ECONOMIC UNCERTAINTY, THE COURTS, AND THE RULE OF LAW

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INTRODUCTION

Should judges protect private property rights and constitutional rights as vigilantly in times of crisis as in ordinary times? Conventional wisdom holds that crises justify suspending the rule of law and allow government discretion to address the crises.[1] The lesson of past economic crises as well as the most recent crisis, however, is that we should uphold the rule of law with special rigor in times of economic crisis because the temptations for politicians to misuse their powers during times of crisis are especially great. During crises, judges must be particularly vigilant in protecting private property and constitutional structure.[2]

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1. *See, e.g.*, JOHN LOCKE, TWO TREATISES OF GOVERNMENT 375 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690) ("[It is] fit that the Laws themselves should in some Cases give way to the Executive Power, or rather to this Fundamental Law of Nature and Government, *viz.* That as much as may be, *all* the Members of the Society are to be *preserved*. For since many accidents may happen, wherein a strict and rigid observation of the laws may do harm . . . ."); *cf.* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435 (2011) (advocating the use of bailouts to address economic crises).

2. I focus only on economic crises here, not other types of crises, such as national security crises, which may warrant a different analysis. While elaborating such a distinction goes beyond the scope of this article a fundamental difference is that national security crises call forth the need for a centralized response by the government whereas responding to an economic crisis requires recalibrating the actions of millions of dispersed economic agents. This failure to recognize the fundamental difference between these different types of crises may partially account for the erroneous belief in the need for government discretion in the face of economic crisis, when in fact the opposite is true.

Crisis often is invoked to rationalize both governmental discretion and waiver of the rule of law.[3] But as the financial crisis and its aftermath reveal, it is precisely during times of crisis that it is most important to tie the hands of government with the bonds of the rule of law. First, in times of economic crisis there is a special need for government behavior to be predictable and rule-bound to encourage investment and economic recovery in a period of uncertainty. Second, adherence to the rule of law in the face of crisis is important to restrain politicians from using the crisis to pursue their own self-interest or unleashing rent seeking by special interest groups—both of which dampen economic recovery and long-term economic growth. Third, the government's seizure of discretion creates a ratchet effect whereby the discretion and exceptions to the rule of law made during the crisis ossify and never return to precrisis levels. Fourth, the dynamics of short-term interventions tend to invite moral hazard that can be exploited by powerful special interest groups.

I. THE RULE OF LAW IN TIMES OF ECONOMIC UNCERTAINTY

Should the rule of law be respected during times of economic crisis or should adherence to the rule of law be attenuated to allow greater executive discretion? First, what is meant by the term "the rule of law" and why does it matter? For current purposes it is not necessary to specifically define the rule of law; it is adequate to adopt a functional shorthand definition. At its heart, the value of the rule of law is Hayekian.[4] Simply, the world is in a state of constant flux.[5] Billions of economic transactions are conducted every minute throughout the world and

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3. For example, Woodrow Wilson invoked the exigencies of World War I to justify the nationalization of the transportation industry, and President Roosevelt used the circumstances of the Great Depression to justify an unprecedented expansion of government with the New Deal. For a detailed exploration of how these crises were used to justify the expansion of government, see generally ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT 123–96 (1987).

4. *See* 1 F.A. HAYEK, LAW, LEGISLATION AND LIBERTY (3d prtg. 1998).

5. *Id.* at 108–09 ("The maximal certainty of expectations which can be achieved in a society in which individuals are allowed to use their knowledge of constantly changing circumstances for their equally changing purposes is secured by rules which tell everyone which of these circumstances must not be altered by others and which he himself must not alter.").

it truly is a miracle that any productive economic activity happens, much less economic activity on such a great scale.

Consider the milk in your refrigerator or cafeteria. Think of the chain of coordination required to get it there: Farmers must decide to use their land to graze dairy cows; determine how many cows to graze; and employ people and use machinery to milk the cows, pasteurize the milk, and deliver it into the stream of commerce. All the coordination in that relatively simple chain of production must then align with millions of consumers deciding whether to buy milk or Coke and ensuring that they can buy both milk and Cheerio's.[6] The extent to which these systems are coordinated is remarkable.

Complex economic processes like the manufacture of cars or the introduction of initial public offerings pose even greater coordination difficulties. Add in the dynamic feature that all of these decisions are subject to a constant feedback loop as millions of individual purchasing decisions send signals about the relative demand for different products, and it is remarkable that this coordination occurs at all. Moreover, once achieved, economic coordination would seem to be in constant peril of disruption. Hayek's profound observation is that the price system is the mechanism by which this profound coordination occurs, leading to a functioning economy.[7]

Hayek's corollary observation is that, in light of this uncertainty, the goal of social and political institutions is to minimize the number of variables that threaten coordination.[8] The legal regime and its governance of property and contract might be the largest and most important variable. Hayek's central insight about the value of the rule of law is that in a world defined by flux and dynamism, economic activity requires as much stability as possible from institutions like the legal regime that make economic coordination possible.[9]

6. Judge Richard Posner has used the milk market as an example of Hayek's notion of "spontaneous order." *See* Richard A. Posner, *Hayek, Law, and Cognition*, 1 N.Y.U. J.L. & LIBERTY 147, 149 (2005).

