

# A State of Inaction: Regulatory Preferences, Rent, and Income Inequality

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*This Article explores several meanings of a regulatory preference for government inaction. It explains the rise to dominance of this inaction preference in the United States and its distorting influence on the perception and understanding of regulation. Specifically, the Article demonstrates how basic terms in regulation, such as “government failure,” “regulatory capture,” and “deregulation,” acquired misleading connotations suggesting that government inaction is always superior to government action. The Article further explains how, through government inaction, the U.S. legal system accommodates rent extraction — the profitable exploitation of market imperfections and favorable laws. Several developments in recent decades have considerably improved the capacity of very small groups in society to collect rents, namely, use talent and positional advantages to gain increasing levels of earnings. The Article argues that the parallel rise of the inaction preference has contributed to this trend, primarily because the availability of rent extraction opportunities draws talent that utilizes them with growing effectiveness. The purpose of the Article is to clarify several aspects of the relationships between regulation and rent extraction or, more precisely, to emphasize that government inaction may entail undesirable income effects.*

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## INTRODUCTION

Since the 1970s, the United States has witnessed considerable increases in income inequality,<sup>1</sup> compensation levels of executives and professionals in the financial sector,<sup>2</sup> consumer and household debt,<sup>3</sup> greenhouse gas emissions,<sup>4</sup> obesity rates,<sup>5</sup> and policy uncertainty.<sup>6</sup> The causes of each phenomenon are not fully understood and are somewhat controversial, among other reasons due to political polarization and denial that undoubtedly have influenced the public discourse.<sup>7</sup>

- 1 Thomas Piketty and Emmanuel Saez made the seminal contributions to the modern study of income inequality. See Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q.J. ECON. 1 (2003); Thomas Piketty & Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AM. ECON. REV. 200 (2006).
- 2 For executive compensation, see Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 23 REV. FIN. STUD. 2099 (2010); and Carola Frydman et al., *CEO Compensation*, 2 ANN. REV. FIN. ECON. 75 (2010). For compensation in the financial sector see Thomas Philippon & Ariell Reshef, *Wages and Human Capital in the U.S. Finance Industry: 1909-2006*, 127 Q.J. ECON. 1551 (2012).
- 3 Dean M. Maki, *The Growth of Consumer Credit and the Household Debt Service Burden* (Fed. Reserve Bd., Working Paper No. 2000-12, 2000); Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze* (Update to 2007, Levy Econ. Inst. of Bard College, Working Paper No. 589, 2010).
- 4 See Markus Hube & Reto Knutti, *Anthropogenic and Natural Warming Inferred from Changes in Earth's Energy Balance*, 5 NATURE GEOSCIENCE 31 (2012); S.A. Montzka et al., *Non-CO<sub>2</sub> Greenhouse Gases and Climate Change*, 476 NATURE 43 (2011).
- 5 See David M. Cutler et al., *Why Have Americans Become More Obese?*, 17 J. ECON. PERSP. 93 (2003); Y. Claire Wang et al., *Health and Economic Burden of the Projected Obesity Trends in the USA and the UK*, 378 LANCET 815 (2011).
- 6 See Scott R. Baker et al., *Why Has US Policy Uncertainty Risen Since the 1960s?*, AM. ECON. REV., May 2014, at 56.
- 7 For the trend in polarization, see Marina Azzimonti, *The Political Polarization Index* (Fed. Res. Bank of Phila., Working Paper No. 13-41, 2013), available at <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2013/wp13-41.pdf>. For polarization effects, see James Andreoni & Tymofiy Mylovanov, *Diverging Opinions*, 4 AM. ECON. J: MICROECONOMICS 209 (2012); Avinash K. Dixit & Jörgen W. Weibull, *Political Polarization*, 104 PROC. NAT'L ACAD. SCI. 7351 (2007); Edward L. Glaeser, *The Political Economy of Hatred*, 120 Q.J. ECON. 45 (2005); Charles G. Lord et al., *Biased Assimilation and*

There is an obvious desire to seek clear explanations for costly trends and effective means to reverse them. This Article does not do that much. Instead, it explores a related question: do public policies influence costly social trends, such as the phenomena listed above? The question whether public policies contribute to long-terms trends is often raised. Political debates and academic literature often question the effects of public policies on economic opportunities, wealth distribution and other factors. Studies of income inequality illustrate this tendency. With the exception of references to tax policies, economists tend to “downplay the role of politics and public policy in generating and perpetuating inequality.”<sup>8</sup>

To show the relevance of public policies, namely, regulatory regimes, the Article explores several aspects of government inaction.<sup>9</sup> It explains the general characteristics of an influential preference for government inaction and shows that this preference has profoundly distorted the understanding of regulation. Specifically, the Article shows that basic terms in regulation such as “government failure,” “regulatory capture,” and “deregulation” are commonly used to criticize action policies implicitly suggesting that government inaction is always superior to government action. In other words, the common understanding of basic terms in regulation suggests that government action is the source of problems, whereas government inaction is the way to prosperity.

Using a fairly simple framework, the Article explains and illustrates why government inaction accommodates rent extraction — the profitable

*Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCH. 2098 (1979); Barak Orbach, *On Hubris, Civility, and Incivility*, 54 ARIZ. L. REV. 443 (2012); and Rajiv Sethi & Muhamet Yildiz, *Public Disagreement*, 4 AM. ECON. J.: MICROECONOMICS 57 (2012). For mechanisms of denial, see Faye Crosby, *The Denial of Personal Discrimination*, 27 AM. BEHAV. SCI. 27 (1984); Delroy L. Paulhus & Douglas B. Reid, *Enhancement and Denial in Socially Desirable Responding*, 60 J. PERSONALITY & SOC. PSYCH. 307 (1991).

<sup>8</sup> Adam Bonica et al., *Why Hasn't Democracy Slowed Rising Inequality?*, 27 J. ECON. PERSP. 103, 121 (2013); *see also* Alan Krueger, Chairman, President's Council of Econ. Advisers, The Rise and Consequences of Inequality in the United States, Speech at the Ctr. for Am. Progress, Wash., D.C. (Jan. 12, 2012).

<sup>9</sup> All regulatory regimes are imperfect. I do not suggest that action is always better than inaction. *See* Alfred E. Kahn, *Applications of Economics to an Imperfect World*, 69 AM. ECON. REV. 1 (1979); Barak Orbach, *What Is Regulation?*, 30 YALE J. REG. ONLINE 1 (2012) (defining “regulation” as a state intervention in the private domain that is a byproduct of imperfections); *see also* Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOC. REV. 894 (1936).

exploitation of market imperfections and favorable laws.<sup>10</sup> It argues that rent extraction contributes to certain costly long-term trends with distributive effects. Further, The Article describes the origins and rise to prominence of the inaction preference in the United States. The primary thesis of the Article is, therefore, modest: government inaction creates rent extraction opportunities and those have long-term consequences. The preference for government inaction builds on denial of this thesis. I do not argue with preferences. *De gustibus non est disputandum.*

The Article continues as following. Part I explains the meaning of “rent,” “rent extraction,” and “rent opportunities.” It emphasizes that rent opportunities draw talent that has the capacity to enhance rent extraction. Part II describes the inaction preference in the United States and illustrates its dominance through the concepts of “government failure,” “regulatory capture,” and “deregulation.”

