might contribute to an Obama reconstruction.

A derivative is a security whose value depends on the price of something else.¹⁰¹ Over the counter means that the security is not traded on an exchange, but sold directly by the originating institution to investors. As the Dodd-Frank Act notes, the derivative market has become enormous; in 2008, the notional amount of outstanding derivatives was \$592 trillion.¹⁰² The general view is that the over-issue and over-valuation of these securities was a major cause, if not *the* major cause, of the financial crisis. One can readily see why; no one really knows how much these things are worth, and a 10 percent reduction of their value represents a sum of money roughly equal to the gross domestic product of Planet Earth.¹⁰³

What caused this mess? The most common answer is “Wall Street,” a bit of synecdoche that facilitates demonization.¹⁰⁴ When assessing the derivative crisis from

⁹⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) [hereinafter Dodd-Frank]. Title VII is designated as The Wall Street Transparency and Accountability Act of 2010. *See id.* at § 701 (Short Title).

¹⁰⁰ *See, e.g.,* Susan B. Zaunbrecher & Nathan E. Hagler, *Dodd-Frank Reshapes Business*, DINSMORE & SHOHL, LLP. PUBLICATIONS (July 15, 2010), http://www.dinslaw.com/dodd_frank_bill/ (“As many of the Bill’s provisions give a basic structure of reform and leave the regulators to fill in the details over the next 6 to 18 months, the process of implementing the Bill’s provisions promises to be a dynamic one. Consequently, the final shape and practical impact of the Bill are still years from being understood”); Aline van Duyn & Francesco Guerrera, *Dodd-Frank bill is no Glass-Steagall*, FINANCIAL TIMES, June 27, 2010, <http://www.ft.com/cms/s/0/e355c680-8212-11df-938f-00144feabdc0.html> (“In the coming months there will be an almighty tussle as regulators . . . devise detailed rules to flesh out and back the 2,000 pages of new laws. Those details could yet determine which groups come out on top, and also the cost of derivatives and investing.”).

¹⁰¹ *See, e.g.,* JAMIL BAZ & GEORGE CHACKO, FINANCIAL DERIVATIVES: PRICING, APPLICATIONS AND MATHEMATICS (2004); ROBERT WHALEY, DERIVATIVES: MARKETS, VALUATION AND RISK MANAGEMENT (2006).

¹⁰² Dodd-Frank, *supra* note 100.

¹⁰³ World Bank, *World Development Indicators*, <http://data.worldbank.org/> (the gross domestic product of the world in 2008 was \$61.1 trillion, in current U.S. dollars). Due to netting, the notional amount of derivatives is not truly comparable to an economic indicator like domestic product. Nonetheless, a notional amount of \$592 trillion is a lot of money.

¹⁰⁴ Interestingly, the official name of the Dodd-Frank Act incorporates this bit of American slang; it is the Wall Street Reform and Consumer Protection Act and its Title VII, discussed below, is the Wall Street Transparency and Accountability Act. While it

this perspective, the twenty first century denizen of “Wall Street”—a supercilious, pampered thirty-something, with an Ivy League education, unbounded self-assurance, and a blistering sense of entitlement—comes readily to mind. It then seems easy to blame the financial crisis on excessive cleverness driven by intemperate avarice. But this instinct, however natural and convenient, should be suppressed. Greed-driven creativity is the hallmark of our economic system; it is the force that, as we learned in elementary school (remember Robert Fulton, Cyrus McCormack, and Thomas Edison?) has catapulted our nation to its unprecedented level of prosperity.¹⁰⁵ To treat “Wall Street” as a whole bushel of bad apples misunderstands the nature of modern social and political theory, which rejects the pre-modern idea that we can solve social problems by increasing public virtue. The trick—and it really is a trick in many ways—is to develop strategies of governance that incorporate a fully realistic view of human behavior, that neither exalt business leaders as our elementary school textbooks did or demonize them as did the undergraduate papers that we wrote in reaction.

