Afterword to *Preventing Regulatory Capture: Special Interest Influence and How to Limit It*

SHELDON WHITEHOUSE AND JAMES LEACH

Afterword to

Preventing Regulatory Capture: Special Interest Influence and How to Limit It

SHELDON WHITEHOUSE
U.S. SENATOR (D-RI)

JAMES LEACH
CHAIRMAN, NATIONAL ENDOWMENT FOR THE HUMANITIES; FORMER MEMBER OF THE U.S. HOUSE OF REPRESENTATIVES (R-IA)

For the most part, our country's regulatory framework serves the public interest well. It helps keep Americans safe from pollutants, personal injury, and other harms, and supports the orderly operation of a dynamic economy. Yet the threat of regulatory capture is ever present. When powerful interests gain excessive influence over regulatory agencies, the integrity of the regulatory process is compromised and catastrophic consequences can unfold.

The concept of regulatory capture is well established in economic, regulatory, and administrative law theory, appearing in the research of Nobel Laureate George Stigler, the writings of President Woodrow Wilson, and contemporary commentary by conservative as well as liberal columnists. Continued research and public attention to the issue is critical as the world becomes increasingly developed and interdependent. To that end, this volume represents an important step towards a better understanding of what regulatory capture is, and points to ways it may be constrained.

Highlighted in the scholarly articles are a variety of opinions about the causes and nature of regulatory capture within government agencies. As legislators (one former), we add an emphasis on the challenges of crafting statutory approaches that enable effective regulation and are conducive to regular oversight to ensure that regulations work as intended. We begin with seven key propositions about regulatory capture. We then touch on the implication of regulatory failures during recent financial crises, and note several potential remedies to the capture issues involved.

The first widely accepted proposition is that the threat of regulatory capture is real and its consequences frequently substantial. As Woodrow Wilson explained over one hundred years ago, "[i]f the government is to tell big business men how to run their business, then don't you see that big business men have to get closer to the government even than they are now? Don't you see that they must capture the government, in order not to be restrained too much by it?"[1] Regulatory agencies, like many other institutions making high-stakes decisions, by their very nature are vulnerable to capture. Marver Bernstein, the first dean of Princeton's Woodrow Wilson School of Public and International Affairs, wrote 58 years ago that regulators tend over time to "become more concerned with the general health of the industry" and that they try "to prevent changes which will adversely affect" the industry.[2] Today, conservative columnist George Will annually identifies these corrupt relationships, such as the Louisiana Board of Embalmers and Funeral Directors, which Will argues "has become yet another example of 'regulatory capture,' controlled by the funeral industry it ostensibly regulates."[3]

Thus, from Wilson to Bernstein to the present day, the threat of regulatory capture has been broadly recognized. This volume takes the next major step forward by illuminating the contours of this threat and, perhaps most importantly, turning attention toward the question of prevention.

This volume not only demonstrates that regulatory capture is a real threat, but also identifies forms of capture that have not been recognized in the earlier literature, such as "cultural capture" and "capture through complexity." James Kwak and Nolan McCarty detail the risks of regulatory capture in the financial sector arising from the oft-mentioned problem of a "well-oiled revolving door," but they also trace new pathways through which this closeness can lead to capture, deemed

[1] Woodrow Wilson, *The New Freedom* 102 (1912).
[2] Marver H. Bernstein, Regulating Business by Independent Commission 87 (1955).
[3] George F. Will, *Will Supreme Court Answer Monks' Prayers?*, Washington Post, Nov. 14, 2012; see also George F. Will, *In Arizona, Nibbling Away at Free Enterprise*, Washington Post, Sept. 23, 2011.

"cultural capture," which comes about when regulators "share strong social ties to the industry and are more sympathetic on average to the industry's interests and viewpoints."[4] Christopher Carrigan likewise documents the types of unethical relationships that regulated industries have strong incentive to develop. He notes that the unethical activity of employees of the Department of Interior's Minerals Management Service (MMS) prior to the BP oil spill was "clearly wrong and, to the degree it favors the regulated industry, can be associated with a captured agency."[5]

Second, regulated entities have a strong incentive to gain influence over the drafting and enforcement of regulations. As Daniel Carpenter notes, for example, the FDA regulates industries that represent nearly a trillion dollar market.[6] Most companies, if given the option, would choose to spend a few million dollars to stop or mitigate rules that would cost them billions more. The bank robber Willie Sutton is said to have once explained that he robbed banks "because that's where the money is." When it comes to why regulated entities seek influence with regulators, a similar answer might be given. Today's financial markets, for example, are very different than in our grandparents' era. The nominal value of derivative products alone is greater than the GDP of the United States.

