

REFORMING THE UNITED STATES' ECONOMIC MODEL AFTER THE FAILURE OF UNFETTERED FINANCIAL CAPITALISM

RICHARD B. FREEMAN*

Once about a time, not so long ago, the U.S. began an experiment in *laissez faire* economics. To many, the high taxes and regulations of the 1940s and 1950s seemed to be stifling the free market. President Reagan argued that government was not the solution to any economic problem, but was instead the problem itself. If the U.S. lowered taxes on the wealthy, they would work harder and produce more output. If the country reduced regulations on business, management would make better decisions and raise economic growth. Weaker union coverage and labor regulations would make the labor market more flexible and lower unemployment. If firms paid executives with performance-based contracts, the interests of executives would align with those of shareholders to their joint benefit. All of these changes would raise the incomes of the rich more than the incomes of other citizens and some would redistribute income to the wealthy, but the promise was that eventually the benefits would trickle down so that everyone would gain.

Moving toward a *laissez faire* economy appealed to conservatives more than to liberals, to economists more than to other social scientists or lawyers, and to Republicans more than to Democrats. But nearly all groups supported some parts of the experiment. The Carter Administration initiated deregulation of major industries. The Reagan administration cut taxes on the wealthy and weakened regulatory laws. The Bush I administration sought to repeal the Glass-Steagall Act that separated commercial and investment banking. The Clinton Administration made stock options and bonuses the preferred mode of compensation for executives,¹ joined with

* Richard B. Freeman holds the Herbert Ascherman Chair in Economics at Harvard University, and is Faculty Director of the Labor and Worklife Program at the Harvard Law School. This Article is based on the 2009 Kenneth M. Piper Lecture at the Chicago-Kent College of Law.

1. The 1993 Tax Law denied a corporate tax deduction for executive wages in excess of \$1 million but continued the tax and accounting advantages for bonuses and stock options. With a thirty five percent corporate tax rate, the change made it thirty-five percent more costly for corporations to pay their top executives above \$1 million per year than before. Companies shifted compensation toward options, which had the advantage that recipients did not pay taxes until they were exercised and which were not counted as an expense on corporate books if they were issued in the money. Tamara Loomis, *In Shift Toward Performance-Based Compensation, Salaries Out, Bonuses In*, CORP. COUNS., July 25, 2007, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1184663194498>.

Republicans to repeal Glass-Steagall, and reappointed laissez faire aficionado Alan Greenspan to head the Federal Reserve. The George W. Bush administration reduced taxes on the wealthy and appointed opponents of deregulation to head regulatory agencies. From the mid-1980s on, the Federal Reserve continually weakened the barriers between commercial and investment banks through administrative rulings.²

As U.S. employment grew rapidly and the rate of unemployment dropped below the rate in advanced Europe in the 1990s, international economic agencies came to believe that the U.S. was the peak capitalist economy that others should copy. The Organization for Economic Cooperation and Development's Jobs Study in 1994 blamed high unemployment in the European Union on inflexible labor markets.³ Many attributed the more rapid growth of productivity in the U.S. than in Europe in the 1990s to the U.S.'s flexible market-driven economy. The World Bank and International Monetary Fund touted the U.S. model in their "Washington Consensus" policy recommendations to developing countries. That the promised trickle-down never reached the average American worker was largely ignored.

In the late 1990s, some analysts argued that the experiment had succeeded so much that it created a "new economy" that obsolesced the business cycle. The Federal Reserve had the monetary policy tools and knowledge to produce great moderation in the volatility of economic aggregates.⁴ James Stock and Mark Watson estimated that the standard deviation of annual growth rates in real Gross Domestic Product (GDP) in the United States dropped from 2.7 percent in 1960–1983 to 1.6 percent in 1984–2001, though they attributed more of the change to "luck" than to improved policy.⁵ Some analysts downplayed the possible adverse effects of the nation's huge trade deficits, of the increased use of debt to fund consumption, or of the great reliance on leverage in finance. If these were market-driven developments, they had to be good. Real business cycle analysts believed that cyclic ups and downs reflected changes in technology and

2. See PBS, *Frontline: The Wall Street Fix: Mr. Weill Goes to Washington: The Long Demise of Glass-Steagall*, May 8, 2003, <http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html>.

3. OECD, *THE OECD JOBS STUDY: FACTS, ANALYSIS, STRATEGIES* (1994), <http://www.oecd.org/dataoecd/42/51/1941679.pdf>.

4. Ben S. Bernanke, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Meetings of the Eastern Economic Association, Washington, DC: The Great Moderation (Feb. 20, 2004), available at <http://www.federalreserve.gov/Boarddocs/Speeches/2004/20040220/default.htm>.

5. James H. Stock & Mark W. Watson, *Has the Business Cycle Changed and Why?* (Nat'l Bureau of Econ. Research Working Paper No. W9127, Aug. 2002), available at <http://ssrn.com/abstract=327153>.

tastes, not the vagaries of financial markets. The Great Depression was a dim memory. To some it had never really occurred.

I. DEREGULATING THE CROWN JEWEL OF CAPITALISM, FINANCE

Deregulation of banking and finance began in 1980 under the Carter Administration, when Congress enacted the Depository Institutions Deregulation and Monetary Control Act which gave savings and loan associations new lending authority and the right to offer new savings products.⁶ The Reagan Administration followed by freeing banks and savings and loan institutions to compete with higher interest rates in the money market and to make commercial loans.⁷ While deregulation and associated loosened accounting practices were not the sole cause of the savings and loan (S&L) crisis that followed, those policies created the incentives and opportunities for the fraud and criminal looting of banks that destroyed nearly 750 S&Ls and sent some 3,600 bankers to prison.⁸ The cost of the S&L disaster to taxpayers was on the order of \$125 billion,⁹ and may have caused greater harm to the economy by lowering household construction for years. Regardless of one's views of the benefits of deregulation, the disaster should have warned the Treasury, Federal Reserve, and Congress that deregulating banking and finance was risky. Deregulation might improve the long run functioning of the financial sector, but the path to the long run was strewn with pitfalls.