7. *See* F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 526–27 (1945) (describing how the price system passes the essential information consumers need to make economic choices).

8. *See* HAYEK, *supra* note 4, at 108–09.

9. *See* Todd J. Zywicki & Anthony B. Sanders, *Posner, Hayek, and the Economic Analysis of Law*, 93 IOWA L. REV. 559, 571 (2008).

For instance, consider what it takes to make a loan.[10] Since credit markets blew up in fall 2008, lending activity has been very slow to recover.[11] It is not hard to understand why. To make a loan, a bank must be able to do two things. It must be able to price the risk of the loan accurately and reduce its risk exposure.[12] Government political response to the financial crisis (or perhaps more accurately rationalized as a response to the financial crisis) created a huge amount of instability that makes it difficult for people to price loans. As a result, lenders reduced their risk exposure by lending to fewer and fewer people, exacerbating the initial constriction of credit caused by the crisis.[13]

The Credit CARD Act of 2009[14] illustrates the counterproductive nature of legislative responses to the crisis. One of the important things that the Credit CARD Act does is to make raising interest rates more difficult when a borrower's risk profile changes.[15] If a card issuer cannot raise a customer's interest rate when she becomes more risky, the issuer will raise everybody's interest rates ahead of time, exactly what has happened in response to the Credit CARD Act.[16]

If a bank cannot price risk accurately by adjusting interest rates, it will reduce its risk exposure, by either lending to fewer people by cutting off higher-risk borrowers or lending less to existing customers by reducing available credit lines.[17] Both market ad-

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10. For more on the lending process and banker considerations, see Todd J. Zywicki, *Why aren't banks lending? Because bureaucrats and politicians won't let them*, WASH. TIMES, June 9, 2010, at B1.

11. *See* FED. RESERVE BANK OF ST. LOUIS, COMMERCIAL AND INDUSTRIAL LOANS AT ALL COMMERCIAL BANKS (BUSLOANS), *available at* http://research.stlouisfed.org/fred2/series/BUSLOANS?cid=100 (showing that a dramatic decrease in lending began in late 2008) [hereinafter FEDERAL RESERVE, COMMERCIAL LOANS].

12. *See* Zywicki & Sanders, *supra* note 9.

13. *See* FEDERAL RESERVE, COMMERCIAL LOANS, *supra* note 11; *see also* Gerald A. Hanweck, Sr. & Anthony B. Sanders, *Six Reasons Why Banks Aren't Lending to Business Or "A Rolling Loan Gathers No Loss"* 6 (Nov. 19, 2010) (unpublished manuscript), *available at* http://www.mason.gmu.edu/~asander7/Banks.pdf (arguing that bankers are "play[ing] it safe" in curtailing lending).

14. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2009).

15. *See id.* § 102 (placing limits on fees and interest charges). The Act has many other wrongheaded mechanisms, but the restrictions on the ability to adjust interest rates are an illustrative case study.

16. *See* Ruth Simon, *Credit-Card Rates Climb*, WALL ST. J., Aug. 23, 2010, at A1.

17. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., NATIONAL SUMMARY OF THE JANUARY 2009 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING

justments followed in the wake of the Credit CARD Act. For example, Jamie Dimon, the CEO of JP Morgan Chase, told the company's shareholders that fifteen percent of its customers would not be able to obtain credit cards anymore as a result of the CARD Act.[18] Similarly, after the financial crisis, banks slashed credit card credit lines by more than three hundred billion dollars.[19] Some of that, of course, is a consequence of the banking crisis. But some also is attributable to the Credit CARD Act's interference with the ability to price risk effectively.[20]

The uncertainty caused by the Credit CARD Act is just a small piece of the regulatory uncertainty spawned in the wake of the financial crisis. If one piles the Credit CARD Act on top of healthcare reform,[21] the Dodd-Frank financial reform legislation,[22] the possibility of a far-reaching and onerous cap-and-trade bill,[23] and extensive and extraordinary growth in the regulatory state in general,[24] the enterprise of economic recovery is

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PRACTICES 1, 5 (2009), *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/200902/fullreport.pdf ("In the January survey, the net fractions of respondents that reported having tightened their lending policies on all major loan categories over the previous three months stayed very elevated [and] [o]n net, domestic banks reported that they had reduced the size of existing credit lines for all major types of business and household accounts.").

18. *See* Letter from Jamie Dimon, Chief Exec. Officer, to JPMorgan Chase shareholders 11 (Mar. 26, 2010), *available at* http://files.shareholder.com/downloads/ONE/882208931x0x362440/1ce6e503-25c6-4b7b-8c2e-8cb1df167411/2009AR_Letter_to_shareholders.pdf.

19. *See* Jon Hilsenrath & Conor Dougherty, *Inside the Disappointing Comeback*, WALL ST. J., July 5, 2011, at A6 ("Since the recovery started, banks have reduced money they make available through credit card lines from $3.04 trillion to $2.69 trillion . . . according to the Federal Reserve Bank of New York.").

20. *See* Todd Zywicki, *Dodd-Frank and the Return of the Loan Shark*, WALL ST. J., Jan. 4, 2011, at A17. In fact, Jamie Dimon explained in JP Morgan Chase's March 2010 letter to shareholders that the company's decision to cease offering credit cards to fifteen percent of its customer base was largely due to the Credit CARD Act's restrictions on the ability to change interest rates. *See* Dimon, *supra* note 18, at 10–11.