One cause of the financial crisis that incorporates what we know about human nature is the agency problem. Although this is endemic to all large institutions, as discussed above, it has particular relevance to the financial intermediaries that spawned the current crisis. Bank lending officers, for example, are often evaluated according to the number of loans they generate or the short-term profitability of the loans. The default rate on their loans is certainly a concern—lenders generally want their loans repaid—and if a disproportionate number of a lending officer’s loans defaulted immediately, that officer would lose his job. But defaults generally occur many years in the future, particularly on long-term loans such as home mortgages. That future not only lies beyond the realistic estimation of the borrowers, who, induced by the American dream of home ownership, will often be overly optimistic about their financial prospects, but also beyond the realistic estimation of the loan officers and their supervisors, who, induced by the more general American dream of getting promoted, will often be overly optimistic about the repayment capacity of the borrowers. Like people who live on the slopes of a volcano,¹⁰⁶ they will use their experience to measure ordinary risks, but will tend to discount or ignore the extraordinary risks that lie beyond their experience and may never occur during their working lifetime or, at any rate, during the time before they are promoted out of the lending office.

might be nice to look forward to the Madison Avenue Reform Act for advertisers, the Forty Second Street Reform Act for theater productions, and the Rodeo Drive Reform Act for expensive leisure suits, “Wall Street” does seem to be a rather informal and perhaps incendiary way to refer to the Financial Services Industry in a major federal statute.

¹⁰⁵ See Steven Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 212 n.2 (2009) (“[B]ecause greed is so ingrained in human nature and so intertwined with other causes, it adds little insight to view it separately.”)

¹⁰⁶ ROBERT LOUIS STEVENSON, *Aes Triplex*, in *SELECTED WRITINGS OF ROBERT LOUIS STEVENSON* 892–93 (Saxe Commins, ed., 1947) (“although few things are spoken of with more fearful whisperings that this prospect of death, few have less influence on conduct under healthy circumstances.”).

While living obliviously on the slopes of the volcano does not, so far as we know, increase the likelihood that the volcano will erupt, the overly sanguine attitudes of bank lending offices contributed significantly to the financial volcano of 2007–08. One way they did so was by issuing increasing numbers of subprime mortgages. In the somewhat peculiar argot of the finance industry, a subprime mortgage is one whose interest rate and initiation fees are higher than an ordinary mortgage, typically because the borrower is less credit worthy.¹⁰⁷ These mortgages are the product of deregulation, specifically the Carter deregulation of interest rates¹⁰⁸ and the Reagan deregulation of mortgage terms,¹⁰⁹ and were fueled by changes in the tax laws during the Reagan administration.¹¹⁰

Attractive though they may have been, subprime mortgages obviously involve risks, but an apparent means of reducing these risks emerged during the 1990s with the growth of securitization. To simplify enormously, a securitized mortgage is a security whose value depends upon the price of an underlying pool of mortgages; in other words, it is a derivative.¹¹¹ By putting many different mortgages into the pool and mixing them around, the risks that might afflict any particular group of mortgages can be reduced. For example, a lender located in Louisiana, whose borrower population consists largely of people who make their livelihood from fishing, might suffer major losses if there just happened to be a downturn in the local fishing economy. Mixing that lender's loans with

¹⁰⁷ See JOHN BELLAMY FOSTER & FRED MAGDOFF, *THE GREAT FINANCIAL CRISIS: CAUSES AND CONSEQUENCES* 94–97 (2009); see also Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FED. RES. BANK ST. LOUIS REV. 31 (2006).

¹⁰⁸ Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), Pub. L. No. 94-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C. (2006)). The DIDMCA removed federal interest rate restrictions on banks and preempted state laws that imposed such restrictions. See 12 U.S.C. § 1735(f)(7).

¹⁰⁹ Alternative Mortgage Transaction Parity Act, Title VIII of the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended at 12 U.S.C. § 3801 (2006)).

¹¹⁰ The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified in scattered sections of 26 U.S.C. (2006)) (phased out the tax deduction for interest payments on consumer debt but retained it for interest payments on home mortgages).