## I. RENT OPPORTUNITIES

### A. Rent

In economics, the word “rent” has two related meanings: (1) a payment for the use of a resource,<sup>11</sup> and (2) “a payment to a resource owner above the amount [her] resources could command in their best alternative use”<sup>12</sup> or, in other words, “returns that firms or individuals obtain due to their positional advantages.”<sup>13</sup> The distinction between these meanings is important to the understanding of controversies regarding income distribution. Certain circumstances allow a resource owner to extract profit that the resource could not have generated in other circumstances. For example, some jobs offer compensation premia to the individuals who hold them, while comparable jobs in other industries pay less. The reasons for such compensation premia are diverse. In some instances, the combination of circumstances and talent creates value,<sup>14</sup> in

<sup>10</sup> Gerritt De Geest examined a related question and concluded that the reliance on legal policies could improve income inequality. See Gerritt De Geest, *Removing Rents: Why the Legal System Is Superior to the Income Tax at Reducing Income Inequality* (Wash. Univ., Working Paper, 2014).

<sup>11</sup> See D.H. Buchanan, *The Historical Approach to Rent and Price Theory*, 26 ECONICA 123 (1929); Alfred Marshall, *On Rent*, 3 ECON. J. 74 (1893).

<sup>12</sup> Robert D. Tollison, *Rent Seeking: A Survey*, 35 KYLKOS 575, 577 (1982).

<sup>13</sup> LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 62 (2004).

<sup>14</sup> See, e.g., ERIK BRYNJOLFSSON & ANDREW McAFFEE, RACE AGAINST THE MACHINE 44 (2011) (“Aided by digital technologies, entrepreneurs, CEOs, entertainment

other circumstances this combination allows the resource owner to draw profit at the expense of others,<sup>15</sup> yet in other circumstances the combination both creates value and allows the resource owner to draw profit at the expense of others. “Rent extraction” loosely refers to the use of a resource to draw profit at the expense of others.<sup>16</sup> “Rent seeking” generally means investment in rent extraction though not all forms of rent seeking activities intend to have income effects. For example, interest groups may simply lobby for or against some idea from which their members may not benefit financially though they may have financial implications for others (environmental policies, gun control, abortion policies, and so forth).

The proposition that rent extraction is a viable strategy with income effects is well established. Vast literature documents and analyzes strategic rent extraction through externalities, imperfect information, bounded rationality, and favorable legal rules. For example, many studies show that, through the design of services and pricing structures, firms strategically take advantage of consumers’ cognitive limitations.<sup>17</sup> Similarly, many other studies show that sophisticated market participants can, and sometimes do, take advantage of market imperfections to manipulate prices profitably or corner the market.<sup>18</sup>

Trends in income inequality indicate that in recent decades a fraction of the population, one percent or less, considerably improved its capacity to collect rent. The past three decades have witnessed an increase in income

stars, and financial executives have been able to leverage their talents across global markets and capture reward that would have been unimaginable in earlier times.”).

15 See, e.g., JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY (2011) (arguing that the trends in income inequality reflect the increasing ability of small groups to extract rent); Josh Bivens & Lawrence Michel, *The Pay of Corporate Executives and Financial Professionals as Evidence of Rents in Top 1 Percent Incomes*, 27 J. ECON. PERSP. 57 (2013) (arguing that rent extraction is one of the sources of the increasing income inequality).

16 See, e.g., BEBCHUK & FRIED, *supra* note 13.

17 See, e.g., Oren Bar-Gill, *Seduction By Plastic*, 98 NW. L. REV. 1373 (2004); Bruce I. Carlin, *Strategic Price Complexity in Retail Financial Markets*, 278 J. FIN. ECON. 278 (2009); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006).

18 See, e.g., BLAIR STEWART, AN ANALYSIS OF SPECULATIVE TRADING IN GRAIN FUTURES (1949); Rajesh K. Aggarwal & Guojun Wu, *Stock Market Manipulations*, 79 J. BUS. 1915 (2006); Markus K. Brunnermeier & Lasse Heje Pedersen, *Predatory Trading*, 60 J. FIN. 1825 (2005); Robert A. Jarrow, *Market Manipulation, Bubbles, Corners, and Short-Squeezes*, 27 J. FIN. QUANTITATIVE ANALYSIS 311 (1992).

inequality around the world.<sup>19</sup> In the United States, the increases were greater than in other countries and followed financial deregulation during an era with two financial bubbles (as shown in Figure 1 below). The share of the top 1% earners dropped with the introduction of financial regulation in the 1930s, soared with financial deregulation, and skyrocketed during the dot-com and housing bubbles. In the financial sector itself, the pattern was even more pronounced.<sup>20</sup> The correspondence between the patterns of change in income inequality and recent bubbles suggests that the top 1% has the capacity to benefit from bubbles. Several factors explain the increased capacity of the top 1% to collect rent, including technological developments, institutional changes, and globalization.

Does the top 1% benefit from rent extraction? Some argue that the top 1% creates value and is compensated for that. Others identify rent extraction. The tension between value creation and rent extraction is old and reflects the distinction between the two meanings of the term “rent.” A market participant can create value and extract rent at the same time. For example, a manufacturer can create value by producing a good product, yet extract rent through some externalities (say, pollution). Similarly, a monopolist can create value by selling good products at low prices, yet extract rent by taking steps to exclude competitors from the market. Or, another example, a financial institution can create value by offering credit to consumers, yet extract rent through predatory practices. Law and politics often exhibit a general preference to ignore rent extraction under such circumstances and focus on the other meaning of rent — compensation for added value.<sup>21</sup> I argue that any fair assessment of the U.S. legal system shows that it accommodates many forms of rent extraction of the types that benefit the top 1%.

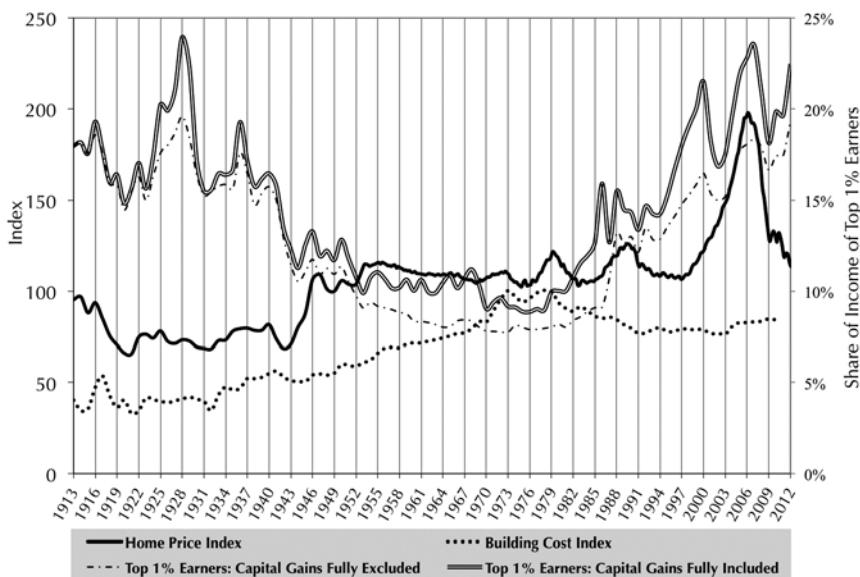
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19 See generally THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (2014); Anthony B. Atkinson et al., *Top Incomes in the Long Run of History*, 49 J. ECON. LITERATURE 3 (2011).

20 Philippon & Reshef, *supra* note 2.

21 See, e.g., Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007); Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986).