21. *See* The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

22. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

23. *See* John M. Broder, *House Bill for a Carbon Tax to Cut Emissions Faces a Steep Climb*, N.Y. TIMES, Mar. 7, 2009, at A13 (detailing a 2009 effort to enact a cap-and-trade bill).

24. For example, shortly after his election, President Obama began creating an extensive regulatory regime. As one journalist noted:

> More than any president in years, Mr. Obama came into office creating new White House czars and special envoys to supervise various hot-button issues at home and abroad, overlaying an additional set of actors upon a bureaucracy already scratchy about who's in charge. . . . Mr.

systematically dealt a death by a thousand regulatory cuts. In the face of a mountain of onerous legislation and regulation, is there any real way for a bank to determine what to charge for a loan that is going to be repaid in five or ten years? Lenders cannot possibly have an accurate sense of what the legal and regulatory regime is going to be like a decade from today.

II. CRISIS, RENT-SEEKING, AND POLITICAL OPPORTUNISM

When judges fail to enforce contract and property rights, they create a target-rich environment for opportunistic politicians. These rights are guaranteed by law to constrain politicians and their special interest constituents.[25] When politicians are not constrained they take advantage of that freedom of opportunity to benefit themselves. The General Motors and Chrysler bailouts might be the most obvious and egregious examples of this dynamic from the financial crisis. One need not be reminded of the details of those bankruptcy proceedings to recall the outcome: With Chrysler, the government intervened to take money from the company's secured creditors—which included the pension funds for teachers and policemen—and give it to the retirement and health care funds of the politically powerful United Auto Workers, who had an unsecured claim in the case.[26] The gov-

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> Obama also created a new White House office to oversee health care, a new White House office to oversee climate change and energy, a new White House office to oversee urban policy and a new White House office to oversee technology. He also created a new group of economic advisers to go along with the two economic councils the president already has. He plans to name a czar to oversee the economic rescue of the auto industry. And on top of all that, he formed a task force to focus on economics specifically for the middle class, this one headed by Vice President Joseph R. Biden Jr.

Peter Baker, *And Now Let the Jockeying Begin*, N.Y. TIMES, Feb. 1, 2009, § 4 (Week in Review), at 1; *see also* Robert Higgs, *Cumulating Policy Consequences, Frightened Overreactions, and the Current Surge of Government's Size, Scope, and Power*, 33 HARV. J.L. & PUB. POL'Y 531, 534 (2010) (observing that by 2009 "the perceived emergency had provoked a huge surge in the federal government's size, scope, and power").

25. *See* THE FEDERALIST NO. 44, at 282 (James Madison) (Clinton Rossiter ed., 1961) (discussing how the Contract Clause was meant to protect private rights from interference by special interest legislation, and noting that such legislation is "contrary to the first principles of the social compact and to every principle of sound legislation").

26. *See* Timothy P. Carney, *The Auto Industry Bailout: How the Shrinking UAW Buys Influence*, LABOR WATCH, Jul. 2010, at 1, 3; *see also* Todd Zywicki, *The Auto Bailout and the Rule of Law*, NAT'L AFF., Spring 2011, at 66, 74–76.

ernment's actions ran roughshod over the longstanding rules of bankruptcy, not only by plundering senior creditors for the benefit of politically powerful junior creditors, but also by circumventing long-established bankruptcy processes governing the sale of a company as a going concern, the right of other parties to offer competing bids, and valuation procedures.[27]

Even in its exit from bankruptcy, GM received a $45-billion windfall through a highly selective tax notice that provided preferential tax treatment to General Motors by allowing GM to carry forward net operating losses that are typically extinguished.[28] As Professor Mark J. Ramseyer and Eric Rasmusen noted, this preferential tax treatment concealed the true cost of the bailout (by reducing GM's tax liability via the obscure IRS "Notice" process) and artificially inflated the value of GM's stock. This valuation allowed UAW to sell its ownership stake at the inflated price and granted it a massive tax benefit not typically counted as part of the price of a bailout.[29]

Financial interventions such as the GM and Chrysler bailouts create political risks, such as wealth seizure for investors, that were previously absent from the American political and economic system.[30] Studying the bond market response to the auto bailouts, Deniz Anginer and Joseph Warburton found that, although before those bailouts investors treated unionized and non-unionized firms identically, afterward investors began to treat them differently and embedded the possibility of a bailout into the price of the bonds of unionized firms.[31] Before the auto bailouts there was a general expectation that political risk was not an element of determining whether to invest in a company.

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27. *See* Zywicki, *supra* note 26, at 75–76; *see also* Carney, *supra* note 26, at 3.

28. J. Mark Ramseyer & Eric B. Rasmusen, *Can the Treasury Exempt its Own Companies from Tax? The $45 Billion GM NOL Carryforward* 2 (July 1, 2011) (unpublished working paper), *available at* http://rasmusen.org/papers/gm-ramseyer-rasmusen.doc.

29. *Id.* at 3.

30. *Cf.* Levitin, *supra* note 1, at 492 (tracing direct, congressionally authorized bailouts back to only 1971). *But cf. id.* (tracing a "history of bailouts via [lender-of-last-resort] activity dating back to at least 1792").