A. *Thin Ice. Proceed with Caution.*

The second phase in legislative deregulation began in 1993. Paying little attention to the lesson of the S&L crisis, Secretary of the Treasury Robert Rubin led the Clinton Administration to join Congressional Republicans in repealing the Glass-Steagall barriers between commercial and investment banking.¹⁰ The immediate precipitant of the repeal was the

6. Depository Institutions Deregulation and Monetary Control Act, 12 U.S.C. § 226 (1980).

7. The major piece of legislation was the Garn-St. Germain Depository Institutions Act of 1982, H.R. 6267, 97th Cong. (1982) (enacted). President Reagan referred to the banking deregulatory agenda when he signed it. Ronald Reagan, President, Remarks on Signing the Garn-St. Germain Depository Institutions Act of 1982 (Oct. 15, 1982), available at <http://www.reagan.utexas.edu/archives/speeches/1982/101582b.htm>.

8. FINANCIAL TIMES reports that 1,072 bankers were jailed for S&L crimes and another 2,558 bankers were jailed for other offenses, which were often S&L-linked. Gillian Tett, *Insight: A matter of retribution*, FIN. TIMES, Sept. 3, 2009, available at http://us.ft.com/figateway/superpage.ft?news_id=fto090320091244573891.

9. See U.S. GEN. ACCOUNTING OFFICE, REPORT TO THE CONGRESS (1996), available at <http://www.gao.gov/archive/1996/ai96123.pdf>.

10. PBS, *supra* note 2.

merger of Citigroup and Traveler's Insurance into a giant conglomerate.¹¹ If Glass-Steagall had remained the law, the merged firm would have had to divest some of its businesses and be less profitable. The new merged conglomerate bank pressured Washington to repeal the Act, and Rubin (who was also the former CEO of Goldman Sachs) delivered what the financial community had long wanted.¹² Indicative of the spirit of the time, the WALL STREET JOURNAL greeted the repeal of Glass-Steagall with the headline "Finally, 1929 Is Put to Rest."¹³ Many in economics and finance believed that the efficient market hypothesis characterized the financial market and thus that deregulation would improve economic performance. Alan Greenspan, head of the Federal Reserve, *knew* that regulation was useless: "[F]ree, competitive markets are by far the unrivaled way to organize economies. We have tried regulation. None meaningfully worked."¹⁴

B. The Country Hadn't Trusted an Unfettered Wall Street Since the 1920s

1. Time to Have Another Go

The new deregulatory regime freed Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns to form huge holding companies that conducted business on all sides of the finance market. It allowed Citigroup to underwrite and trade mortgage-backed securities and collateralized debt obligations and to create investment vehicles to buy the securities (and to hire Mr. Rubin after he left the Clinton Administration).¹⁵ Moreover, since no agency had jurisdiction over the full scope of bank transactions, the banks could evade some government oversight if they so desired. If this did not give them enough wiggle room, the Gramm-Leach-Bliley Bill that eliminated Glass-Steagall contained a provision that further restricted government oversight to voluntary monitoring in some areas.¹⁶

11. *Id.*

12. *Id.*

13. Robert McGough, *The New Financial Landscape: Finally, 1929 Is Put to Rest*, WALL ST. J., Oct. 25, 1999 at A20.

14. As quoted by Henry Waxman at the Congressional Hearings of October 23, 2008: "[Y]ou had an ideology, you had a belief that free, competitive—and this is your statement—'I do have an ideology. My judgment is that free, competitive markets are by far the unrivaled way to organize economies. We have tried regulation. None meaningfully worked.' That was your quote." PBS Newshour, *Greenspan Admits 'Flaw' to Congress, Predicts More Economic Problems*, Oct. 23, 2008, http://www.pbs.org/newshour/bb/business/july-dec08/crisishearing_10-23.html.

15. PBS, *supra* note 2.

16. Gramm-Leach-Bliley Financial Modernization Act, P.L. 106-102 (Nov. 12, 1999).

Great Depression? S&L crisis? The “best and brightest” had new tools for risk management. This time the unfettered financial market was going to glisten and glitter as the crown jewel of capitalism.

To be sure, some observers worried that deregulation might not work out as promised. Analysts at MOTHER JONES predicted that overturning the Glass-Steagall Bill would “pave the way for a new round of record-shattering financial industry mergers, dangerously concentrating political and economic power [and] create too-big-to-fail institutions that are someday likely to drain the public treasury as taxpayers bail out imperiled financial giants to protect the stability of the nation’s banking system.”¹⁷ But no one in authority paid attention to MOTHER JONES. The Secretary of the Treasury/future chairman of Citigroup, the head of the Federal Reserve, and the academic and Wall Street experts surely knew more about how the finance market operated than some radical critics at MOTHER JONES.

