Regulatory Breakdown

The Crisis of Confidence in U.S. Regulation

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Preface

Has the United States suffered a regulatory breakdown? The answer to this question would appear to be an obvious "yes." Times have been especially tough over the past several years, and virtually every account of the nation's woes places considerable blame on regulation. One might even say that criticism of regulation has become one of the rare commonalities between Democrats and Republicans—although their respective critiques differ profoundly. For those on the left, the United States never would have suffered calamities such as the financial crisis or the Gulf Coast oil spill had regulatory standards been more stringent or had regulators kept from falling asleep at the switch. For those on the political right, the country never would have suffered such deep and sustained economic problems had burdensome regulations—in particular, uncertainty over new regulations—not stifled the business risk-taking needed to jumpstart economic growth. Whichever account is correct—and perhaps both have merit—U.S. regulation clearly suffers a deep crisis of confidence. Government has become less trusted and politics more polarized, with debates over regulatory policy readily devolving into highly charged ideological disputes.

In such a heated political climate, academic research on regulation can make a valuable contribution. If policymakers hope to fix what ails the U.S. system of regulation, they need to do more than just act on hunches or respond to hasty conclusions. They need to understand problems as fully as possible and discover the causes that underlie those problems. Regulatory failures, after all, can arise for a variety of reasons, with triggering factors occurring at one or more stages of the regulatory process. Failures may occur because problematic activities or behaviors have remained unregulated when they should have been regulated. Or they may occur because relevant activity was regulated but with the wrong kind of rules. The process of creating the rules might well have broken down through ignorance, ideology, delay, or corruption. Another possibility is that the rules and the processes that generated them may have been appropriate but the monitoring and enforcement of those rules may have been insufficient—or, alternatively, much too overbearing. What we need is further research and careful analysis to disentangle the possible causes of regulatory failure, help identify appropriate policy responses, and assess whether reforms actually work.

The chapters assembled in this book provide much-needed scholarly perspective on recent controversies over regulation in the United States. Written by some of the nation's foremost experts in law, economics, political science, and public policy, the chapters dig beneath the surface-level diagnoses that have tended to dominate policy deliberations. In Chapter 1, Chris Carrigan and I explain how psychological and political factors have contributed to the current crisis of confidence over regulation, as politicians and the public naturally seek something to blame when calamities occur. We caution against leaping to the conclusion that regulation has failed whenever disaster occurs. Regulation manages risk; it cannot purport to eliminate it altogether, unless of course a risky business activity is banned outright. Accordingly, when a disaster occurs it may not necessarily reflect the failure of regulation as much as the tragic but rare and inevitable consequence of a regulatory policy that responds to and makes tradeoffs in society's competing values.

Effective risk regulation is not a one-size-fits-all proposition, as W. Kip Viscusi and Richard Zeckhauser remind us in Chapter 2. Disasters arise out of complex social interactions that have varying causes, victims, losses, and compensation challenges. Regulatory policies directed at different types of catastrophes must also necessarily be varied and at times complex. Invoking a range of examples in their chapter, Viscusi and Zeckhauser offer an accessible but rigorous framework for identifying successful regulatory responses to the problem of catastrophic risk. They urge the adoption of a portfolio approach that searches for an optimal deployment of market and tax incentives, ex post liability, and preventive regulation. For high-stakes risks such as those associated with nuclear power generation or deepwater oil drilling, they favor holding all firms engaged in risky operations strictly liable for damages after a catastrophe arises. They also believe firms should be required to demonstrate substantial financial resources—assets plus insurance—to cover most levels of potential harms. Firms should also face an up-front tax, before any accident occurs, for the expected excess costs of extreme catastrophes, that is, harms that would exceed their ability to pay. Such a tax would provide firms an immediate and continuous incentive to operate safely.

Viscusi and Zeckhauser's chapter provides a broad theoretical framework not only for identifying successful regulatory solutions but also for situating the next three chapters of the book, each of which zeroes in on a specific regulatory crisis: the Gulf Coast oil spill, the mortgage meltdown, and the financial crisis. In Chapter 3, Lori Bennear carefully analyzes the environmental and safety risks from offshore drilling in the wake of the Gulf Coast spill, showing how the current regulatory approach fails to address human factors that cut across the technological redundancies mandated by current rules. Bennear compares the regulatory status quo with two alternative strategies, one that requires firms to develop detailed management systems and the other that would require drilling firms to pay "safety deposits" that would provide meaningful, new incentives for firms to implement effective risk management.