**Figure 1: Top One Percent Income Shares and Home Prices in the United States, 1913-2012<sup>22</sup>**



Rent extraction has many facets that are not directly related to income. To illustrate, consider sugary drinks. This class of products is legal and many healthy people enjoy them. Studies, however, show that sugary drinks are leading contributors to changes in obesity rates.<sup>23</sup> In the United States, about one out of three children (age two to nineteen) is overweight, and about one out of six is obese.<sup>24</sup> Among adults (age twenty years and over), about one out of three is obese, and seven out of ten are overweight.<sup>25</sup> As already noted, obesity rates have considerably increased since the 1970s.<sup>26</sup> In June 2013, the American Medical Association recognized obesity as a disease and

22 Data: Thomas Piketty & Emmanuel Saez; Robert Shiller.

23 See, e.g., JENNIFER L. HARRIS, EVALUATING SUGARY DRINK NUTRITION AND MARKETING TO YOUTH (2011), available at [http://www.sugarydrinkfacts.org/resources/sugarydrinkfacts\\_report.pdf](http://www.sugarydrinkfacts.org/resources/sugarydrinkfacts_report.pdf).

24 AM. HEART ASS’N, OVERWEIGHT & OBESITY: STATISTICAL FACT SHEET (2013). The data suggests that during the first decade of the twenty-first century, the obesity rates among two to five-year-old children declined. Cynthia L. Ogden et al., *Prevalence of Obesity Among Adults: United States, 2011-2012*, 311 J. AM. MED. ASS’N 806 (2014).

25 35.9% obese, and 69.2% overweight. Ogden et al., *supra* note 24.

26 See Cutler et al., *supra* note 5; Wang et al., *supra* note 5.

identified it as an epidemic that warrants national policies.<sup>27</sup> Empirical evidence shows that the “wage penalty” of obesity is meaningful.<sup>28</sup> Notwithstanding, the sugary drink industry has been aggressively marketing its products and fighting against regulation.<sup>29</sup> Stated differently, the uncalculated private and social costs of sugary drinks consumption are an interest of the industry being related to its profitability: a decline in obesity rates would adversely affect the sugary drinks industry. In this industry, as well as several others, the product design, marketing, and anti-regulation campaigns are intended to protect and enhance rent extraction — a benefit at the expense of others (as opposed to mutually beneficial transactions).<sup>30</sup> This form of rent extraction is similar to the sales of addictive tobacco products and the encouragement of excessive borrowing.<sup>31</sup>

## B. Rent Opportunities

“Rent opportunities” are situations in which some have the capacity to obtain returns at the expense of others — the ability to utilize market imperfections or secure favorable laws that some, but not all, market participants can exploit. These opportunities and the ability to exploit them define the difference between the two meanings of the term “rent.” Five types of rent opportunities are well studied and well documented: (1) externalities, (2) limitations of

- 27 Am. Med. Ass’n House of Delegates, Resolution 420, Recognition of Obesity As a Disease, (2013); *see also* THE SURGEON GENERAL’S CALL TO ACTION TO PREVENT AND DECREASE OVERWEIGHT AND OBESITY (2001); Jay Bhattacharya & Nerraj Sood, *Who Pays for Obesity*, 25 J. ECON. PERSP. 139 (2011); Michelle M. Mello et al., *Obesity — The New Frontier of Public Health Law*, 354 NEW ENG. J. MED. 2601 (2006).
- 28 See, e.g., Charles L. Baum II & William F. Ford, *The Wage Effects of Obesity: A Longitudinal Study*, 13 HEALTH ECON. 85 (2004); Rebecca M. Puhl & Chelsea A. Heuer, *The Stigma of Obesity: A Review and Update*, 17 OBESITY 941 (2009). When medical expenditure and productivity are included, the income effect is larger. See Bhattacharya & Sood, *supra* note 27.
- 29 See, e.g., Shi-Ling Hsu, *A Cost-Benefit Analysis of Sugary Drink Regulation in New York City*, 10 J. FOOD L. & POLICY 73 (2014); Kent Muhtar, *Coca Cola Didn’t Make America Fat*, WALL ST. J., Oct. 7, 2009, at A17 (Coca Cola CEO arguing that “Americans need more exercise, not another tax”).
- 30 The food industry advanced the production of addictive processed food, as well as sophisticated marketing methods. See generally MICHAEL MOSS, SALT SUGAR FAT: HOW THE FOOD GIANTS HOOKED US (2014); *see also* Cutler et al., *supra* note 5.
- 31 For excessive borrowing, see Maki, *supra* note 3; and Wolff, *supra* note 3.

market participants, (3) access to favorable laws, (4) agency problems, and (5) rent sharing. These forms of rent opportunities emphasize the opportunity costs of government inaction: it accommodates certain forms of inefficiencies and involuntary transfers.

(1) *Externalities*. The ability of a market participant to externalize costs to others may be the simplest form of rent opportunities. For example, whenever a business freely pollutes, it extracts rent. For that matter, there is no difference between businesses that dump waste in nearby rivers and those that produce high levels of greenhouse gas emissions.

(2) *Limitations of market participants*. Transaction costs, imperfect information, bounded rationality, and inattention often cause decision-makers to make imperfect decisions, mistakes and compromises. Such patterns, in turn, can be profitably exploited and offer numerous opportunities for rent extraction.<sup>32</sup> The ability of sophisticated firms to successfully market products with known negative effects — tobacco, unhealthy food, excessive credit, and fads — often builds on exploitation of such limitations. In such circumstances, a sophisticated party designs and markets a product and takes advantage of consumers' limitations, disregarding or discounting adverse effects on consumers (as long those effects do not give rise to costly legal liability). Further, these opportunities draw “talent” that can devise creative ways, preferably legal, to extract rent.

(3) *Access to favorable laws*. The ability to influence laws and regulations is valuable. It may take the form of securing laws that grant privileges, allocate subsidies, or raise rivals' costs.<sup>33</sup> It may also take the form of fending off unfavorable laws and regulations. Interest groups use every possible means

32 See generally Aggarwal & Wu, *supra* note 18; John Y. Campbell, *Household Finance*, 61 J. FIN. 1553 (2006); Carlin, *supra* note 17; Stefano DellaVigna & Ulrike Malmendier, *Paying Not to Go to the Gym*, 96 AM. ECON. REV. 694 (2006); Gabaix & Laibson, *supra* note 17; Edward L. Glaeser, *The Political Economy of Hatred*, 120 Q.J. ECON. 45 (2005); Sendhil Mullainathan & Andrei Shleifer, *The Market for News*, 95 AM. ECON. REV. 1031 (2005).

33 See, e.g., *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664 (1970) (exemptions from taxes); *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961) (discussing “a publicity campaign [of railroads] against . . . truckers designed to foster the adoption and retention of laws and law enforcement practices destructive of the trucking business”); *A. Magnano Co. v. Hamilton*, 292 U.S. 40 (1934) (discussing tax on butter substitutes promoted by the dairy industry); *United States v. Terminal R.R. Ass'n of St. Louis*, 224 U.S. 383 (1912) (an exclusive privilege to operate a bridge over a river); *Wiggins Ferry Co. v. E. St. Louis*, 107 U.S. 365 (1883) (an exclusive right to operate ferries); *Charles River Bridge v. Warren Bridge*, 36 U.S. 420 (1837) (an exclusive

to accomplish their goals, including government inaction. Sophisticated interest groups typically secure bundles of “laws” that include both actions and inactions. They successfully lobby for the adoption of favorable statutes and regulations and the rejection of unfavorable statutes and regulations.