Wall Street responded to deregulation with an array of mathematically sophisticated financial instruments designed to spread risks. But almost simultaneously the banks increased risk by increasing their leverage so they could make more money with less capital. Extolling credit default swaps as providing the correct insurance for the new financial products while ignoring the increased leverage, Greenspan was ecstatic: “As the market for credit default swaps expands and deepens, the collective knowledge held by market participants is exactly reflected in the prices of these derivative instruments [which] embody all relevant market prices of the financial instruments issued by potential borrowers.”¹⁸

Great Depression? Ancient times. Savings and loan crisis? Many of the banks that went under were in Texas, Oklahoma, Louisiana, Colorado, Kansas, and Missouri, far from Wall Street.¹⁹ Surely the Wall Street financiers were a lot smarter. And the efficient market theorem said the market could not be wrong.

During the 1990s, countries around the world deregulated their financial sectors to join the global capital market. If these policies had succeeded in improving financial stability and raising economic growth, U.S. deregu-

17. Russell Mokhiber & Robert Weissman, *Robert Rubin Rewrites the Rules*, MOTHER JONES, Nov. 9, 1999, available at <http://motherjones.com/politics/1999/11/robert-rubin-rewrites-rules>.

18. Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks before the Council on Foreign Relations: International Financial Risk Management (Nov. 19, 2002), available at <http://www.federalreserve.gov/BoardDocs/Speeches/2002/20021119/default.htm>.

19. Of the 1617 banks that failed in this period, 599 were in Texas, 122 in Oklahoma, seventy in Louisiana, sixty-nine in Kansas, fifty-nine in Colorado, and forty-one in Missouri. This compares to thirty-four in New York. See FEDERAL DEPOSIT INSURANCE CORPORATION, *THE BANKING CRISES OF THE 1980S AND EARLY 1990S: SUMMARY AND IMPLICATIONS*, available at http://www.fdic.gov/bank/historical/history/3_85.pdf (last visited Apr. 19, 2010).

lation could reasonably be expected to succeed as well. But the 1990s was a period of near continuous financial crisis. There was the 1994–1995 Mexican Crisis, the 1997 Asian Financial Crisis, the 1998 Russian Crisis, the late 1990s–early 2000s Argentine financial crisis, and on and on.²⁰ Despite its deep commitment to the laissez faire agenda, the International Monetary Fund (IMF) found no evidence that countries that liberalized their financial markets did better than those that had not done so.²¹ Could it be that laissez faire finance did not work according to plan? The proponents of deregulation thought not. The problem was that crisis countries had incompletely developed financial markets. If the countries had transparent efficient institutions like Wall Street, things would have gone well. No one outside of the MOTHER JONES crowd could imagine that the U.S. capital market would crash like those in Latin America, Asia, or the ex-Soviet Union.

Another warning sign came in 1998. Long-Term Capital Management (LTCM), a five billion dollar hedge fund with over \$130 billion in highly leveraged assets and huge off-balance sheet derivative positions, was suddenly unable to pay its bills and was about to crash.²² LTCM's sophisticated trading strategies, developed under the direction of Nobel Laureates in economics and Wall Street insiders, proved riskier than the firm's risk models had predicted.²³ Fearing that the collapse of LTCM would set off a domino effect in financial markets that would force other highly leveraged hedge funds and financial houses into bankruptcy as asset prices fell, the New York Federal Reserve worked with the biggest Wall Street banks to have them take over LTCM's debt.²⁴

20. See generally INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: APRIL 2009 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>. Table 3.2 lists 1990s financial crises and associated recessions in Australia, France, Finland, Greece, Italy, Japan, Sweden, and the United Kingdom in the advanced countries. *Id.* at 107 tbl.3.2. Table 3.6 gives crises associated with deregulation of the mortgage market. *Id.* at 129 tbl.3.6. Luc Laeven and Fabian Valencia identified 124 systemic banking crises over the period 1970 to 2007. Luc Laeven & Fabian Valencia, *Systemic Banking Crises: A New Database 5* (Int'l Monetary Fund, Working Paper No. 08/224, 2008), available at www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf.

21. M. Ayhan Kose et al., *Financial Globalization: A Reappraisal 4* (Int'l Monetary Fund, Working Paper No. 06/189, 2006), available at http://www.brookings.edu/~media/Files/rc/papers/2006/08globaleconomics_rogoff/20060823.pdf.

22. Sungard Ambit ERisk, Case Study: LTCM-Long-Term Capital Management, <http://www.erisk.com/Learning/CaseStudies/Long-TermCapitalManagemen.asp> (last visited Mar. 17, 2010).

23. *Id.* In September 1998, the heavily leveraged hedge fund with mountains of derivatives told the Federal Reserve that it could not cover \$4 billion in losses due to financial problems that resulted from Russia defaulting on its debt. *Id.*

24. See Wikipedia, Long-Term Capital Management, http://en.wikipedia.org/wiki/Long-Term_Capital_Management (last visited Apr. 19, 2010).

Thin ice? LTCM had fallen into a frozen lake and drowned. The Federal Reserve and the financial community could not have asked for a stronger warning signal to proceed with caution.