¹¹¹ FRANK J. FABOZZI, ANAND K. BHATTACHARYA & WILLIAM S. BERLINER, *MORTGAGE BACKED SECURITIES: PRODUCTS, STRUCTURING AND ANALYTIC TECHNIQUES* (2007); JANET M. TAVAKOLI, *COLLATERALIZED DEBT OBLIGATIONS AND STRUCTURED FINANCE: NEW DEVELOPMENTS IN CASH AND SYNTHETIC SECURITIZATION* 14–15 (2003); Lakhbir Hayre, *A Concise Guide to Mortgage-Backed Securities (MBSs)*, in SALOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 9–68 (Lakhbir Hayre ed., 2001); DOUGLAS J. LUCAS, LAURIE S. GOODMAN & FRANK J. FABOZZI, *COLLATERALIZED DEBT OBLIGATIONS: STRUCTURES AND ANALYSIS* 103–25 (2d ed. 2006); R. Russell Hurst, *Securities Backed by Closed-End Equity Loans*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 281 (Frank J. Fabozzi ed., 5th ed., 2001); Linda Lowell, *Mortgage Pass-Through Securities*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 25–50 (Frank J. Fabozzi ed., 5th ed. 2001).

loans from Houston, London, and Abu Dhabi will diversify away the area-specific risk.¹¹² The security thus becomes an attractive investment. At the same time, the originating lender is able to reduce its risk by getting its housing loans “off its books,” in the sense that the purchasers of the mortgage-backed security receive the benefit of the borrowers’ interest payments and take the risk of their default. The lender still makes money from the initiation fees, which typically involve zero risk because they are paid up front and are higher than usual for sub-prime loans.

This seems like a happy situation, but the amplification of agency problems jumps right out. The lender’s incentive to make sure that the loans will be repaid is much reduced because it will no longer own the loan or the interest payment stream. The financial intermediary that creates the mortgage-backed derivative is in a similar position because it makes its money on the sale and will not own the loan and its interest stream either. The purchasers of the security care about repayment, but they are induced to buy the security by the attractive return that subprime mortgages can support, and they typically have very little knowledge about the specific risks of the underlying mortgages that were responsible for these attractive returns. Instead, they rely on rating agencies, which have just as little specific knowledge, and also on economic models. More importantly, neither the investors nor the rating agency has the ability to monitor and discipline the process by which the original lender generates the loan.¹¹³ Securitization, like traditional securities and public ownership, separates ownership from operations. It is a powerful financing mechanism, but it severs the motivational links that are regarded as responsible for the efficiency of the market.

Sub-prime mortgage securities are only one type of derivative. There are innumerable others, including interest rate swaps, credit default swaps, currency swaps, commodity swaps, currency futures, bond futures, commodity futures, and swaptions. The luxuriant proliferation of these financial exotica is hardly surprising. There is a great deal of money to be made in the financial sector—perhaps too much relative to the economy as a whole—and opportunities of this sort will naturally attract bright people into the business. Bright people tend to come up with bright ideas, in this case, increasingly sophisticated ways to divide up potential income and risk, thereby attracting investment from people with different preferences and expectations. One example of such creativity is the credit default swap.¹¹⁴ In an ordinary sale of a mortgage-backed security, no one benefits if the borrower defaults on the mortgage. The borrower loses the existing

¹¹² Further diversification is achieved by mixing sub-prime mortgages with prime mortgages. This decreases risk that results from local or temporary downturns, but may increase the risk of system-wide downturn. Between 2000 and 2005, the amount of subprime mortgages embedded in mortgage-backed securities increased from \$56 billion to \$508 billion. FOSTER & MAGDOFF, *supra* note 107, at 96.

¹¹³ Similarly, a bank’s depositors are unlikely to be effective monitors. *See generally* MATHIAS DEWATRIPONT, JEAN-CHARLES ROCHET & JEAN TIROLE, *BALANCING THE BANKS: GLOBAL LESSONS FROM THE FINANCIAL CRISIS* (Keith Tribe trans., ed.) (2010).