Given the high stakes of regulation – the gains or losses caused by regulatory action or inaction – it is no surprise that tremendous efforts are undertaken every year to influence regulatory decisions. The same incentive is at work when powerful interests spend millions of dollars to lobby Congress. In the Eisenhower era, Senator Everett Dirksen is rumored once to have commented that "a billion here, a billion there, and pretty soon you're talking real money." With regard to drugs, derivatives, and other massive industries, it would appear that a trillion here and a trillion there can be the stakes of regulatory capture. In one sense it is impressive how much money is spread throughout the political process; yet these money flows are trivial compared to the potential benefits particular interests might receive with well-placed political "investments." This cost/benefit advantage to

[4] Kwak 108-10; McCarty 4.
[5] Carrigan 302.
[6] Carpenter 152.

vested interests is particularly stark in the regulatory capture area where so much decision-making and oversight is outside of public view.

Third, regulated entities often have substantial organizational and resource advantages in the regulatory process, especially compared to the diffuse public interest. James Kwak highlights this point. Industry groups have extraordinary resources and can focus with great precision on a narrow group of regulators. In contrast, the public interest tends to be represented by broad-based groups that advocate on a number of issues and "likely lack the organization infrastructure and staying power to knock on regulators' doors month-in, month-out on issue after issue."[7] Intensity of interest matters in the regulatory as well as the political world. And industry interest in regulatory decision-making is difficult to match. As Luigi Zingales points out, industry's resource advantages help to grease the revolving door between regulatory positions and well paid private sector jobs in the regulated industry, serving as both a cause and a symptom of regulatory capture.[8]

Fourth, some regulatory processes are more easily manipulated by special interests than others. McCarty demonstrates, for example, that agencies which rely on industry for funds, information, or expertise can be particularly susceptible to excessive industry influence.[9] This is particularly the case in high finance where governmental overseers frequently lack relevant experience to keep up with fast changing markets and product offerings. On the flip side, as Mariano-Florentino Cuellar argues in this volume, public health agencies seem to be less susceptible to capture. They are able to achieve some degree of independence from the industries they regulate, in large part due to their success in building in-house expertise.[10] Understanding this range of susceptibility to capture is integral to developing better and smarter regulation.

[7] Kwak 106.
[8] Zingales 125.
[9] McCarty 4.
[10] Cuellar, 5.

Fifth, regulatory capture is often difficult to detect. With respect to the revolving door between industry and government, Zingales explains that "this form of regulatory capture does not require an explicit *quid pro quo* between regulators and regulated, where a job is offered in exchange for a favorable decision."[11] The implicit prospect of a high-paying industry job may subtly influence a regulator to favor industry in a way that Zingales describes as "much more legitimate, and thus pervasive." Carpenter's chapter on detecting and measuring capture responds to this threat with a new set of tools for scholars and regulators to determine where industry influence has risen to the level of regulatory capture.[12] This can be quite difficult as capture can be present even in regulations that never result in conspicuous failures. Prevention may be most effective and do the most good then when capture is detected *before* a catastrophe or when it is still in a mild form.

Sixth, regulatory capture can cause great damage. Although the cost of regulation can often seem high, the cost of inadequate regulation can be even greater. The failures at the MMS before the BP oil spill, of banking and housing regulators before the global financial crisis, and of the Mine Safety and Health Administration in the lead-up to the Sago Mine disaster, reveal the enormous damage ineffectively regulated industries can cause. Incidents like these bring about human, environmental, and economic loss, and undermine public confidence in government. However, not all damage caused by failed regulations is due to capture. That is why it is so important to distinguish when capture is occurring from when it is not, so that reforms can target the real problem.

Seventh, congressional oversight and legislation are key to preventing and combating regulatory capture, so it is critical that Congress overcome barriers to effective action in this area. Members of Congress tend to focus on regulatory issues only within the jurisdictions of their committees, so there is an absence of meaningful, comprehensive oversight of regulatory capture as a general threat. Gaps or overlaps in committee jurisdictions can lead to oversight failures. Further, Congressional

[11] Zingales 125.
[12] Carpenter, "Detecting and Measuring"

oversight is generally reactive rather than proactive, with hearings or investigations often only held after rather than before a disaster has occurred.