Citing the failure of LTCM at a seminar at the Chicago Kent-IIT commodities law institute on October 15, 1998, Brooksley Born, the head of the Commodity Futures Trading Commission, warned that the lack of transparency, excess of leverage, and absence of sufficient prudential controls in over-the-counter derivatives posed a danger to U.S. financial markets.²⁵ In the spring of 1999, she sought public debate on whether derivatives should be regulated in some fashion. In response, Secretary of the Treasury Rubin, Securities & Exchange Commission (SEC) Commissioner Arthur Levitt, Deputy Secretary of the Treasury Lawrence Summers, and Alan Greenspan moved almost instantly to squelch her for “cast[ing] the shadow of regulatory uncertainty over an otherwise thriving market.”²⁶ Congress enacted the Commodity Futures Modernization Act, which preempted derivatives from oversight under state gaming laws and excluded certain swaps from being considered securities under SEC rules.²⁷

2. Thin ice? Caution? Off with Her Head! Within a Year, Born Left the Government.

Financial economists and macro-economists paid close attention to these developments. Labor experts did not; banking and finance were not part of our territory. When I wrote *America Works*,²⁸ which gave “critical thoughts” on the performance of the U.S. labor market and economy, I noted the country’s successes in generating full employment, creating new opportunities for women and immigrants, increasing productivity, and producing high mobility of labor that kept unemployment spells short. The weaknesses of the U.S. economic model that troubled me were the failure to distribute the gains of economic growth to the bulk of U.S. workers, the U.S.’s third-world level of inequality, and the inability of workers who sought unions to gain that representation.²⁹ Finance entered my analysis only peripherally through its link to executive stock options and bonuses

25. Brooksley Born, Chairperson, Commodity Futures Trading Comm’n, Remarks at Chicago Kent-IIT Commodities Law Institute: The Lessons of Long-Term Capital Management L.P. (Oct. 15, 1998), available at <http://www.cftc.gov/opa/speeches/opaborn-37.htm>.

26. Lawrence H. Summers, Deputy Secretary, U.S. Dep’t of the Treasury, Testimony before the Senate Committee on Agriculture, Nutrition, and Forestry on the CFTC Concept Release (July 30, 1998), available at <http://treasury.gov/press/releases/rr2616.htm>.

27. Pub. L. No. 106-554, 114 Stat. 2763, 2763A-411 (2000).

28. RICHARD B. FREEMAN, *AMERICA WORKS: CRITICAL THOUGHTS ON THE EXCEPTIONAL U.S. LABOR MARKET* (2007).

29. *Id.* at 1, 3.

that seemed designed to enrich CEOs and their cronies rather than to incentivize and reward exceptional performance.³⁰ Why were options not indexed to other economic variables? Why did firms issue new options when old ones went under water? Why did firms backdate stock options? Why did some firms issue options immediately after the temporary fall in stock prices post 9-11?³¹ I noted the criminal behavior that led to the 2001 crash of Enron and the Worldcom, Tyco, and other scandals, but I never imagined that this was the tip of an iceberg of fraud and risk-taking that endangered the entire economy.

Labor research has shown that unions and labor regulations sometimes create modest inefficiencies as they increase labor's share of the economic pie, but it has also shown that these inefficiencies pose no danger to the economy.³² Naively I assumed that something similar must be true in capital markets. If the efficient market hypothesis was right, finance created no problems. If the efficient market hypothesis was an exaggeration (as most empirical studies found it to be), it was surely not such an exaggeration that deregulating finance risked a second Great Depression. In any case, the Federal Reserve, the Treasury, SEC, and diverse other agencies still had enough authority to put a stop to anything truly dangerous. That was their job.

Thin ice? Put up a no skating sign and make sure banks and other financial institutions stay in the safe zone.

II. *The Implosion of Finance*

In mid-September 2008, the experiment in laissez faire capitalism in finance came to a sudden, disastrous end. It did not end with T.S. Eliot's whimper, but with a bang.³³ Finance never ends with whimpers. It ends with crashes and panics that reduce the cumulated assets of years to rubble all at once. THE WALL STREET JOURNAL referred to the September 2008 implosion of banking and finance precipitated by the Lehman Brothers bankruptcy as "The Weekend Wall Street Died."³⁴ Credit froze. Banks had "toxic assets" on their books of questionable value which made other banks

30. *Id.* at 120.

31. *Id.* The editor of the Harvard Business Review was so incensed by this behavior as to denounce these executives on public radio as "sleaze balls and profiteering ghouls." *Id.*

32. *Id.* at 86-87.

33. *Cf.* T.S. ELIOT, *The Hollow Men* (1925), available at <http://zachd.com/writing/hollowmen.html> ("This is the way the world ends. Not with a bang but a whimper.").

34. Susanne Craig et al., *The Weekend That Wall Street Died*, WALL ST. J., Dec. 29, 2008, available at <http://online.wsj.com/article/SB123051066413538349.html>.

unwilling to deal with them. They had off-the-books subsidiaries of unknown value and debt. Greenspan's fabled swaps turned out to be useless, or rather worse than useless, as they spread the crash and panic more widely. American International Group (AIG), the big insurance firm, was about to crash. The grand poobah was in a state of "shocked disbelief" as "[t]he whole intellectual edifice [on which his policies hinged] collapsed."³⁵

Terrified that the U.S. was falling through thin ice and that Great Depression II loomed, the Bush Administration, the Federal Reserve, and the leaders of Congress and business and finance asked Congress to give billions of dollars to the Treasury to save finance from finance. In October 2008, over the opposition of many Congressional Republicans, Congress enacted the Troubled Assets Relief Program (TARP) that gave the Treasury authority to spend up to \$700 billion to promote financial market stability.³⁶ The money was first supposed to buy toxic assets from the banks. Then the Treasury decided to add to the capital stock of the financial firms by buying preferred stock. Then President Bush declared that he had the authority to spend the money on whatever would mitigate the crisis. The Treasury ended up establishing eleven programs to which it allocated \$529 billion as of November 30, 2009—ranging from equity purchases, loans, and guarantees to aid for the auto industry and small businesses.³⁷ The Federal Reserve lowered interest rates and undertook diverse innovative financial maneuvers to provide liquidity to credit markets.³⁸ The Congressional Oversight Panel estimated that the maximum federal exposure at the end of 2009 was \$3.1 trillion.³⁹

The influx of government support ended the financial panic. In its 2009 year-end report, the Congressional Oversight Panel concluded that TARP helped stabilize financial markets and restore the flow of credit but warned that the banking sector was still on shaky ground.⁴⁰ The Treasury had applied "stress tests" to banks that did not revalue toxic assets at cur-

35. Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1.