¹¹⁴ *See generally* ANTULIO BOMFIM, *UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS* 67–82 (2005); GEORGE CHACKO, ANDERS SJÖMAN, HIDETO MOTOHASHI & VINCENT DESSAIN, *CREDIT DERIVATIVES: A PRIMER ON CREDIT RISK, MODELING AND INSTRUMENTS* 147–90 (2006); TAVAKOLI, *supra* note 111, at 45–81.

equity on the home and the investor loses the expected interest stream. In a credit default swap involving mortgage-backed securities,¹¹⁵ one party, called the protection seller, assumes the risk that the security's underlying mortgages will default in exchange for periodic payments from the protection buyer. In effect, the protection buyer is "short" on the underlying mortgage; if the mortgage defaults, the buyer receives payment of the security's par value from the seller in exchange for delivery of the now discounted or worthless security.¹¹⁶ The instrument thus allows an investor to benefit from an event that previously represented a loss to both parties, thereby attracting investors with a different view of the future.

In a recent article, Steven Schwarcz attributes the financial crisis of 2007–08 to the complexity of these instruments and the resulting market failures.¹¹⁷ According to Schwarcz, market failures can result from the complexities of the underlying assets, the complexities of the securities themselves, and the complexities of the markets for these securities.¹¹⁸ With respect to the complexity of the securities, Schwarcz notes that "[e]ven if all information about a complex structure is disclosed, complexity increases the amount of information that must be analyzed in order to value the investment with a degree of certainty."¹¹⁹ Confronted with prospectuses hundreds of pages long, investors regularly resorted to heuristics such as credit ratings.¹²⁰ Complexity may undermine diversity by obscuring the correlations among apparently diverse assets.¹²¹ For example, a security that mixes the income stream from home mortgages in coastal Louisiana, Houston, London, and Abu Dhabi might not be as diverse as it appears if the downturn in the Louisiana fishing industry is the result of an oil spill that threatens the profits of the entire petroleum industry. A credit default swap involving such securities will be even more difficult to assess.

B. Cures

An appropriate reaction to the financial crisis is the rejection of the Reagan paradigm of regulation, and this was indeed part of the reason for Bush II's disjunction. Deregulation of mortgage rates and terms led to the proliferation of subprime mortgages, and failure to regulate derivatives led to the proliferation of mortgage-backed securities

¹¹⁵ This is merely a simplified example. Most credit default swaps do not involve mortgage-backed securities, but other underlyings such as portfolios, total returns, bond options, and so forth. See BOMFIM, *supra* note 114.

¹¹⁶ Note once more the somewhat contradictory terminology of finance. If there is a default, the protection buyer will, in effect, sell the security to the protection seller for its par value. Thus, the security moves in the opposite direction from the terminology, which is based on the direction that the "protection" moves.

¹¹⁷ Schwarcz, *supra* note 105, at 216–35.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 221 (footnotes omitted); see also Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Information Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993); Steven Schwarcz, *Disclosure's Failure in the Subprime Crisis*, 2008 UTAH L. REV. 1109.

¹²⁰ Schwarcz, *supra* note 105, at 222.

¹²¹ *Id.* at 223–24.

and other complex derivatives whose over-valuation led to the crisis. Any linkage to other aspects of the Reagan paradigm are speculative. However, one might imagine that a proposal for a government rating system of securities would have been met by the Bush Administration's confidence that private rating agencies were more efficient, while a proposal to impose new regulations would have been vulnerable to OMB cost-benefit analysis that did not take a catastrophic, comprehensive decline in derivate values into account.

But a return to the Roosevelt paradigm of command and control regulation, however tempting, may not be appropriate at all. First, that paradigm was not particularly effective at combating agency problems, which, as suggested above, was one major cause of the crisis. Command and control imposes sanctions on the regulated party as an entity, being modeled on the traditional prohibitions that governments imposed on individuals. It does not effectively get "inside" the regulated party to adjust its internal incentive structure. To say that a firm subject to sanctions will adjust its own incentive structure because it must function in a competitive market assumes the same Darwinian mechanism that free market advocates espouse, with even less justification.¹²² Moreover, the response to a sanction will be affected, and probably blunted, by the same agency problems.