In Chapter 4, Adam Levitin and Susan Wachter place the recent home mortgage crisis in historical context, arguing that the latest crisis emerged as a result of the unsynchronized development of the housing finance market and the regulatory structure overseeing that market. After tracing market and regulatory conditions from before the Great Depression to the present day, Levitin and Wachter suggest that successful regulation of housing finance requires either strong federal institutions that dominate the market or robust regulation of private market actors. Following the Great Depression, the United States built a mortgage market based on dominant governmental institutions, displacing the need for conventional forms of regulation. Yet as this public model broke down in the latter part of the last century, with the widespread emergence of private securitization in the secondary markets, the conventional regulatory model failed to return to take the place of the institutions.

Roberta Romano, in Chapter 5, looks closely at the recent financial crisis and the principal regulatory response to it, the Dodd-Frank Act. Romano explains that Congress's sense of a need to "do something" in the wake of a financial crisis has, both recently and in the past, resulted in legislation that increases costs and uncertainty for business without necessarily generating corresponding tangible benefits for the overall economy. In situations of crisis-driven legislation, she proposes that Congress incorporate into its statutes sunset provisions that would automatically force the evaluation and reconsideration of legislation after the crises subside. She also recommends legislative provisions that would give the agencies implementing such legislation the authority to grant waivers and introduce elements of flexibility and experimentation.

Romano's chapter shows how political factors can lead economic and natural crises to become regulatory ones, not only by contributing to the perception that regulation must have failed when disaster occurs but also by prompting the hasty adoption of "solutions" that later can result in other problems. In Chapter 6, Matthew Baum examines another major political force—ideology—and considers how the media reinforce the extreme ideological polarization that surrounds regulatory policy debates in Washington, D.C. Focusing on media coverage of the healthcare reform debate, Baum argues that the nation's ideological divide over regulatory issues derives in part from the breakdown of a shared informational environment that once existed in American mass media. The media balkanization revealed by Baum's data, a predicament characterized by Republicans and Democrats relying on different news sources that tend to reinforce their ideological predispositions, makes it more difficult to achieve agreement over both regulatory diagnoses and policy prescriptions.

Jonathan Baron and his coauthors, in Chapter 7, consider a further political factor affecting government's ability to craft successful regulatory policy, namely, the preferences of the public. Reporting results from four experimental surveys, Baron and his collaborators show that citizens generally do not appreciate the advantages that economists have attributed to various market-based regulatory innovations. The public instead tends to view regulatory policy in simple, moralistic terms. If something is deemed to be bad, it should be banned. Yet if effective regulatory policy requires adopting complex solutions that are adapted to complex problems, as Viscusi and Zeckhauser posit in Chapter 2, then democratically elected decision makers will face public pressure to eschew the very kinds of policies that are most likely to succeed. Perhaps regulatory failure is at least partly a price paid for democratic responsiveness.

Chapters 8 and 9 consider a further possible factor affecting regulatory performance, namely, the legal procedures imposed upon regulators. Many observers have claimed that the steady accretion of procedural hoops in the regulatory process prevents officials from addressing problems quickly and responding to potential threats before they arise. Jason Webb Yackee and Susan Webb Yackee consider this popular diagnosis of regulatory breakdown in Chapter 8—and they find the evidence wanting. Drawing on an empirical analysis of rulemaking by all federal agencies since 1983, they see no indication that regulatory agencies are systematically hampered by the procedures that have been placed upon them.

Susan Moffitt, in Chapter 9, considers whether the procedures governing the Food and Drug Administration help or hinder the agency's mission of improving the safety of pharmaceuticals. Moffitt suggests that drugs do suffer fewer safety problems if they have been adopted following consultation with an expert advisory committee, especially under procedures that screen committee members for conflicts of interest. However, she also finds that statutory deadlines for drug reviews make it less likely that agency officials will consult an advisory committee for expert advice. Analyses such as Moffitt's in Chapter 9 and Yackee and Yackee's in Chapter 8 reveal that procedures, much like other potential causes of regulatory failure, play a more nuanced role in explaining regulatory performance than conventionally assumed.