31 *See* Deniz Anginer & A. Joseph Warburton, *The Chrysler Effect: The Impact of the Chrysler Bailout on Borrowing Costs* 31–32 (World Bank, Working Paper No. 5462, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1640801 (noting that the market provided a premium to the bonds of unionized firms, reflecting an expectation that the government would stand behind those firms).

Following the government's intervention, however, investors began to recognize that the American financial landscape had changed and that political risk—long present in other parts of the world—was now a factor to consider.[32]

III. CRISIS AND GOVERNMENT DISCRETION

In times of economic crisis, unleashing political discretion and rent seeking is highly destructive to the rule of law. Discretion, some insist, is necessary to give the government power to act for the public good during the crisis.[33] As Rahm Emmanuel, who would become President Obama's Chief of Staff, famously observed, politicians should "[n]ever allow a crisis to go to waste."[34] The crisis becomes the excuse for any and all political agendas that can plausibly (or even implausibly) be linked to the crisis. More importantly, discretion to address the crisis provides cover for identifying political winners and losers and favoring political supporters while punishing others—as Indiana's teachers and policemen learned the hard way in the Chrysler bailout.[35]

Political discretion is dangerous in a second way: once it is unleashed, it creates a ratchet effect. When judges relax the rule of law and allow politicians to exercise discretion, it is difficult to reestablish the rule of law. After the crisis abates, politicians consolidate the political discretion used to respond to the crisis.[36]

The Great Depression is a historical example of this ratchet effect. In the face of supposed public necessity, New Deal judges essentially stopped enforcing contract rights, property rights, and structural limits on the federal government.[37] The

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32. *See id*.

33. *See* Levitin, *supra* note 1, at 513 (concluding that "[b]ailouts are an inevitable fact of modern economic life" because of systemic risk).

34. Jeff Zeleny, *Obama Reviewing Bush's Use of Executive Powers*, N.Y. TIMES, Nov. 10, 2008, at A19.

35. *See* Carney, *supra* note 26, at 3.

36. For a detailed exploration of the ratchet effect, see HIGGS, *supra* note 3, at 57–74.

37. *See, e.g.*, Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447–48 (1934) (upholding state law that suspended the terms of mortgage contracts). Professor Richard Epstein has this comment on *Blaisdell*: "*Blaisdell* trumpeted a false liberation from the constitutional text that has paved the way for massive government intervention that undermines the security of private transactions. Today the police power exception has come to eviscerate the contracts clause." Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 738 (1984); *see*

federal government seized broad discretionary control, which was supposed to improve the economy. In reality, the endless ill-conceived experimentation made the economy worse, not better.[38] After the Great Depression, the constitutional constraints on government that were temporarily suspended were never reimposed. Instead, the Supreme Court's endorsement of the Roosevelt Administration's lawlessness during the New Deal became the new baseline for government power, thereby laying the foundation for the rise of the administrative and rent-seeking state.[39]

The massive Dodd-Frank legislation[40] enacted in the wake of the financial crisis provides another textbook example of this ratchet effect. Reading through the 2,400 pages of Dodd-Frank, one is left with one overriding conclusion: The legislation epitomizes the caprice and discretion that characterized the bailouts and other ad hoc interventions of the government during the financial crisis. Filled with vague terminology and broad grants of governmental authority, Dodd-Frank embodies not only government discretion as a way of life, but also the principle that politicians should have free rein to pick economic winners and losers through political, not market, processes.

Most notably, Dodd-Frank institutionalizes the policy of "too big to fail" and establishes an implicit guarantee to bail out the

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also Wickard v. Filburn, 317 U.S. 111 (1942) (providing an expansive interpretation of Congress's commerce power).

38. *See* Robert Higgs, *Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War*, 1 INDEP. REV. 561, 563–64 (1997) (concluding that the character of the federal government's actions during the New Deal caused "uncertainty among investors about the security of their property rights" and that it was not until 1945 that private investors regained confidence and were thus able to initiate the postwar investment boom that lifted the country out of the Great Depression).

39. *See, e.g.*, Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483, 488, 491 (1955) (upholding, under rational basis review, a state economic regulation challenged on due process grounds); *see also* Mark Tushnet, *Public Choice Constitutionalism and Economic Rights*, *in* LIBERTY, PROPERTY, AND THE FUTURE OF CONSTITUTIONAL DEVELOPMENT 23, 37 (Ellen Frankel Paul & Howard Dickman eds., 1990) ("A classic rent seeking statute was presented to the Court in *Williamson v. Lee Optical Co.* Oklahoma prohibited opticians from fitting duplicate lenses without a prescription from an ophthalmologist or optometrist . . . . Essentially all that this statute did was to generate business for eye doctors, thereby raising the price of duplicate lenses.").

40. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

nation's largest financial institutions.[41] It creates new bureaucracies with broad and loosely defined powers subject to minimal restraint or oversight, such as the new Bureau of Consumer Financial Protection in the Federal Reserve: an agency headed by a single director removable only for cause[42] and funded with a guaranteed budget of several hundred million dollars that is not subject to Congress's standard appropriations process.[43]

The so-called Durbin Amendment that places price controls on debit card interchange fees (the fees paid by merchants when consumers pay with a debit card)[44] is illustrative of how government institutionalizes discretionary power after a crisis. Although debit cards obviously could not have had any contribution to what was, after all, a *credit* crisis, big box retailers were able to use the frenzied anti-bank environment of the post-crisis era to secure long-sought price controls on debit cards through the Durbin Amendment to the Dodd-Frank legislation.[45] The Amendment imposes price controls only on banks that have more than $10 billion in assets.[46] As originally introduced, the legislation applied to all banks with more than $1 billion in assets. After some political jockeying, however, the threshold was raised to $10 billion.[47] The Act offers no explanation for the asset cutoff, but the answer seems obvious: The prevailing political winds favored the interests of small banks over merchants and the interests of merchants over big banks. Therefore, the winning political interests limit the profitability of big banks but not of small ones. Apparently, these days that

41. *See* Shahien Nasiripour, *A Year After Dodd-Frank, Too Big to Fail Remains Bigger Problem than Ever*, HUFFINGTON POST, Sept. 23 2011, www.huffingtonpost.com/2011/07/20/-dodd-frank-too-big-to-fail/_n_903969.html?.

42. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1011.

43. *Id*. § 1017(a)(2)(C).

44. *Id*. § 1075(a)(2); *see also* Binyamin Appelbaum, *Debit Fee Cut Is a Rare Loss For Big Banks*, N.Y. TIMES, May 15, 2010, at A1, A3 (describing how the Durbin Amendment places controls on debit card interchange fees) .

45. *See* Edward Wyatt, *Lowering of Fees for Debit Cards is Lobby Battle*, N.Y. TIMES, Mar. 8, 2011, at A1, A3.

46. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1075(a)(6).

47. *See* Stacey Kaper, *In Surprise Move, Senate Passes Interchange Amendment*, BANK INVESTMENT CONSULTANT (May 14, 2010), http://www.bankinvestmentconsultant.com/news/interchange-senate-durbin-2666843-1.html ("Durbin amended his language earlier in the week to exempt all financial institutions with less than $10 billion of assets from Fed restrictions. Previously, it had exempted banks with less than $1 billion of assets.").

is a good enough reason to create a distinction on which tens of billions of dollars will turn.

Congress passed the Durbin Amendment to create a windfall for retail merchants—especially "big box" retailers, who will save tens of millions of dollars annually from the Amendment's price controls.[48] Merchant lobbying groups, including the CEO of Walgreens, called Senator Durbin to complain that the interchange fees set by the market were too high.[49] Now, like a Soviet central planning board, the Federal Reserve has the responsibility to fix the price of interchange fees that banks can charge for processing debit card payments.[50] As absurd as it is for the Federal Reserve to be in the business of fixing interchange fees, the more pernicious principle, embodied by the Durbin Amendment's arbitrary wealth reallocation, is that the Amendment treats as uncontroversial the premise that politicians should pick winners in the economic marketplace.[51] In a period of ad hoc unprincipled interventions, politics becomes a free for all where the strongest survive.

Once politicians get into the business of using their discretion to pick economic winners, it becomes inevitable that interest groups will engage in rent seeking to persuade politicians to grant preferential or oppose harmful regulations.[52] A fundamen-

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48. For example, Home Depot initially estimated that it expected to add $35 million per year on its bottom line as a result of the Durbin Amendment. *The Home Depot's CEO Discusses Q4 2010 Results—Earnings Call Transcript*, SEEKING ALPHA (Feb. 22, 2011), http://seekingalpha.com/article/254224-the-home-depot-s-ceo-discusses-q4-2010-results-earnings-call-transcript?part=qanda.

49. Richard A. Epstein, *The Dangerous Experiment of the Durbin Amendment*, 34 REGULATION 24, 24 (2011).

50. The Durbin Amendment requires that interchange transaction fees be "reasonable" and provides, in pertinent part, that "[t]he Board shall prescribe regulations . . . to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Dodd-Frank Wall Street Reform and Consumer Protection Act § 1075(a),(3).

51. *See* Epstein, *supra* note 49, at 24:

> Without committee hearings by either chamber of Congress, [Durbin] proposed (and in all likelihood the merchants had drafted) a price-capping arrangement for debit (but not credit) card interchange fees that had never been proposed or discussed in the extensive academic and industry literature on the subject. The boldness of his proposal is palpable.

52. *See* Stewart E. Sterk, *Information Production and Rent-Seeking in Law School Administration: Rules and Discretion*, 83 B.U. L. REV. 1141, 1148–49 (2003) (observing that

tal purpose of the rule of law is to constrain rent seeking by limiting arbitrary distinctions among parties and imposing due process requirements that promote rational policymaking.[53] Discretion, however, is rooted in an attitude of pragmatism, thus eliminating politicians' need to provide a principled justification for their actions, thereby making it easier for politicians to dole out political favors (such as the Durbin Amendment) than if the politicians had to justify the law with some articulable principle.