Second, the command and control paradigm does not appear to be an effective way of dealing with complexity. It would be possible, of course, to simply forbid the use of certain instruments or certain provisions that appear in various instruments. This may well be a good way to eliminate clauses that create specific, identifiable abuses.¹²³ But more general prohibitions would hobble the finance system that is an increasingly important sector of the U.S. economy, and would place us at a disadvantage in the fast-moving global economy of the twenty-first century.¹²⁴ The bright ideas of the bright people in American finance are no less admirable than the innovations of nineteenth and twentieth century inventors like Fulton, McCormack, and Edison. The fact that their discoveries emerge from an invisible world of computer programs and contingent obligations, rather than from clanging garages or equipment-filled laboratories, reflects the incorporeality of the modern economy, not some moral defect of its inhabitants. Without resorting to inappropriately bucolic clichés about golden eggs and geese, we can say that heavy-handed regulation risks stifling the entrepreneurial creativity upon which much of our prosperity depends.

In addition, command and control regulation may have paradoxical effects in the interconnected, finely-tuned world of modern finance. An investor, like Rodgers and

¹²² If that mechanism worked, why would there be a need for regulation in the first place?

¹²³ For example, the federal agency that buys home loans for securitization place limits on the prepayments terms in subprime loans. The Federal Home Loan Mortgage Corporation (Freddie Mac) will not buy mortgages that impose prepayment penalties more than three years after initiation. Chomsisengphet & Pennington-Cross, *supra* note 107, at 52.

¹²⁴ See Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, in *NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES* 101 (Yasayuki Fuchita & Robert E. Litan eds., 2007).

Barer's princess, is a "delicate thing";¹²⁵ regulatory controls can undermine confidence in the financial system and send capital fleeing into cash or Japanese government bonds where it does the American economy no good. Schwarcz gives the example of a perfectly reasonable requirement that investments such as mortgage-backed securities should be "mark[ed] to market."¹²⁶ If these securities are used as collateral for a margin account, however, a decrease in their value will trigger a requirement that the investor provide additional collateral. If the investor does so by selling other mortgage-backed securities, this will further depress the price of these securities, leading to a further demand for additional collateral and a self-reinforcing downward spiral.¹²⁷

Rather than returning to the Roosevelt command and control model in response to the disjunction of the Reagan model under Bush II, the Obama Administration might deal with the financial crisis by employing the regulatory approach of New Public Governance, and thereby contributing to a reconstruction. Financial regulators could meet with major investment companies and explore the possibilities of a cooperative, flexible approach in this arena. The basic idea would be to reach agreements about the sorts of instruments that the institution could offer and the safeguards that would be attached to each. Instead of attempting to impose general rules, the process would focus on individualized arrangements that increase safety while leaving room for creativity. Agreement on the basic goal in this case is relatively easy. The government wants the financial sector to prosper, not only because it is an important source of employment and national wealth in itself, but because it is the engine of the entire American economy. At the same time, no major financial institution wants, or at least will admit that it wants, to generate or broker unsafe investments. These attitudes can provide a basis for the kinds of relationships between regulators and regulated parties that New Public Governance recommends.

Negotiated agreements might provide a partial solution to the agency problem. It is difficult to imagine any general federal law or regulation that could effectively adjust the incentives of loan officers, traders, investment analysts, and strategic planners in financial institutions. But these institutions could well agree to redesign their own incentive structure in return for reduced examinations and other regulatory forbearances, as the "TIT for TAT" strategy proposes.¹²⁸ Basing bonuses and rewards on risk assessment as well as sales volume would, at the very least, sensitize employees to these issues and might generate more realistic assessments. It might also be possible to make each promotion or bonus dependent upon a review of past as well as recent performance; for example, evaluation of a senior employee being considered for a promotion might be partially based on how many of the loans she generated ten years earlier as a junior loan

¹²⁵ "A princess is a delicate thing
Delicate and dainty as a dragonfly's wing
You can recognize a lady by her elegant air
But a genuine princess is exceedingly rare."