One of the distinctive features of the U.S. regulatory system is the way it overlays and interacts with a common law system based on judicial resolution of private litigation. Litigation brought by private actors continues to coexist with the work of federal regulatory agencies—at times complementing and at times undercutting regulatory policy. William Bratton and Michael Wachter, in Chapter 10, focus on a peculiar feature of U.S. securities regulation that authorizes enforcement of antifraud provisions by private actors through class action lawsuits. Bratton and Wachter show that this system of private enforcement is itself widely judged to have broken down, becoming little more than an insider game that mainly advantages plaintiffs' lawyers at the expense of shareholders without delivering much in the way of broader benefits. The better approach, they argue, would be to eliminate the traditional private enforcement route and instead vest responsibility for antifraud enforcement fully with the Securities and Exchange Commission, greatly expanding its enforcement budget.

Eric Helland and Jonathan Klick, in Chapter 11, entertain the possibility that private litigation helps check the dangers of regulatory capture, a source of perennial concern about the corruption of purpose in regulation. Using data they collected on both state insurance regulation and class action lawsuits over insurance, Helland and Klick fail to find support for a reliance on litigation as a check on regulatory capture. The states with insurance agencies least susceptible to capture—those with elected rather than appointed officials—also tend to have the most class action litigation. Helland and Klick's analysis suggests that regulation and litigation, rather than working in a coordinated fashion, actually operate as two independent systems in the United States, greatly complicating any effort to ensure that their combined impacts achieve optimal outcomes for society.

The overarching questions linking the chapters in this volume—namely, whether the regulatory system has systematically broken down and, if so, how to fix it—are premised on the existence of regulations on the books that at least ostensibly aim to solve major societal problems. Certainly the U.S. government has plenty of such regulations on its books, so most of the time the key issue is whether those rules are optimally designed and effectively enforced. Yet in the final chapter of this book, Theodore Ruger offers the fitting and important reminder that a regulatory system can fail through *inaction* as much as through ill-designed or ineffective action. Some of the most significant problems facing society, Ruger suggests, are those that remain unregulated. In the context of food and drug policy, the particular setting he emphasizes, the most pressing public health issues, such as obesity and the affordability of medicines, remain entirely outside the purview of the Food and Drug Administration's existing statutory authority.

Whether failure arises from action or inaction, making regulation work better stands as one of the most significant challenges of our time. The current crisis over the U.S. regulatory system draws into stark relief the stakes involved and the important demands that society places upon regulation. Perhaps in some cases society's demands are unrealistic, such as when the public expects regulation to be able to accommodate both unfettered economic risk taking and at the same time to provide absolute safety from harm. But certainly it is not unrealistic to ask that regulation today work better than it did yesterday and to hope that regulation tomorrow will respond to new problems more effectively than it does to those of today.

Achieving even realistic improvements in regulatory problems still presents major challenges and requires vast information and deep understanding. Regulation is a human institution, built on ideas and implemented within complex webs of institutions and individuals. To regulate well, policymakers must come to grips with the varied and complex technological, economic, and social realms within which regulation struggles to make a difference. Yet our knowledge about how regulation operates remains woefully undersupplied relative both to the stakes and to other fields of study. More academic research like that assembled within the pages of this volume is greatly needed, for without careful analysis and empirical inquiry policymakers have nothing other than instincts and ideologies to inform their judgments. Of course, we cannot expect to replace instinct and ideology entirely. Certainly no single academic study—nor even a single book with work by excellent scholars—can be expected to bridge the political divide in the United States. But greater research can help, especially when—as occurs more often than we might admit—what appear to be ideological disputes are actually disputes over empirical claims rather than genuine moral differences.

When a car stalls on the freeway, the driver and passengers can get out and debate all they want about what broke and how to fix it. Yet the only way to find out with any certainty what went wrong is for knowledgeable people to look under the hood and get their hands dirty. The same is true when we think regulation has broken down.

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