(4) *Agency problems*. In every setting that affords a person some control over the assets of others, she has the capacity to extract rent. This is the essence of the agency problem.<sup>34</sup> The executive compensation literature shows that the hikes in executive compensation are at least partially related to agency problems.<sup>35</sup> In essence, any agency problem, including executive compensation, represents a classic form of rent extraction in a private setting — benefitting from other people’s resources.

(5) *Rent sharing*. Firms that successfully extract rent often distribute a portion of the rent among their employees and executives through wages and other forms of compensation. Empirical evidence shows that some industries pay employees poorly, while others offer wage premiums for otherwise comparable jobs.<sup>36</sup> Studies of the phenomenon show that the income premium in an industry tends to be related to the rent that firms in the industry extract.<sup>37</sup> In some industries, such as the financial sector, rent sharing is attributed, among other things, to the need to draw specialized skills and talent. Rent sharing means that the rent captured by a firm trickles down to employees.

privilege to operate a bridge over a river); *Gibbons v. Ogden*, 22 U.S. 1 (1824) (an exclusive right to operate ferries).

- 34 See generally Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
- 35 See generally BEBCHUK & FRIED, *supra* note 13; Lucian A. Bebchuk & Holger Spemann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247 (2010).
- 36 Sumner Slichter identified the phenomenon. See Sumner Slichter, *Notes on the Structure of Wages*, 32 REV. ECON. & STAT. 80 (1950). Subsequent scholars reached similar conclusions utilizing better data. See, e.g., William T. Dickens & Lawrence F. Katz, *Inter-Industry Wage Differences and Industry Characteristics*, in UNEMPLOYMENT AND THE STRUCTURE OF LABOR MARKETS 48 (Kevin Lang & Jonathan Leonard eds., 1987); Lawrence F. Katz & Lawrence H. Summers, *Industry Rents: Evidence and Implications*, 1989 BROOKINGS PAPERS ECON. ACTIVITY 209; Alan B. Krueger & Lawrence H. Summers, *Efficiency Wages and the Inter-industry Wage Structure*, 56 ECONOMETRICA 259 (1988).
- 37 See generally David G. Blanchflower et al., *Wages, Profits, and Rent-Sharing*, 111 Q.J. ECON. 227 (1996).

However, rent sharing does not eliminate the gap between employees and executives. Here, again, the financial sector offers a good example. During the income hikes experienced in recent decades in the financial industry, the average wage premium of executives went up more than three times than the increase gained by employees.<sup>38</sup>

Quite importantly, as already mentioned, rent opportunities draw talent — individuals who have the profitability of rent opportunities attracts talent that has the capacity to enhance the effectiveness of rent extraction.<sup>39</sup> The appeal of rent opportunities for sophisticated talent, in turn, only allows relevant segments in the economy to extract more rent and have a greater advantage over market regulators.

In sum, in the modern economy there are many forms of rent extraction opportunities that allow sophisticated market participants to draw profit at the expense of others. The exploitation of such opportunities may be consistent with productive and beneficial activities. A manufacturer can produce and market great products while engaging in undesirable activities. The modest proposition made in this Article is that a preference to disregard the private and social costs of such activities has influenced both the understanding of regulation and the regulatory landscape in the United States.

## II. THE INACTION PREFERENCE

### A. Meaning and Context

Sentiments for and against regulation are cyclical.<sup>40</sup> In the United States and other countries, a powerful anti-regulation cycle began in the 1960s. Like prior cycles, this one was carried by ideologies, political agendas, and academic literature.<sup>41</sup> The crash of the financial markets in the fall of 2008 possibly marked a change of direction. Yet, anti-regulation sentiments still dominate

38 Philipon & Reshef, *supra* note 2.

39 See William J. Baumol, *Entrepreneurship: Productive, Unproductive, and Destructive*, 98 J. POL. ECON. 893 (1990); Kevin M. Murphy et al., *The Allocation of Talent: Implications for Growth*, 106 Q.J. ECON. 503 (1991); Thomas Philippon, *Financiers Versus Engineers: Should the Financial Sector Be Taxed or Subsidized?*, 2 AM. ECON. J.: MACROECONOMICS 158 (2010).

40 See, e.g., HAROLD U. FAULKNER, *THE DECLINE OF LAISSEZ FAIRE*, 1897-1917 (1951); SIDNEY FINE, *LAISSEZ FAIR AND THE GENERAL-WELFARE STATE* (1956).

41 See, e.g., MARVER H. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* (1955); JAMES M. LANDIS, *REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT* (1960); Thomas G. Moore, *The Purpose of Licensing*, 4 J.L. & ECON. 93 (1961);

many of the legal institutions in the United States, including the Supreme Court. These sentiments represent an “inaction preference.”

The inaction preference rests on a somewhat perplexing proposition that government regulation is inherently bad, tends to expand, and should be eliminated.<sup>42</sup> As stated by Milton Friedman: “The government solution to a problem is usually as bad as the problem and very often makes the problem worse.”<sup>43</sup> Three contemporary manifestations of the proposition are the rise of the Tea Party,<sup>44</sup> the mantra that “regulation kills jobs,”<sup>45</sup> and the use of regulatory moratoria.<sup>46</sup> The proposition and the inaction preference typically refer to regulation in the form of formal legal rules and their enforcement (“government action”), as opposed to situations in which no formal rules are promulgated or enforced (“government inaction”). For example, motor vehicle safety regulations and their enforcement are perceived as “government action,” whereas the freedom from such regulations exists under government inaction.<sup>47</sup>

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George J. Stigler & Claire Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J.L. & ECON. 1 (1962).

- 42 See, e.g., MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962); MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE (1982).
- 43 MILTON FRIEDMAN, AN ECONOMIST’S PROTEST 6 (1975); see also MILTON FRIEDMAN, WHY GOVERNMENT IS THE PROBLEM (1993); 127 CONG. REC. 715, 716 (1981) (President Ronald Reagan declaring in his Inaugural Address that “government is the problem”).
- 44 See JILL LEPORE, THE WHITES OF THEIR EYES: THE TEA PARTY’S REVOLUTION AND THE BATTLE OVER AMERICAN HISTORY (2011); William Voegeli, *The Meaning of the Tea Party*, 10 CLAREMONT REV. BOOKS 12 (2010).
- 45 See generally DOES REGULATION KILL JOBS? (Cary Coglianese et al. eds., 2014); Jonathan S. Masur & Eric A. Posner, *Regulation, Unemployment, and Cost-Benefit Analysis*, 98 VA. L. REV. 579 (2012); Richard D. Morgenstern et al., *Jobs Versus the Environment: An Industry-Level Perspective*, 43 J. ENVTL. & ECON. MGMT. 412 (2002); see also Repealing the Job-Killing Health Care Law Act, S. 192, Cong. 112th 1st Sess. (2011).
- 46 See Kathryn A. Watts, *Regulatory Moratoria*, 61 DUKE L.J. 1883 (2012). The political use of government shutdowns is somewhat similar. See CLINTON T. BRASS, SHUTDOWN OF THE FEDERAL GOVERNMENT: CAUSES, PROCESSES, AND EFFECTS (2013); OFFICE OF MGMT. & BUDGET, IMPACTS AND COSTS OF THE OCTOBER 2013 FEDERAL GOVERNMENT SHUTDOWN (2013).
- 47 The National Traffic and Motor Vehicle Safety Act of 1966, Pub. L. 89-563, 80 Stat. 718 (1966), authorizes the National Highway Traffic Safety Administration (NHTSA) to issue motor vehicle safety regulations. There was great skepticism over the potential cost-effectiveness of such regulations. See, e.g., JERRY L. MASHAW & DAVID L. HARFST, THE STRUGGLE FOR AUTO SAFETY (1990); Lester B. Lave & Warren E. Webber, *A Benefit-Cost Analysis of Auto Safety Features*,

In essence, the inaction preference is formalistic and simplistic. People who hold this preference emphasize the social costs of government actions and downplay or disregard the social costs of government inactions. However, as already discussed, government inaction could permit and accommodate rent extraction.