Mary Rodgers & Marshall Barer, *Finale, from ONCE UPON A MATTRESS* (Broadway Opening 1959).

¹²⁶ Schwarcz, *supra* note 105, at 233.

¹²⁷ *Id.* at 232–33.

¹²⁸ *See supra* notes 88–91 and accompanying text.

officer went into default. The amount of job mobility in the financial sector is notorious, but this mode of evaluation might produce its primary effect on today's junior loan officers, who would need to anticipate such review, even if that effect was discounted by the possibility that they would switch firms in less than ten years. Other promotion and bonus schemes are possible as well. One goal of a New Public Governance approach would be to harness the financial sector's creativity for the task of finding new ways to reduce agency problems. Whatever the incentives might be of doing so now, they would be greater if rewarded by regulatory forbearance.

With respect to the complexity problem, a regulatory agency might require specific permission to issue a new type of security, rather than establishing legal limits in advance on the types of securities that could be issued. The permission would be provided through negotiation between the issuer and the regulatory agency. In the negotiation, the issuer would need to explain the idea of the security, the risks involved, the disclosures that it would provide, and the safeguards that it would put in place. Design of the security might then be seen as a cooperative process between the issuer and the agency, where the expertise and differential incentives of each were joined to produce a product that served the dual goals of attracting money and avoiding danger. This procedure would not reduce complexity itself, but might well reduce the market failures that result from this complexity. It would not be used for established types of securities, where experience allows a realistic estimation of risk, but for new ones whose performance is undetermined. The flexibility of the negotiation process would allow for arrangements where the conditions for issuing the new security would vary over time as information about the security's performance became available.

It cannot be said that Title VII of Dodd-Frank encourages a flexible approach of this sort. The legislation has the form of traditional command and control regulation, authorizing the relevant federal agencies to issue regulations designed to control what is clearly viewed as an industry gone wild. Interestingly, however, its specific provisions do not preclude such an approach. While a detailed analysis of Dodd-Frank, or even of Title VII, would require much more space than this entire Essay, a few relevant sections are worthy of note. Section 716(j), for example, prohibits banks and bank holding companies from engaging in swaps, including credit default swaps, unless it “conducts its swap or security-based swap activity in compliance with such minimum standards set by its prudential regulator as are reasonably calculated to permit the swaps entity to conduct its swap or security-based swap activities in a safe and sound matter and mitigate systemic risk.”¹²⁹ This is followed by a list of the factors that the regulator should consider in setting these minimum standards, including the expertise and financial strength of the swaps entity, its “systems for identifying, measuring and controlling risks,” and participation in new and existing markets.¹³⁰

The list of considerations is introduced by the words: “In prescribing rules, the prudential regulator for a swaps entity shall consider. . . .”¹³¹ It would appear, then, that the statute contemplates the promulgation of uniform, law-like rules to enforce the

¹²⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 716(j), 124 Stat. 1376 (2010).

¹³⁰ *Id.*, § 716(k).

¹³¹ *Id.*

prohibition of the previous sub-section. The standard procedure for promulgating such rules is for the regulator to publish a “Notice of Proposed Rulemaking” and then elicit comments from interested parties.¹³² Although the Notice sounds like it would be a sort of announcement that the agency was planning to develop a rule on a specified topic, it is usually a draft rule in semi-final form, which means that the comments come rather late in the process. The Negotiated Rulemaking Act provides an alternative approach;¹³³ it establishes a procedure under which the agency can convene a group of interested parties to design the rule in advance of the required Notice. This procedure clearly reflects the ideas of New Public Governance,¹³⁴ but its value is a matter of controversy.¹³⁵ An alternative might be for the agency to encourage various banking associations to develop rules binding their members, and then draw upon those rules in issuing its own.