36. CONGRESSIONAL OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 4 (2009), available at <http://cop.senate.gov/documents/cop-120909-report.pdf>.

37. CONGRESSIONAL OVERSIGHT PANEL, *supra* note 36, at tbl. 25.

38. CONGRESSIONAL OVERSIGHT PANEL, *supra* note 36, at 100.

39. *Id.* at 77. At the peak of the disaster, BLOOMBERG estimated that the full value of the bailout was over \$7.4 trillion, the bulk of which consisted of lending programs and guarantees, almost all under the Fed and FDIC. Mark Pittman & Bob Ivry, *U.S. Taxpayers Risk \$9.7 Trillion on Bailout Programs (Update)*, BLOOMBERG.COM, Feb 9, 2009, available at <http://www.bloomberg.com/apps/news?pid=washingtonstory&sid=aGq2B3XeGKok>.

40. CONGRESSIONAL OVERSIGHT PANEL, *supra* note 36, at 103.

rent market price. This meant that the banks were weaker than the stress tests indicated unless recovery went smoothly and restored the value of those assets. With near-zero-interest loans, some institutions started to speculate in ways that risked setting off new asset bubbles. Most banks used the government cash and guarantees to re-capitalize themselves but did not make the new loans that would fund investment or help mortgagees refinance their homes.⁴¹ In September 2009, five Wall Street investment banks held thirty-seven percent of the sector's assets while ten global banks held a sizable proportion of world banking assets; this made them all "too big to fail."⁴² Would they take on riskier investments than otherwise, knowing that the government would come to their rescue (if not now, then later) and thereby precipitate another meltdown of finance?

The implosion of Wall Street brought near immediate recession to the U.S. economy and economies worldwide. Real gross domestic output in the U.S. decreased at an annual rate of 5.4 percent in the fourth quarter of 2008 and by 6.4 percent in the first quarter of 2009 versus activity in the year-ago periods.⁴³ Other countries also registered substantial drops in GDP.⁴⁴ In response, the Obama Administration pushed the American Recovery and Reinvestment Act through Congress to provide a Keynesian stimulus to the economy.⁴⁵ Governments elsewhere also ran sizable Keynesian fiscal deficits. U.S. GDP turned positive in the third quarter of 2009.⁴⁶ Stimuli programs in other economies also succeeded in restoring positive economic

41. *Id.* at 153.

42. For the U.S., the five largest bank holding companies in terms of total assets as of December 31, 2009 had \$8.2 trillion in assets, as reported by the FDIC. See National Information Center, Top 50 BHCs, <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx> (last visited Apr. 19, 2010). The Federal Reserve's flow of accounts file shows all bank holding companies having \$27.21 trillion in assets as of the last quarter of 2009 compared to \$22.528 trillion in assets for all BHCs. This gives the five largest thirty percent of bank holding assets. See Table L.112 Bank Holding Companies, available at <http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf> (Mar. 11, 2010). The CONGRESSIONAL OVERSIGHT PANEL REPORT, at table 12, shows a market share of about thirty-seven percent for the four banks with the most deposits. *Id.* at 46 tbl.12; compare Mark Whitehouse, *The Outlook: Economic Crisis Ebbs, Systemic Risks Don't*, WALL ST. J., Dec. 7, 2009, at A2 (reporting that the world's ten largest banks have seventy percent of global banking assets), with Bankers Almanac, *Bank List—Top Banks in the World* (Mar. 3, 2010), <http://www.bankersalmanac.com/addcon/infobank/bank-rankings.aspx> (showing the world's ten largest banks with less than half of global banking assets).

43. TradingEconomics, *United States GDP Growth Rate*, <http://www.tradingeconomics.com/Economics/GDP-Growth.aspx?Symbol=USD> (last visited Mar. 17, 2010).

44. See Marcus Walker, *Record GDP Drop Sharpens Pain Across Euro Zone*, WALL ST. J., May 16, 2009, at A5.

45. See Lee E. Ohanian, *The \$787 Billion Mistake*, FORBES, June 10, 2009, available at <http://www.forbes.com/2009/06/09/american-recovery-reinvestment-act-roosevelt-opinions-contributors-depression.html>.

46. See Bureau of Economic Analysis, *Gross Domestic Product: Fourth Quarter 2009 (Second Estimate)* (Feb. 26, 2010), http://www.bea.gov/newsreleases/national/gdp/2010/gdp4q09_2nd.htm.

growth. Stock prices increased. Some major banks reported large profits, which encouraged the bankers to begin again paying themselves huge bonuses. Executives in other firms benefited from options that their firms granted them when the market had bottomed out or from grants of even larger numbers of shares than in the past (so that the options had the same value as in the past)—even though their decisions had nothing to do with the increase in stock prices. But even with the TARP bailout of banks and the stimulus, the financial sector and economy remained fragile; the labor market in particular showed little sign of recovery.⁴⁷ Many feared that reduced government support for the banks or reduced deficit spending would precipitate another, possibly worse, economic recession.⁴⁸

The end result of the experiment in deregulation of finance was thus the opposite of what the aficionados of *laissez faire* intended. It created a finance sector and real economy more dependent on the government than before. It raised suspicions about competence and honesty not only in banking but in business in general.⁴⁹

A. *Thin ice. Take precaution. Or suffer the consequences.*

1. Effect on Labor

The 2008–2009 recession hurt working Americans more severely than did earlier post-Depression recessions. The number of jobs fell by nearly eight million from 2007 to October 2009.⁵⁰ The employment-population ratio fell from sixty-three percent to 58.5 percent.⁵¹ Unemployment at the end of 2009 hovered around ten percent.⁵² “Duration of joblessness was the

47. See Martin Neil Baily, Senior Fellow and Bernard L. Schwartz Chair, The Brookings Inst., Testimony to the Senate Democratic Policy Committee: Putting Americans Back to Work: Competing Visions for Job Creation (Dec. 16, 2009), available at <http://dpc.senate.gov/hearings/hearing52/baily.pdf>.