The inaction preference gained dominance in U.S. law and politics in the 1970s and 1980s.<sup>48</sup> It has had a considerable impact on the jurisprudence of the U.S. Supreme Court.<sup>49</sup> Specifically, since the confirmation of Chief Justice John Roberts in September 2005, the Court's regulatory jurisprudence is largely an expression of a strong inaction preference. More than any other Court since the Great Depression, the Roberts Court has been hostile to government regulation and has been expanding corporate rights at the expense of individual rights through repeals of campaign financing restrictions and barriers to lawsuits against firms.<sup>50</sup> With the exception of conservative moral

<sup>2</sup> APPLIED ECON. 265 (1970); Sam Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 677 (1975); *see also* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983) (reviewing an administrative decision to abandon a motor vehicle safety regulation).

- <sup>48</sup> For the inaction preference at the Office of Management and Budget (OMB), see Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260 (2006); and Michael A. Livermore & Richard L. Revesz, *Regulatory Review, Capture, and Agency Inaction*, 101 GEO. L.J. 1337 (2012). *See also, e.g.*, Executive Order 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (2011); Executive Order 13579, 76 Fed. Reg. 41587 (2011) (extending Executive Order 13563 to independent agencies); Executive Order 13610, 77 Fed. Reg. 28469 (2012) (extending Executive Order 13563 to further “modernize our regulatory system and to reduce unjustified regulatory burdens and costs”); Barack Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17 (explaining Executive Order 13563); Memorandum from Cass R. Sunstein for the Heads of Executive Departments and Agencies, and of Independent Regulatory Agencies (Feb. 2, 2011) (same); Cass Sunstein, *Toward a 21st-Century Regulatory System: An Update on the President’s Reforms*, WALL ST. J., May 26, 2011, at A17.
- <sup>49</sup> *See, e.g.*, United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 741 (1975) (interpreting the meaning of government inaction).
- <sup>50</sup> *See* Lee Epstein, William M. Landes & Richard A. Posner, *How Business Fares in the Supreme Court*, 97 MINN. L. REV. 1431 (2013):

[T]he Roberts Court is much friendlier to business than either the Burger or Rehnquist Courts, which preceded it, were. . . . [F]ive of the ten Justices who, over the span of our study (the 1946 through 2011 Terms), have been the most favorable to business are currently serving, with two of them ranking at the very top among the thirty-six Justices in our study.

regulation and climate change regulation,<sup>51</sup> the Court's hostility to regulation has been undermining the effectiveness of public policies and raising the costs of private enforcement.<sup>52</sup> The Roberts Court has been consistently increasing the influence of wealth and interest groups on U.S. politics by narrowing the constitutionality of limits on campaign financing,<sup>53</sup> and trimming the scope of private enforcement by erecting procedural hurdles to bar plaintiffs from moving forward on substantive issues.<sup>54</sup> The Court's decisions almost uniformly reflect a strong distaste for regulation by the majority of the justices.

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*See also* Erwin Chemerinsky, *Justice for Big Business*, N.Y. TIMES, July 2, 2013, at A25 ("[T]he Roberts court . . . obviously believes, and sometimes expressly says, that there is a need to protect big business from litigation. But in discrimination, product liability and arbitration, it has left injured employees, consumers and small businesses without recourse."); Jedediah Purdy, *The Roberts Court v. America*, DEMOCRACY, Winter 2012, at 46.

- 51 For moral regulation, see, for example, FCC v. Fox Television Stations, Inc., 132 S. Ct. 2307 (2012) (examining the FCC's indecency policy); and FCC v. Fox Television Stations, Inc., 556 U.S. 502 (2009) (same). For climate change regulation, see, for example, EPA v. EME Homer City Generation, L.P., 134 S. Ct. 1584 (2014); Am. Elec. Power Co., Inc. v. Connecticut, 131 S. Ct. 2527 (2011); and Massachusetts v. EPA, 549 U.S. 497 (2007).
- 52 See, e.g., Wheaton College v. Burwell, 134 S. Ct. 2806 (2014) (holding that religious colleges cannot be required to fill out forms noting their religious objections to providing birth control coverage under the Affordable Care Act); Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751 (2014) (holding that regulations requiring closely held corporations to provide their female employees with no-cost access to contraception violate the Religious Freedom Restoration Act.); Nat'l Fed. of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012) (criticizing the federal government's use of the Commerce Clause); Sorrell v. IMS Health Inc., 131 S. Ct. 2653 (2011) (striking down a state law restricting the sale, disclosure, and use of pharmacy records that reveal the prescribing practices of individual doctors).
- 53 See, e.g., Fed. Election Comm'n v. Wisconsin Right to Life, Inc., 551 U.S. 449 (2007); *see also* McCutcheon v. Fed. Election Comm'n, 134 S. Ct. 1434 (2014); Am. Tradition P'ship, Inc. v. Bullock, 132 S. Ct. 2490 (2012); Ariz. Free Enter. Club's Freedom Club PAC v. Bennett, 131 S. Ct. 2806 (2011); Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010).
- 54 See, e.g., Halliburton v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014); Am. Exp. Co. v. Italian Colors Restaurant, 133 S. Ct. 2304 (2013); Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064 (2013); Comcast Corp. v. Behrend, 133 S. Ct. 1426 (2013); Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 180 L. Ed. 2d 374 (2011); AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011); 14 Penn Plaza LLC v. Pyett, 556 U.S. 247 (2009); Ledbetter v. Goodyear Tire & Rubber Co., Inc., 550 U.S. 618 (2007); Bell Atlantic Corp. v. Twombly, 550

Below, I use the concepts of “government failure,” “regulatory capture,” and “deregulation” to further explain and illustrate the influence of the inaction preference.

## B. Government Failure

The government may fail through both action and inaction, but the term “government failures” typically refers to deficient government actions, supposedly suggesting that any reduction in the scope of government action is likely to benefit society.<sup>55</sup> This common meaning of the phrase demonstrates the effects of the inaction preference on the understanding (or perception) of regulation.

This common perception of the term “government failure” rests on theories that started emerging in the 1960s.<sup>56</sup> During that time, confidence in government regulation began to erode with the publication of studies showing that many regulatory policies failed to serve the public and sometimes even protected the interests of small groups at the public’s expense.<sup>57</sup> These studies inspired government failure theories emphasizing the costs of government regulation and the limitations of the traditional “market failure” theories.<sup>58</sup> Under the

U.S. 544 (2007); *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264 (2007). For the trend before the appointment of Chief Justice Roberts, see Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571 (2004).