Alternatively, the regulators might negotiate with banks individually before authorizing new or potentially risky swaps. These negotiations might produce agreements about the institution’s internal structure, compensation and promotion scheme, risk assessment, or self-imposed limitations that would be unwise to promulgate as general rules. The rule adopted by the agency might allow for such negotiated agreements as exceptions to the rule’s provisions; that is, the rule could state that it applies to any bank that has not entered into an individualized agreement. A more subtle approach would be to promulgate a rule that established guidelines for such individualized negotiations, and then require an agreement before the bank could enter the swap market.

A separate section of Title VII requires that the regulators “treat functionally or economically similar products or entities . . . in a similar manner” but adds the caveat that “[n]othing in this subtitle requires the [regulators] to adopt joint rules or orders that treat functionally or economically similar products or entities . . . in an identical manner.”¹³⁶ The word “similar” carries almost all the weight of this provision. While it would be possible to argue that individualized agreements were not “similar” treatment, the better interpretation, given what we know about the variability of organizations, is that the degree of similarity would be sufficient if the individualized agreements were designed to achieve the same basic purposes, that is, the ones specified in Section 716. In fact, treating different organizations in different ways that achieve the same purposes might be more “similar” treatment than imposing a uniform rule on all of them. In any event, the individualized approach would almost certainly be permissible under the *Chevron*

¹³² Administrative Procedure Act, 5 U.S.C. Sec. § 553 (2006).

¹³³ Negotiated Rulemaking Act, 5 U.S.C. §§ 561–70 (2006).

¹³⁴ See Freeman, *supra* note 83, at 653–57.

¹³⁵ For criticisms, see generally Cary Coglianese, *Assessing Consensus: The Promise and Performance of Negotiated Rulemaking* 46 DUKE L.J. 1255 (1997); William Funk, *When Smoke Gets in Your Eyes: Regulatory Negotiation and the Public Interest—EPA’s Woodstove Standards*, 18 ENVTL. L. 55 (1987); James Rossi, *Participation Run Amok: The Costs of Mass Participation for Deliberative Agency Decisionmaking*, 92 NW. U. L. REV. 173 (1997). Some of the defects that the critics have found in the process might be mediated if negotiation and cooperation were more central to the government’s general regulatory approach.

¹³⁶ Dodd-Frank, §§ 712(a)(7)(A)–(B)

doctrine.¹³⁷

IV. CONCLUSION

According to Skowronek, presidential administrations generally move in cycles, beginning with a reconstruction, followed by one or several articulations, and ending with an unfortunate disjunction.¹³⁸ Reagan represented a reconstruction, and one of its major elements was a regulatory policy based on deregulation, privatization and cost-benefit analysis. Bush I and Clinton were both articulations of that policy, but by the time of Bush II, it had become a disjunction. The 2007–08 financial crisis was certainly a major element in that disjunction. Barak Obama’s election signals the possibility of a new reconstruction, one that might carry us through at least the first part of this rather threatening century. A potential basis for a new regulatory policy is provided by the New Public Governance literature. In contrast to the rational actor theory that lay behind Reagan’s regulatory policy, it is based on a model of human behavior that recognizes institutional dynamics and a wide range of individual motivations. On this basis, it recommends that we replace the command and control model that prevailed before Reagan with a flexible, interactive and cooperative approach. That approach might be particularly beneficial in dealing with the complex problems and complex institutions involved in the financial industry that produced and will ultimately be involved in resolving, the current crisis.

Few people would contest the idea that we must allow the U.S. financial industry to be creative in dealing with our rapidly changing world. But our system of government must be equally creative. George W. Bush has brought us to the point of realizing that we cannot avoid the need for governmental creativity by abandoning the regulatory project of the modern administrative state. Perhaps Barak Obama will provide the needed creativity that will equip us to deal with this challenging and changing world as we advance into the millennium that has started out so badly for us.

¹³⁷ *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (holding that when Congress assigns implementation of a statute to an agency, that agency has broad discretion to interpret the statute).

¹³⁸ *See supra* Section I.A; Skowronek, *supra* note 3, at 3–58.