48. See Edward Harrison, Obama: Debt Could Cause a Double Dip Recession, NAKED CAPITALISM, Dec. 18, 2009, <http://www.nakedcapitalism.com/2009/11/obama-debt-could-cause-a-double-dip-recession.html>.

49. Gallup.com, *Business and Industry Sector Ratings*, <http://www.gallup.com/poll/12748/Business-Industry-Sector-Ratings.aspx> (Aug. 2009); Gallup.com, *Honesty/Ethics in Professions*, <http://www.gallup.com/poll/1654/Honesty-Ethics-Professions.aspx> (Nov. 2009).

50. See Josh Bivens, *Budgeting For Recovery* 1 (Econ. Pol’y Inst., Briefing Paper No. 253, 2010), available at http://epi.3cdn.net/1616707e0c784d8134_4nm6becsb.pdf.

51. See Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS12300000 (change output options to “from 2000 to 2010” and click “go”) (last visited Feb. 25, 2010).

52. Bureau of Labor Statistics, *Regional and State Employment and Unemployment Summary* (Jan. 22, 2010), <http://www.stats.bls.gov/news.release/laus.nr0.htm>.

longest since the Great Depression.”⁵³ Millions were on involuntary short term and “[m]illions more were too discouraged by lack of jobs to seek work.”⁵⁴ The Bureau of Labor Statistics’ most inclusive definition of labor underutilization reached 17.5 percent of the work force in October 2009.⁵⁵ The conventionally defined unemployment rate rose in the U.S. above that in the European Union.⁵⁶ The International Labor Organization estimated that jobs may not recover in the advanced countries until 2015.⁵⁷ For the U.S., only an economic miracle would restore full employment in that time span. In the 1993–1998 boom, the employment-population rate increased by 2.9 percentage points, or nearly 0.6 percentage points per year.⁵⁸ If employment began to increase in 2010 at the rate as in the boom, the employment-population rate would not reattain its pre-recession level of sixty-three percent until 2017; however, a lower rate of job creation, or one that began later, would delay full recovery in the job market until later in the decade. The rate of unemployment could easily remain on the order of six to eight percent for close to a decade.

Extended periods of joblessness are toxic for economic well-being. Young persons who seek first jobs and experienced workers who lose jobs in a weak job market suffer income losses that last their lives.⁵⁹ Unemployment reduces happiness by as much as the loss of a family member.⁶⁰ The effects of a job loss on health are more equivocal. Christopher Ruhm

53. Richard Freeman, *A Jobless Recovery?*, PROJECT SYNDICATE, Dec. 9, 2009, <http://www.project-syndicate.org/commentary/rfreeman1/English>.

54. *Id.*

55. See Bureau of Labor Statistics, *The Employment Situation—October 2009* (Nov. 6, 2009), <http://www.bls.gov/news.release/archives/empst11062009.pdf>. This is the BLS’s U-6 measure that includes total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers.

56. See Freeman, *supra* note 53. Advanced Europe, Canada, and Japan also suffered major job losses and high rates of unemployment. Spain, with its temporary employment contracts, had the biggest increase in unemployment since firms can fire workers quickly. See US Bureau of Labor Statistics, International unemployment rates and employment indexes, available at http://www.bls.gov/fls/intl_unemployment_rates_monthly.pdf (Apr. 10, 2010). Some countries, such as Germany and Sweden in Europe and Korea in Asia, have “hidden” their joblessness by paying firms to keep workers on board. Richard Freeman, Remarks at the AEA Panel Discussion: Europe’s Role and Position in the Current Economic Crisis Annual Meetings in Atlanta, Georgia (Jan. 5, 2010).

57. INTERNATIONAL LABOUR CONFERENCE 98TH SESSION, GENEVA, JUNE 2009, COMMITTEE OF THE WHOLE ON CRISIS RESPONSES 6 (2009), available at <http://www.ilo.org/public/libdoc/ILC2009/TD1/ILC98-CPI-TD1-Brief-2009-06-0016-1-En.pdf>.

58. See Bureau of Labor Statistics, *Labor Force Statistics for the Current Population Survey*, http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 (change output options to “from 1993 to 1998” and click “go”) (last visited Feb. 26, 2010).

59. Till von Wachter & Stefan Bender, *In the Right Place at the Wrong Time: The Role of Firms and Luck in Young Workers’ Careers* 37 (Inst. for the Study of Labor, IZA Discussion Paper No. 1348, 2004).