55 See Barak Orbach, *What Is Government Failure?*, 31 YALE J. REG. ONLINE 44 (2013); see also Gary S. Becker, *Competition and Democracy*, 1 J.L. & ECON. 105, 109 (1958) (“[D]oes the existence of market imperfections justify government intervention? The answer would be ‘no,’ if the imperfections in government behavior were greater than those in the market.”); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 211 (1976) (“The revisionism [in the economic analysis of regulation] had its genesis in a growing disenchantment with the usefulness [of] . . . regulation in . . . eliminate[ing] one or another unfortunate allocative consequence of market failure.”); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 336 (1974) (“The conception of government as a costless and dependably effective instrument for altering market behavior has . . . gone by the boards.”).

56 See Orbach, *supra* note 55.

57 See, e.g., sources cited *supra* note 41.

58 See Orbach, *supra* note 55; see also CLIFFORD WINSTON, GOVERNMENT FAILURE VERSUS MARKET FAILURE (2006); Roland N. McKean, *The Unseen Hand in Government*, 55 AM. ECON. REV. 496 (1965); Charles Wolf, Jr., *A Theory of Nonmarket Failure: Framework for Implementation Analysis*, 22 J.L. & ECON. 107 (1979).

new paradigm, the costs of government regulation were the primary source of concern, while the costs of government inactions were heavily discounted (or disregarded). A central proposition of this new paradigm was that erroneous actions (false-positive errors) impose heavy costs on society while erroneous inactions (false-negative errors) at most create a temporary burden.<sup>59</sup> In essence, government failure theories replaced one naïve belief with another.

The distaste for government regulation and the corresponding confidence in market institutions, however, can be costly. For example, consider drug compounding, which is the “process by which a pharmacist or doctor combines, mixes, or alters ingredients to create a medication tailored to an individual patient’s needs.”<sup>60</sup> Compounding is used to prepare medications that are not commercially made. It ranges from drugs in lower dosage for children, to drugs without specific allergy-triggering ingredients, to lethal injections that states use for execution. Congress was reluctant to regulate drug compounding until a contamination was linked to a multistate fungal meningitis outbreak that resulted in over fifty deaths.<sup>61</sup> Another example is the financial crisis of 2008. Many factors contributed to the crisis that led to the Great Recession, but government inaction was one of the chief contributors to the crisis.<sup>62</sup>

### C. Regulatory Capture

The most popular rent extraction theory may be “regulatory capture.”<sup>63</sup> The theory of capture was born of observations that regulatory agencies might

59 See, e.g., Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 3 (1984) (“[E]rrors that tolerate baleful practices are self-correcting while erroneous condemnations are not.”).

60 Thompson v. W. States Med. Ctr., 535 U.S. 357, 360-61 (2002).

61 ANDREW NOLAN, CONG. RESEARCH SERV., FEDERAL AUTHORITY TO REGULATE THE COMPOUNDING OF HUMAN DRUGS (2013); U.S. GOV’T ACCOUNTABILITY OFFICE, DRUG COMPOUNDING: CLEAR AUTHORITY AND MORE RELIABLE DATA NEEDED TO STRENGTHEN FDA OVERSIGHT (2013). In November 2013, Congress passed the Drug Quality and Security Act, 127 Stat. 587, Pub. L. 113-54 (2013), creating a framework for regulation of compounded drugs.

62 See NAT’L COMM’N ON THE CAUSES OF THE FIN. & ECON. CRISIS IN THE U.S., THE FINANCIAL CRISIS: INQUIRY REPORT (2011) [hereinafter INQUIRY REPORT].

63 See William A. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J.L. & ECON. 151 (1972); Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). For surveys of the topics, see Ernesto Dal

become “susceptible to private pressures [and] manipulation for private purposes”<sup>64</sup> and over time “develop an orientation toward the views and interests of their clientele and become ripe for capture.”<sup>65</sup> Consistent with these observations, scholars have examined the question “why do we observe state intervention in economic life?”<sup>66</sup> George Stigler famously framed the theory: “As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.”<sup>67</sup> Stigler’s theory has been extremely influential. Its spirit is embedded in the design of the federal regulatory oversight and has been shaping the direction of federal regulation.<sup>68</sup> Nonetheless, its historical-legal context is typically misunderstood and its use is frequently misguided. Stigler wrote about the “economic regulation” that dominated the federal system until the 1980s. Loosely speaking, economic regulation in the United States in that era focused on prices and entry in regulated industries, utilizing command-and-control measures. In that regulatory system, the “captured” regulator served the regulated industry by limiting entry and maintaining profitable rates. This form of captured regulation was implemented through both action and inaction. Agencies issued regulations that erected barriers to entry and did not sufficiently regulate the regulated industries to facilitate competition.

Bó, *Regulatory Capture: A Review*, 22 OXFORD REV. ECON. POL’Y 203 (2006); Thomas W. Merrill, *Capture Theory and the Courts*, 72 CHI.-KENT L. REV. 1039 (1997); and William J. Novak, *A Revisionist History of Regulatory Capture*, in PREVENTING REGULATORY CAPTURE 25 (Daniel Carpenter & David A. Moss eds., 2014).

64 BERNSTEIN, *supra* note 41, at 296; see also Marver H. Bernstein, *Independent Regulatory Agencies: A Perspective on Their Reform*, 400 ANNALS AM. ACAD. POL. SOC. SCI. 14 (1972); Samuel P. Huntington, *The Marasmus of the ICC: The Commission, the Railroads, and the Public Interest*, 61 YALE L.J. 467 (1952); Louis L. Jaffe, *Effective Limits of the Administrative Process*, 67 HARV. L. REV. 1113 (1954).

65 BERNSTEIN, *supra* note 41, at 23.

66 Bó, *supra* note 63, at 203.

67 Stigler, *supra* note 63, at 5; see also GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM, A REINTERPRETATION OF AMERICAN HISTORY, 1900-1916 (1963); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Sam Pelzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

68 See Bagley & Revesz, *supra* note 48; Livermore & Revesz, *supra* note 48.

Starting in the mid-1970s, economic regulation in the United States has substantially contracted and transformed.<sup>69</sup> It no longer focuses on prices and entry, but on the facilitation of healthy competition. Joseph Kearney and Thomas Merrill described this development as “the great transformation of regulated industries law.”<sup>70</sup> In the opposite direction, since the mid-1960s the United States has been experiencing a continuing expansion of “social regulation” aimed at externalities, consumer protection, workplace safety, and civil rights.<sup>71</sup> While economic regulation intended to substitute for market mechanisms, social regulation intends to impose restrictions on activities and products that could cause harm to the public and the environment. The capture of social regulation could also be in the form of both action and inaction.<sup>72</sup>

Thus, like “government failure,” “regulatory capture” is a term that could describe both government action and inaction. It is the private utilization of influence to secure favorable laws, through action and inaction, at the expense of the public.<sup>73</sup> In practice, however, the term typically refers to government action.

## D. Deregulation

In an important 1998 article, Joseph Kearney and Thomas Merrill argued that the transformation of the U.S. regulatory system through deregulation was an example of how the legal community could be “largely oblivious to legal changes of enormous significance.”<sup>74</sup> Kearney and Merrill possibly *understated* the misunderstanding of “deregulation.”

69 See Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 COLUM. L. REV. 1323 (1998).

70 *Id.*

71 See SOCIAL REGULATION: STRATEGIES FOR REFORM (Eugene Bardach & Robert A. Kagan eds., 1982); Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1278-315 (1986); Clifford Winston & Robert W. Crandall, *Explaining Regulatory Policy*, 1994 BROOKINGS PAPERS ECON. ACTIVITY 1.