Yet with so much law made through regulation, and so much influence brought to bear on regulators, Congress has a responsibility to pursue regulatory capture as a systemic risk across all agencies. It must go beyond just investigating past failures. Hearings should periodically be held focusing on how to search for and identify regulatory capture across the entirety of the federal government. The need to give continual attention to the integrity and independence of regulatory institutions is a social imperative.

Regulatory authority, like all governmental power, is divided within and between federal, state, county and city agencies. Accordingly, Congress must be vigilantly aware of the strengths and weaknesses of regulation at the state and community levels, particularly if that regulation affects national liabilities. For instance, during the savings and loan crisis of the 1970s and 1980s cozy regulation of state chartered S&Ls in a handful of states compounded the massive losses that had accumulated in a federal insurance fund. In the more recent financial crisis, lax state regulation of mortgage brokers allowed mortgage fraud to infect bundled products sold across the world. The federal government eventually found itself responsible for bailing out many of these bundled mortgage offerings as well as a state-regulated insurance company for losses embedded in a London subsidiary.

In the development and execution of laws, as of regulations, word-smithing nuances and manners of application can affect the bottom line of business. Accordingly, in many parts of American commerce, most notably finance, regulatory arbitrage can be an understandable but sometimes mischievous business option. Corporations have a natural preference to seek state and local jurisdictions where taxes are lowest and establish charters where the regulatory burden is least.

Conversely, regulators in different institutions and jurisdictions sometimes compete for authority in ways that are most attuned to the regulated rather than the public.

These concerns make it easier to understand the regulatory failures in the lead-up to the financial crisis. To that end, Kwak explains that in the years preceding the 2007-2009 financial crisis, "several signs of traditional capture were present"[13] – for example, the Securities and Exchange Commission (SEC) allowed investment banks to increase their leverage while foregoing comprehensive oversight.[14] In housing, Fannie Mae and Freddy Mac were ineffectually regulated by an agency largely unknown to the public, the Office of Federal Housing Enterprise Oversight. The agency was hamstrung by statutory restrictions, limitations placed on manpower, lack of expertise, and inattentive, industry-conflicted legislative oversight.

Washington's commercial banking regulators – the Federal Reserve, the Treasury, and the Federal Deposit Insurance Corporation – were more knowledgeable, experienced and laden with greater regulatory discretion than the housing regulators. Nevertheless, their actions taken together had an industry-accommodating ideological bent that allowed our largest commercial and investment banks to leverage excessively their capital. High-risk strategies involving off-balance sheet investments and investments in derivatives became the norm in the first decade of the 21st Century with disastrous consequences. There are many interrelated causes of the recent financial crisis, but the governmental intervention that followed could in large part have been constrained, perhaps avoided, if traditional leverage ratios applied to community banks had been maintained for money center institutions.

The full scope and form of regulatory capture involved in the financial crisis has yet to be fully documented, but this episode in the economic history of our country underscores the need for more independent regulatory processes and more vigorous congressional oversight. The American

[13] Kwak 108.
[14] Kwak 82.

taxpayer has compelling reason to demand that systemically consequential institutions operate in the future with more prudence, fewer conflicts, and less leverage.

There will never be a silver bullet to completely prevent regulatory capture. There are too many aspects of human nature involved, and with such rapid commercial and technological change, governmental policy makers will always be a step behind the sophistication of American industry. Nonetheless, a variety of approaches have been suggested to constrain and at least put a spotlight on the problem. For instance, contributors to this volume Michael Livermore and Richard Revesz recommend a centralized review of all regulations by an independent government body that they believe would not face the same pressures that specialized agencies experience from regulated industries;[15] Kwak proposes the appointment of an official public advocate who would represent the public interest during the regulatory process;[16] and Daniel Schwarcz suggests creating "consumer empowerment programs" to counteract industry influence over regulation.[17] In addition, Senator Whitehouse has pressed for the creation of an inspector general for regulatory capture.

Specific remedies aside, it is past time to acknowledge that regulatory capture has been observed too long and addressed too little. Scholars and advocates must together spread the word and engage voters and the media to be alert to the capture of regulatory agencies and to the possibility of prevention. Congress and the Executive Branch must at last pay adequate attention to this recurring infection in the body politic. The great challenge that these policymakers face is to infuse a public interest perspective into the regulatory decision-making process, because ultimately, the principal oversight that matters is of the public over its government.

[15] Livermore and Revesz 543.
[16] Kwak 112.
[17] Schwarcz 474-75 (looking at consumer empowerment programs in state insurance regulation).