60. Andrew E. Clark & Andrew J. Oswald, *Unhappiness and Unemployment*, 104 *ECON. J.* 648, 655 (1994).

found that on average health improves in a recession.⁶¹ But, looking at high-seniority men who lost their job in the 1970s and 1980s, Daniel Sullivan and Till von Wachter estimate that their annual mortality increased by ten to fifteen percent,⁶² which implies a loss in life expectancy of one to one and a half years. Analysis of the mental health of workers in five countries shows that loss of employment reduced mental well-being while moving from unemployment to a full-time regular job improved mental well-being.⁶³

Previous post-World War II finance-induced recessions provide some insight into how the 2008–2009 crisis might impact workers over the long run. The early 1990s housing bubble and banking collapse in Sweden raised unemployment from 1.8 percent in 1990 to 9.6 percent in 1994.⁶⁴ In the ensuing recovery, unemployment bottomed out in 2001 at five percent.⁶⁵ In 2007, sixteen years after the crisis but before the 2008–2009 recession, the rate of unemployment was 6.2 percent—more than three times as high as in 1990.⁶⁶ In 1997, the Asian financial crisis struck Korea. The IMF and U.S. insisted that Korea raise interest rates and undertake “Washington Consensus” style reforms to receive the financial assistance it needed to deal with runs on its currency.⁶⁷ Unemployment rose to around eight percent, real wages declined, and unions battled management and government in a futile effort to preserve job security for workers in large firms. Growth and employment recovered quickly but the new jobs were primarily in “non-regular” positions with limited benefits and low wages. Inequality in Korea went from moderate levels to the second highest among advanced OECD countries, behind only the U.S.⁶⁸ The recession in Argentina that followed the collapse of the peso in January 2002 raised already high rates of unemployment, lowered real wages, and increased poverty.⁶⁹

Data for 2007–2009 show that the U.S. recession increased inequality in hourly earnings, annual income, and wealth. Between 2007 and 2009, usual hourly earnings at the bottom decile increased less than at the me-

61. Christopher J. Ruhm, *Are Recessions Good for Your Health?*, 115 Q.J. OF ECON. 617, 617 (2000).

62. Daniel Sullivan & Till von Wachter, *Job Displacement and Mortality: An Analysis Using Administrative Data*, 124 THE Q.J. OF ECON. 1265 (2009).

63. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD EMPLOYMENT OUTLOOK, 205, 209 (2008).

64. See Freeman, *supra* note 53.

65. See *id.*

66. See *id.*

67. See *id.*

68. See *id.*

69. See JIM SAXTON, JOINT ECON. COMM. OF THE U.S. CONGRESS, ARGENTINA’S ECONOMIC CRISIS: CAUSES AND CURES 2 (2003), available at <http://www.house.gov/jec/imf/06-13-03.pdf>.

dian, which in turn increased less than at the top decile.⁷⁰ Earnings increased less for high school graduates without college education than for college graduates, which in turn increased less than for those with graduate or professional degrees.⁷¹ Earnings increased less for younger workers than for older workers, and so on.⁷² Turning to income, the rate of poverty in the U.S. rose from 12.5 percent to 13.2 percent, while median household income fell by 3.6 percent in real terms between 2007 and 2008.⁷³ Since the recession began in late 2008, poverty and household income figures will almost certainly show greater losses through 2009. Edward Wolff estimates that the mean wealth fell less than median wealth between 2007 and 2009, which implies that inequality in wealth grew.⁷⁴ The reason for the increased wealth inequality is that the government bailout of banks and stimulus helped raise share prices, which restored some of the wealth of persons with considerable equity while the price of houses—which constitute the main wealth of most families—had not recovered by the end of 2009. By contrast, inequality in income and wealth fell in the Great Depression, when the fall in asset values was concentrated among the tiny upper crust that was invested in the stock market.⁷⁵

Given the huge impact that financial disasters have on labor, it seems incumbent that labor scholars examine what went wrong in finance and participate in debates over ways to reform financial markets. It is difficult to imagine what could harm American workers and the economy on which their living standards depend more than financial debacles like that of 2008–2009. Labor experts cannot ignore finance, as most of us have done,

70. See Bureau of Labor Statistics, *Usual Weekly Earnings of Wage and Salary Workers: Third Quarter 2007* (Oct. 18, 2007), http://www.bls.gov/schedule/archives/wkyeng_nr.htm#current (click on “Third Quarter” for years 2007, 2008, and 2009 to compare).

71. *Id.*

72. *Id.*

73. CARMEN DENAVAS-WALT, BERNADETTE D. PROCTOR & JESSICA C. SMITH, U.S. CENSUS BUREAU, *INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2008 6, 14* (2009), available at http://www.census.gov/Press-Release/www/releases/archives/income_wealth/014227.html.

74. See Edward N. Wolff, *The Squeeze Before the Storm*, PATHWAYS, Fall 2009, at 3 (“[M]ean wealth (in 2007 dollars) fell by 17.3 percent between 2007 and 2009 (to \$443,600), median wealth plunged by an astounding 36.1 percent (to \$65,400, about the same level as in 1992!)”).

75. See Simon Kuznets & Elizabeth Jenks, *Average Levels of Income Shares, 1919–1938*, in *SHARES OF UPPER INCOME GROUPS IN INCOME AND SAVINGS* 1, 11 (1953); HORST MENDERSHAUSEN, *CHANGES IN INCOME DISTRIBUTION DURING THE GREAT DEPRESSION* 35 (1946); Thomas Piketty and Emmanuel Saez, *Income Inequality in the United States, 1913–1918*, *THE Q.J. OF ECON.* 1, 12 (2003); Wojciech Kopczuk & Emmanuel Saez, *Top Wealth Shares in the United States, 1916–2000: Evidence from Estate Tax Returns* (Nat’l Bureau of Econ. Research, Working Paper No. 10399, 2004), available at <http://www.nber.org/papers/w10399>. Since a small proportion of the population holds a disproportionate share of stocks and other fixed assets, whose prices fall in recessions, most cyclic downturns tend to lower wealth inequality as did the Depression.

if we are to understand the determinants of labor outcomes and find ways to improve the economics of working men and women. The remainder of this essay is a first step in such an examination. I apply the insights of labor economics to the incentives and rules in finance, in regulatory agencies, and in politics that helped produce the decisions that led to the financial collapse. Then I make the case that the U.S. needs groups representing labor from unions to non-governmental organizations (NGOs) to exercise countervailing power to Wall Street and business in economic policy-making to reform those incentives and rules for the good of workers and our market economy at large.