72 For inaction on social regulation, see, for example, Sanford C. Gordon & Catherine Hafer, *Conditional Forbearance as an Alternative to Capture: Evidence from Coal Safety Regulation*, in PREVENTING REGULATORY CAPTURE, *supra* note 63, at 208.

73 Cf. Nicholas Bagley, *Agency Hygiene*, 89 TEX. L. REV. 1, 2 (2010) (defining “capture” as “shorthand for the phenomenon whereby regulated entities wield their superior organizational capacities to secure favorable agency outcomes at the expense of the diffuse public”).

74 Kearney & Merrill, *supra* note 69, at 1408.

The emergence of the inaction preference in the United States triggered many necessary regulatory and economic adjustments, playing a pivotal role in the deregulation movement that was, in turn, critical to the modernization of the U.S. economy. The increased competition had adverse effects on wages and working conditions in jobs that previously benefitted from rent through regulation.<sup>75</sup> These income effects of deregulation are understood as a positive outcome of increased efficiency and reduced capture.

The meaning of deregulation as a reform process is typically misunderstood or, worse, misused.<sup>76</sup> Technically, “deregulation” refers to the repeal or relaxation of regulatory policies,<sup>77</sup> but historically, the U.S. deregulation movement constituted a complex transformation of the regulatory system “from hostility to competition to the maximum promotion of competition.”<sup>78</sup> These were reforms that introduced new rules governed by a different paradigm. As Paul Joskow explained:

The word *deregulation* . . . is a simplistic characterization of a much more complex process that involves the relaxation of government controls over prices and entry, the restructuring of industry to facilitate competition in some industry segments and better regulation in others, stricter but more effective environmental regulation, and efforts to improve the performance of product quality and safety and workplace safety regulations to increase the net benefits to society.<sup>79</sup>

For most people, however, “deregulation” means a reform intended to reduce government action.<sup>80</sup> The literal meaning of the word governs the

75 See Sandra E. Black & Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 AM. ECON. REV. 814 (2001); David Card, *The Impact of Deregulation on the Employment and Wages of Airline Mechanics*, 39 INDUS. & LAB. REL. REV. 527 (1986); James Peoples, *Deregulation and the Labor Market*, 12 J. ECON. PERSP. 111 (1998).

76 See, e.g., Rabin, *supra* note 71, at 1316 (“In the rhetoric of political conservatives, the deregulation movement was often equated with a desire to turn back the clock to a vanished golden age before the New Deal proliferation of regulatory agencies and mass benefit programs. This yearning, however, constitutes an erroneous view of history.”).

77 See, e.g., OECD, THE OECD REPORT ON REGULATORY REFORM 6 (1997) (“Deregulation is a subset of regulatory reform and refers to complete or partial elimination of regulation in a sector to improve economic performance.”).

78 Kearney & Merrill, *supra* note 69, at 1408.

79 PAUL L. JOSKOW, Deregulation: WHERE DO WE GO FROM HERE? 1 (2009).

80 See Cass R. Sunstein, *Deregulation and the Courts*, 5 J. POL’Y ANALYSIS & MGMT. 517, 518 (1986) (explaining that the term “deregulation” is “misleading,” and

understanding of the concept. For example, in a well-cited literature review of deregulation, Clifford Winston interpreted “economic deregulation” as “the state withdrawal of its legal powers to direct the economic conduct (pricing, entry, and exit) of nongovernmental bodies.”<sup>81</sup> Similarly, in his 2007 memoir, Alan Greenspan summarized the theory underlying deregulation: “markets and prices, not central planners, [are] the best allocators of society’s resources.”<sup>82</sup>

Because the term “deregulation” is misunderstood and misused, its derivative “partial deregulation” is even more misunderstood and misused. “Partial deregulation” is (of course) an incomplete deregulatory reform.<sup>83</sup> It is recognized as a source of “asymmetries and distortions” in the marketplace.<sup>84</sup> Following the common understanding of “deregulation” as relaxation of regulatory policies, “partial deregulation” typically means incomplete relaxation of regulatory controls in a regulated industry. Under this meaning, the term “partial deregulation” supposedly suggests that a transition to free markets is expected.<sup>85</sup> This expectation is not practical.

To illustrate, consider the Savings and Loan (S&L) Crisis of the 1980s. It is generally agreed that partial deregulation was the primary cause of the crisis. A relaxation of regulatory controls enabled S&L institutions to increase risk, relying on the cushion of the insurance provided by Federal Deposit Insurance Corporation (FDIC). The outcome was excessive risk-taking and

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defining it as “decisions that relax or rescind existing regulatory requirements . . . to distinguish deregulation from traditional regulatory action . . . and pure inaction”).

- 81 Clifford Winston, *Economic Deregulation: Days of Reckoning for Microeconomists*, 31 J. ECON. LITERATURE 1263, 1263 n.1 (1993).
- 82 ALAN GREENSPAN, THE AGE OF TURBULENCE 72 (2007).
- 83 For studies of partial deregulation see, for example, PAUL W. MACAVOY, THE UNSUSTAINABLE COSTS OF PARTIAL DEREGULATION (2007); ROGER G. NOLL, THE ECONOMICS AND POLITICS OF THE SLOWDOWN IN REGULATORY REFORM (1999); and Paul W. MacAvoy et al., *Is Competitive Entry Free? Bypass and Partial Deregulation in Natural Gas Markets*, 6 YALE J. REG. 209 (1989).
- 84 Alfred E. Kahn, *Deregulation: Looking Backward and Looking Forward*, 7 YALE J. REG. 325, 333 (1990); Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 FORDHAM INT’L L.J. 7, 7 (2000) (“[T]he effects of partial deregulation can be particularly complex and sometimes perverse.”).
- 85 See, e.g., Clifford Winston, *Government Policy for Partially Deregulated Industry: Deregulate It Fully*, 102 AM. ECON. REV. 391 (2012); see also Günter Knieps & Pablo T. Spillber, *Regulating by Partial Deregulation: The Case of Telecommunications*, 35 ADMIN. L. REV. 391 (1983) (arguing that partial deregulation was a “temporary strategy” regulators adopted under changing market conditions).

a financial debacle.<sup>86</sup> A complete relaxation of all regulatory policies in the financial sector, namely, a transition to a free market regime, was not and is not a practical proposition. Thus, the problem with the partial deregulation was not incompleteness in the sense that some regulatory measures were not repealed, but in the sense that the reform left the system unstable.

Now, consider the financial crisis of 2008. Financial deregulation intended to “modernize our financial services laws, stimulating greater innovation and competition in the financial services industry.”<sup>87</sup> It was advanced through a large number of deregulatory actions (as shown in Figure 2). Competition in the financial sector is not necessarily a good thing, as it is mostly competition in risk.<sup>88</sup> A competitive financial institution trades higher risks for lower prices. In a competitive financial industry, a person who cannot receive a loan from one institution will receive it from another; a firm whose risk is too great for one insurer will insure its risk with another insurer; and so forth. “Free competition” in the financial sector is somewhat equivalent to a never-ending car race in which the participants can keep accelerating. Such races always end in accidents because the vehicles cannot sustain the increasing speed and the drivers have limited control skills. Like a never-ending car race, free competition in the financial sector is likely to result in unsustainable excessive risk taking. Notwithstanding, until the crash of 2008, risks associated with competition, including excessive borrowing, were largely dismissed.<sup>89</sup> During the twenty-five years that preceded the crash, economic fluctuations were small relative to the ones observed in prior decades. Economists dubbed the decline in volatility the “Great Moderation.”<sup>90</sup> It was even suggested that the

86 See generally WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE (2005); see also Timothy Curry & Lynn Shibus, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV., Fall 2000, at 26.