Unsurprisingly, during the post-crisis period one has witnessed an unprecedented explosion of rent-seeking behavior as well-heeled lobbyists swarmed Washington to funnel more money into the pockets of special interests, create more loopholes for their clients, and preserve the benefits they have already won. From the myriad special interest provisions marbleized throughout Dodd-Frank,[54] to the arbitrary process of granting waivers from the mandates of Obamacare to favored applicants,[55] to the pork-laden "green" subsidies and "stimulus" bill enacted soon after President Obama took office,[56] the dialectic relationship between government discretion and special interest rent seeking has been on full display in the post-crisis period. Huge swaths of the economy—health care, banking, energy, auto manufacturing, and probably others—have become utterly politicized as economic success has come to be defined by one's ability to buy and sell political favors rather than one's ability to meet consumer demand efficiently.

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discretion-limiting, inflexible rules reduce rent-seeking because they reduce rent-seekers' chances of success and give decision makers a better reason to say "no").

53. *See* Todd J. Zywicki, *The Rule of Law, Freedom, and Prosperity*, 10 S. CT. ECON. REV. 1, 11–14 (2003).

54. Section 342 of Dodd-Frank, for instance, requires each agency involved in financial regulation to establish an "Office of Minority and Women Inclusion" tasked with developing standards for "equal employment opportunity and the racial, ethnic, and gender diversity of the workforce and senior management of the agency. . . ." Dodd-Frank § 342. Section 1502 bizarrely tasks the SEC commissioner to require disclosure of the use of Congolese conflict minerals from the corporations that it regulates. *See id.* § 1502.

55. *See* 26 U.S.C. § 5000A(e)(5) (2006) (allowing the Secretary of Health and Human Services to exempt from the healthcare mandate any individual determined to have suffered a "hardship with respect to the capability to obtain coverage under a qualified health plan"); *see also* Richard A. Epstein, *Government By Waiver*, NAT'L AFF., Spring 2011, at 39, 51–52 (describing discretion in Obamacare).

56. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); *see also* Editorial, *A 40-Year Wish List*, WALL ST. J., Jan. 28, 2009, at A14 (describing pork in the "stimulus" bill).

When economic success results from one's relative ability to operate the levers of power, the ultimate winners are big business and big labor. Goldman Sachs, General Motors, the SEIU, and the UAW can hire the lawyers and lobbyists to create and exploit loopholes in the legal system to advance their narrow interests at the expense of the public at large.[57] Conversely, the prime beneficiaries of constraining government behavior by the rule of law are the little guys who lack the time, money, or interest required to manipulate the levers of government discretion to their advantage.

Opponents assert that the governing economic principle of the Obama administration is socialism, or government ownership of economic production to engage in wholesale wealth redistribution from the wealthy to the poor.[58] But the philosophy revealed by the response to the financial crisis and its aftermath suggests something different. Instead of socialism, President Obama's economic philosophy appears to be a form of corporatism, similar to that which prevailed in the United States during the 1950s and 1960s, where a symbiotic relationship between big business, big labor, and big government intertwines players in a public-private "partnership" to carve up the economy through political bargains among these powerful interest groups.[59] The central model in this worldview is eco-

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57. *See* MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 143 (2d ed. 1968).

58. *See, e.g.*, Ralph Z. Hallow, *Steele urged to label Obama a socialist*, WASH. TIMES, Apr. 23, 2009, at A1; Matthew Mosk, *McCain Assails Obama's Plans as Socialist*, WASH. POST, Oct. 24, 2008, at A7.

59. One commentator offers these anecdotes on the merger of state and private interests during the 1960s:

> [I]n the Department of Agriculture, not only did the main farmer interest groups, the Farm Bureau and the Farmers' Union, have political influence as outside interests groups; they also had actually moved *into* the department, taken over the running of many public programs, and were using the department's resources mainly to benefit themselves through subsidies and price supports. At the Department of Commerce the story was similar, except that here the main interest (now corporate—operating *inside* the bureaucratic system) group was big business, which had moved into some of Commerce's bureaus, "colonized" them for itself, and essentially used a public agency for private purposes. Much the same happened at the Department of Labor where, in effect, organized labor, in return for moderating its demands, was "bought off" by being given programs and cushy patronage positions within the federal bureaucracy.

HOWARD J. WIARDA, CORPORATISM AND COMPARATIVE POLITICS: THE OTHER GREAT "ISM" 140–41 (1997).

nomic stasis; a fixed pie of wealth is to be divided among various interest groups, stifling economic growth and individual entrepreneurship in favor of a government-managed economy, directing investment and outcomes through a dovetailing of ideological and political goals.[60]

Manifestations of this mindset are ubiquitous. Perhaps most notable is the Obama Administration's funneling of extraordinary amounts of funds into cockamamie "green energy" programs that promise little prospect of an economically-justifiable return,[61] but also support a vast infrastructure of corporate welfare programs for industry titans such as General Electric and General Motors.[62] In exchange, these once-productive economic leaders lend their political support to maintain the flow of funds—GE's CEO Jeffrey Immelt, for example, has emerged as a leading ally and spokesman for the Obama Administration's economic and regulatory policies, and, in particular, the Administration's schemes of political

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60. *See id.* at 173 ("[C]orporatism demands an ever-expanding economic and social-welfare pie so there will always be new 'pieces' to hand out to the clamoring new groups demanding a greater say in decision making and bigger pieces of the pie for themselves.").

61. *See* Kenneth P. Green, *The Myth of Green Jobs: The European Experience*, 1 ENERGY & ENVTL. OUTLOOK, Feb. 2011, at 1, http://www.aei.org/outlook/101026 (discussing how the $2.3 billion in stimulus tax credits allocated to "green" manufacturers likely will kill jobs and raise energy prices).