87 A Statement of President William J. Clinton Signing the Gramm-Leach-Bliley Act (Nov. 12, 1999).

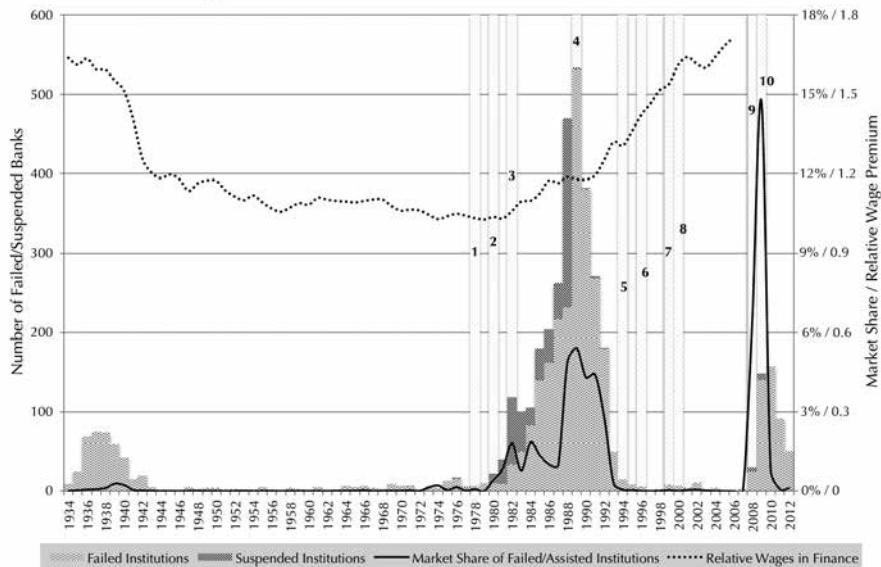
88 See generally Frank Allen & Douglas Gale, *Competition and Financial Stability*, 36 J. MONEY, CREDIT & BANKING 453 (2004); Sherrill Shaffer, *The Winner’s Curse in Banking*, 7 J. FIN. INTERMEDIATION 359 (1998); Marcel Canoy et al., *Competition and Stability in Banking* (CPB Netherlands Bureau for Econ. Pol’y Analysis, Working Paper No. 15, 2001), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=296479](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296479).

89 See generally CARMEN M. REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (rev. ed. 2009).

90 See Olivier Blanchard & John Simon, *The Long and Large Decline in U.S. Output Volatility*, 2001 BROOKINGS PAPERS ON ECON. ACTIVITY 135; Ben S. Bernanke,

“problem of depression prevention has been solved.”<sup>91</sup> Ultimately, however, competitive exploitation of rent opportunities led to the growth of the housing bubble and the market crash.<sup>92</sup>

**Figure 2: Failed/Suspended Commercial Banks in the United States, 1934-2012<sup>93</sup>**



### Legend

1. *Marquette v. First of Omaha*, 439 U.S. 299 (1978): The Supreme Court allows banks to export the usury laws of their home states, effectively releasing them from the restrictions on usury laws.
2. The Depository Institutions Deregulation and Monetary Control Act of 1980: Deposit interest-rate ceilings are phased out and the deposit insurance limit is raised from \$40,000 to \$100,000.
3. The Garn-St Germain Depository Institutions Act of 1982 (the Alternative Mortgage Transaction Parity Act): Legalizing adjustable-rate mortgages

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91 The Great Moderation, Remarks at the Meetings of the Eastern Economic Association, Wash., D.C. (Feb. 20, 2004).

92 Robert E. Lucas, Jr., *Macroeconomic Priorities*, 93 AM. ECON. REV. 1, 1 (2003).

93 INQUIRY REPORT, *supra* note 62; see also ANAT ADMATI & MARTIN HELLWIG, THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

93 Data: David Moss; Thomas Philippon & Ariell Reshef; FDIC.

- by preemption of state laws that allowed only conventional fixed-rate mortgages.
4. The Financial Institutions Reform and Recovery Act of 1989: Following the savings and loan crisis of the 1980s, Congress reformed savings and loan regulations and tried to address professional standards in real estate transactions.
  5. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Restrictions on interstate branching of national banks are reduced.
  6. The Federal Reserve Reinterprets Glass-Steagall (1996): Commercial banks are allowed to earn up to twenty-five percent of their revenues from securities transactions.
  7. The Gramm-Leach-Bliley Act: The core restrictions of the Glass-Steagall Act are repealed; restrictions on consolidation between and among commercial banks, securities firms, and insurance companies are lifted.
  8. The Commodity Futures Modernization Act of 2000: The regulation of derivatives, such as credit default swaps, is largely eliminated.
  9. The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the Credit CARD Act): Certain practices of the credit card industry that exploit bounded rationality are prohibited.
  10. The Dodd-Frank Wall Street Reform and Consumer Protection Act: A new framework for U.S. financial regulation.

Other significant federal legislation included the Competitive Equality Banking Act of 1987; the Financial Institutions Reform and Recovery Act of 1989; the Federal Deposit Insurance Corporation Improvement Act of 1991; and the Omnibus Budget Reconciliation Act of 1993.

In sum, there is an inconsistency between the theory and perception of U.S. deregulation and its substance. Deregulation is largely understood as a repeal of government regulation, while, historically, the deregulatory reforms were transitions from legal regimes that did not permit competition to legal regimes that facilitate competition.<sup>94</sup> The difference between the way people

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94 Between 2007 and 2013, several courts, including the Supreme Court, examined challenges related to decisions of the Animal and Plant Health Inspection Service to deregulate and partially deregulate genetically engineered crops before completing evaluation of environmental impact. The term “deregulation” in these cases meant ending inspection of genetically engineered crops and allowing their commercialization without restrictions. *See Grant v. Vilsack*, 892 F. Supp. 2d 252 (D.D.C. 2012); *Ctr. for Food Safety v. Vilsack*, 718 F.3d 829 (9th Cir. 2013); *Monsanto Co. v. Geertson Seed Farms*, 561 U.S. 139 (2010); *Service’s Ctr. for Food Safety v. Vilsack*, 734 F. Supp. 2d 948 (N.D. Cal. 2010); *Geertson*

tend to refer to deregulation and its content is yet another reflection of the inaction preference, which in turn accommodates rent extraction.

## CONCLUSION

The purpose of this Article was to clarify several aspects of the relationships between regulation and rent extraction or, more precisely, to emphasize that government inaction may entail income effects. In the United States, one of the most dominant and uncompromising influences on regulatory policies in recent decades has been an inaction preference. This inaction preference rests on various ideologies and theories that largely disregard the costs of government inaction. The private and social costs of this regulatory preference should be recognized. To be clear, many forces shape regulatory policies and influence long-term trends.<sup>95</sup> The inaction preference is merely a factor that contributes to long-term trends that we witness, but the preference and its costs are as real as the trends.

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Farms Inc. v. Johanns, C 06-01075 CRB, 2007 WL 1839894 (N.D. Cal. June 26, 2007).

95 For regulatory policies see BARAK ORBACH, REGULATION: WHY AND HOW THE STATE REGULATES (2012).