62. *See* Patrick Michaels, *Chevy Volt: The Car From Atlas Shrugged Motors*, FORBES.COM (Mar. 3, 2011), http://www.forbes.com/2011/03/16/chevy-volt-ayn-rand-opinions-patrick-michaels.html (describing the GM electric car as "the car that subsidies built" and recounting how "General Motors lobbied for a $7,500 tax refund for all buyers, under the shaky (if not false) promise that it was producing the first all-electric mass-production vehicle"). As Michaels went on to describe:

> Recently, President Obama selected General Electric CEO Jeffrey Immelt to chair his Economic Advisory Board. GE is awash in windmills waiting to be subsidized so they can provide unreliable, expensive power. Consequently, and soon after his appointment, Immelt announced that GE will buy 50,000 Volts in the next two years, or half the total produced. Assuming the corporation qualifies for the same tax credit, we (you and me) just shelled out $375,000,000 to a company to buy cars that no one else wants so that GM will not tank and produce even more cars that no one wants. And this guy is the chair of Obama's Economic Advisory Board?

Id.; *see also* David Kocieniewski, *GE's Strategies Let it Avoid Taxes Altogether*, N.Y. TIMES, Mar. 24, 2011, http://www.nytimes.com/2011/03/25/business/economy/25tax.html?_r=1 (noting that GE "had a very good year in 2010," paying no federal taxes and claiming a tax benefit of $3.2 billion, and attributing GE's success in part to its lobbying of Congress for green energy credits).

management of the American economy.[63] The cost of this policy, however, is a profound hampering of economic dynamism, innovation, and entrepreneurship.

For example, the Obama Administration touts the auto bailouts as having preserved the domestic auto industry from collapse.[64] This boast is a highly dubious assertion. General Motors almost certainly would have reorganized successfully in Chapter 11 without political interference (and would have reorganized more effectively and emerged more ready to compete had it gone through a clean, non-political Chapter 11 process).[65] In the end, Chrysler will be majority-owned by the Italian automaker Fiat, which presumably will continue to manufacture and sell some cars in the United States.[66] That is no different from any other foreign automaker with domestic manufacturing facilities, such as Honda, Toyota, or BMW.[67] It is not obvious why the U.S. government believes that putting American tax dollars at risk to subsidize the Italian automotive industry makes sense.

The larger cost of the auto bailouts is the uncertainty they spawn for the future of the economy and the message that by trumpeting them as a success sends.[68] As noted, the initial market response to the bailout was to increase the uncertainty of investors.[69] Uncertainty about whether contracts and property rights will be honored according to regularized rules raises the cost of capital in the economy, thereby hampering investment and new wealth creation.[70] The cost of subsidizing large obsolete enterprises is that it raises the cost of capital for new start-

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63. *See, e.g.*, Timothy P. Carney, *The GE-Obama affair and Jeff Immelt's harsh words*, WASH. EXAMINER, Jul. 1, 2010, http://washingtonexaminer.com/blogs/beltway-confidential/ge-obama-affair-and-jeff-immelt-s-harsh-words (detailing Immelt's history of supporting President Obama's policies and tax breaks).

64. *See* Peter Baker, *At Chicago Ford Plant, Obama Says Critics Lack Faith in Americans*, N.Y. TIMES, Aug. 6, 2010, at A11 (noting President Obama "portrayed his efforts to save the industry as an act of patriotism").

65. *See* Zywicki, *supra* note 26, at 70–71.

66. *See* James B. Stewart, *Salvation at Chrysler, In the Form of Fiat*, N.Y. TIMES, Jul. 30, 2011, at B1, B4.

67. Todd Zywicki, *The Truth About the Auto Bailouts*, REAL CLEAR POLITICS (Jul. 13, 2011), http://www.realclearpolitics.com/articles/2011/07/13/the_truth_about_the_auto_bailouts_110558.html.

68. Todd J. Zywicki, *Chrysler and the Rule of Law*, WALL ST. J., May 13, 2009, at A19.

69. *See* Anginer & Warburton, *supra* note 31, at 3–4.

70. *See* Zywicki, *supra* note 67.

ups seeking to enter the market.[71] Thus, for every job saved through government intervention on behalf of favored political groups, dozens or hundreds of jobs might never be created because of uncertainty about the political and legal climate.[72] Similarly, by entrenching "too big to fail" as government policy, it appears Washington has placed its thumb on the scale in favor of the massive banks favored by this designation. As a result of the government's implicit guarantee of their debts, favored banks can gain access to capital markets at a discount to other banks, a reflection of the public's belief that the government will bail them out.[73] These institutions now resemble Fannie Mae and Freddie Mac, which capital markets valued as having an implicit government guarantee.[74] As their subsequent multi billion dollar bailouts demonstrated, investors were correct in assuming that the government would actually stand behind Fannie Mae and Freddie Mac—and one suspects that they are correct about the "too big to fail" banks too.

IV. CRISIS AND MORAL HAZARD

The final lesson of the past several years is that interventions in times of crisis (often animated by understandable sympathy for those seemingly harmed by the crisis) invite moral hazard. For example, the bank bailouts, beginning with the rescue of Bear Stearns, can be traced in a straight line back through the rescue of Long-Term Capital Management in the 1990s to bailout of Continental Illinois in the 1980s.[75] Each intervention

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71. *Id.*; *see also* Hanweck & Sanders, *supra* note 13, at 9 ("[T]he subsidy afforded GM, Chrysler, GMAC and GE Capital . . . gives them an edge to gain financing from the Commercial Paper market. This further crowds out banks from raising capital to fund the medium and small businesses that create jobs in the U.S.").

72. *See* Zywicki, *supra* note 67; *see also* Hanweck & Sanders, *supra* note 13, at 9 ("Effectively these policies combine to utilize scare capital that would be more productively used to fund business expansion as opposed to funding mortgage loans that have gone bad and companies that have demonstrated weak management, are 'too big to fail,' have little chance of paying off taxpayers and no chance of increasing employment.").

73. *See* Gretchen Morgenson, *The Cost of Saving These Whales*, N.Y. TIMES, Oct. 4, 2009, at B1.

74. *Cf.* Vernon L. Smith, *The Clinton Housing Bubble*, WALL ST. J., Dec. 18, 2007, at A20 (describing Fannie Mae and Freddie Mac as "implicitly taxpayer-backed agencies").

75. *See* Russell Roberts, *Gambling with Other People's Money: How Perverted Incentives Caused the Financial Crisis*, MERCATUS CENTER, 9–11 (May 2010), (detailing this history of the Long-Term Capital Management rescue and the Continental Illinois bailout).

plants the seeds of the need for larger future rescues. In turn, politicians face extremely strong temptations to engage in bailouts and to incur the moral hazard problems that they create. In the short run, bailouts avert possible disaster, even if disaster is implausible.[76] Because politicians focus on their next election,[77] they face a compelling incentive to focus on the short-term benefit of a bailout and to discount the long-term harm which different, future politicians will have to confront. Yet when that time comes, private interests know that future politicians face exactly the same short-term incentive to kick the can still further down the road if they can.

Banks are not the only institutions that raise issues of moral hazard. Moral hazard also arises when it comes to simple consumer events such as foreclosure. According to empirical studies, foreclosure rates are two to three times higher in states that have anti-deficiency laws (laws that limit the bank to taking a consumer's house upon default and prohibit suing the consumer for the remainder) than elsewhere.[78] Anti-deficiency laws[79] create much stronger incentives for a consumer to walk away from his house when it is underwater. Designed to provide a soft landing for consumers who *can't* pay their mortgages, anti-deficiency laws invite moral hazard and become hammocks for those who *won't* pay their mortgages and who recognize the investment value of walking away.[80]

In addition, the rules imposed in many areas of the country during the early days of the foreclosure crisis to make foreclosure slower and more expensive than it otherwise would be also

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76. Political motivations may give rise to over-dramatization of implausible crises. *See* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 43–44 (2004) ("[P]olicymakers may protect creditors of banks because doing so maximizes personal welfare. In this case, policymakers view the benefit and cost trade-off through their own lens, as opposed to the costs and benefits confronting society.").

77. This orientation towards the next election exerts the greatest influence on policymakers when they are unconfident of their reelections. *See* Kenneth A. Schultz, *The Politics of the Political Business Cycle*, 25 BRIT. J. POL. SCI. 79, 79–81 (1995) (outlining a model for how the political business cycle incentivizes politicians to manipulate the economy).

78. *See* Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993).

79. *See, e.g.*, CAL. CIV. PROC. CODE § 580b (West 2011) (prohibiting deficiency judgments).

80. *See* Jones, *supra* note 78, at 135.

encourage moral hazard and strategic behavior.[81] If foreclosure amelioration and mitigation make it more expensive and more difficult for lenders to foreclose, then more people will choose to default and enter foreclosure.[82] Intended to help consumers who want to stay in their homes work out arrangements to do so, these rules instead turn into opportunities for investors to live in their houses rent free even as they pocket the money they otherwise would pay. People respond to incentives, and rules that encourage moral hazard will increase opportunistic behavior over the long run.

In addition, when it comes to bailouts of individual home owners the government simply does not have the ability to make nuanced assessments to distinguish worthy parties from strategic rent-seeking ones. The government is even less able to distinguish the two groups in the midst of a crisis.

CONCLUSION

So what is the role of the rule of law in a time of economic uncertainty? As the most recent events teach us, it is precisely in times of crisis that we must adhere to the rule of law. We should want to tie government's hands more tightly. Instead, consumers are learning the opposite, that in a time of crisis we will unleash government discretion and arbitrariness. In that mindset lies the next crisis, the continued ascendancy of political recklessness, and the rent-seeking state.

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81. *See, e.g.*, CAL. CIV. CODE § 2923.5 (West 2011) (a law that went into effect on Sept. 6, 2008, requiring lenders to attempt workouts and modifications of existing mortgages); *see also* Nelson D. Schwartz & David Streitfeld, *A Plan to Make It Harder for Banks to Foreclose on Homeowners*, N.Y. TIMES, Mar. 5, 2011, at B1, B6 (detailing a recent proposal by state attorneys general that would slow the foreclosure process and make the process more expensive).

82. *See* Editorial, *Dukes of Moral Hazard*, WALL ST. J., Feb. 19, 2009, at A18.