2. What Went Wrong: The Incentives of Big Bucks

The first thing that strikes anyone about the Wall Street debacle and the disasters that struck Enron and other firms earlier in the decade is the huge amount of money paid to those responsible for the disasters. Executive compensation in the U.S. allows top management to earn massive amounts for meeting or *seeming to meet* performance criteria that management sets for itself. In 2000 or so, American executives were making roughly 300 times the earnings of normal workers with the bulk of their earnings coming in the form of stock options and bonuses.⁷⁶ The top managers in finance were among the highest paid of all. U.S. capitalism has not always been marked by such earnings differentials. The exceptional pay of management reflects three to four decades of rising income inequality that brought Gini coefficients and other measures of inequality to levels comparable to those that existed before the Great Depression.⁷⁷ Much of the 1980s–2000s income gain in the U.S. went to the upper ten percent, while much of the gain among the upper ten percent went to the upper one percent, and much of the gain in the upper one percent went to the upper 0.1 percent and so on.⁷⁸

Finance benefited more than other sectors from the concentration of economic gains at the top of the income distribution. Compensation per full-time equivalent employee for security and commodity brokers in the finance sector rose from 146 percent above the national average of compensation per full-time equivalent employee in 1990 to 290 percent above

76. G. William Domhoff, *Wealth, Income, and Power*, WHO RULES AMERICA, Sept. 2005, <http://sociology.ucsc.edu/whorulesamerica/power/wealth.html>.

77. See Piketty & Saez, *supra* note 75.

78. See *id.*; Robert J. Gordon & Ian Dew-Becker, *Controversies about the Rise of American Inequality: A Survey 1* (Nat'l Bureau of Econ. Research, Working Paper No. 13982, 2008), available at <http://www.nber.org/papers/w13982>.

average in 2007.⁷⁹ In 1990, total compensation for security and commodity brokers was thirty-one percent of the compensation for federal civilian employees.⁸⁰ In 2007, it was ninety-three percent that of federal civilian employees.⁸¹ Much of the increased incomes went to those in the highest positions. In 2006, Wall Street paid out \$62 billion in bonuses.⁸² Some heads of hedge funds made around \$1 billion to or more a year.⁸³ In 2008, even the banks that received TARP government aid gave out huge bonuses.⁸⁴ Given the precarious state of the financial markets and the public outrage at the banking sector, this behavior has the flavor of “endgame bargaining” in which agents grab what they can as they go out of the door, fearful that there is no tomorrow. *Après moi, le déluge.*

In 2008, Greenspan opined that Wall Street collapsed in part because risk modelers limited their data analysis to periods of time when the market was doing well.⁸⁵ That the “best and brightest” or their bosses atop the big banks were not aware that they should take account of experiences in earlier periods boggles the mind. They had ample warning that something was amiss with risk models when LTCM crashed and that something was amiss with accounting practices when Enron crashed. Why did they fail to react? Rather than blaming ignorance or incompetence, economic analysis suggests that, *cui bono*, executives focused on short term data and ignored warning signs because such behavior was profitable for them. The compensation system for executives in the U.S. gives huge bonuses and stock options if executives report high profits and/or raise share prices. They can do this in several ways.

79. See Bureau of Economic Analysis, *Table 6.2C. Compensation of Employees by Industry*, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N> (choose table 6.2c, then choose 1990 for the “First Year” and “Last Year,” then click “Update”) (last visited Feb. 27, 2010); Bureau of Economic Analysis, *Table 6.2D. Compensation of Employees by Industry*, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N> (choose table 6.2d, then choose 2007 for the “First Year” and “Last Year,” then click “Update”) (last visited Feb. 27, 2010).

80. See Bureau of Economic Analysis, *Table 6.2C. Compensation of Employees by Industry*, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N> (choose table 6.2c, then choose 1990 for the “First Year” and “Last Year,” then click “Update”) (last visited Feb. 27, 2010).

81. See Bureau of Economic Analysis, *Table 6.2C. Compensation of Employees by Industry*, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N> (choose table 6.2c, then choose 1997 for the “First Year” and “Last Year,” then click “Update”) (last visited Feb. 27, 2010).

82. Mortimer B. Zuckerman, *We Deserve a Better Bailout*, U.S. NEWS & WORLD REP., Mar. 10, 2010, available at <http://www.usnews.com/opinion/mzuckerman/articles/2008/10/03/we-deserve-a-better-bailout.html>.

83. Jenny Anderson and Julie Creswell, *Top Hedge Fund Managers Earn over \$240 Million*, N.Y. TIMES, Apr. 24, 2007, http://www.nytimes.com/2007/04/24/business/24hedge.html?_r=1&fta=y&pagewanted=all.

84. Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, N.Y. TIMES, Jan. 29, 2009, available at <http://www.nytimes.com/2009/01/29/business/29bonus.html>.

85. Patrick Thibodeau, *Greenspan: Bad data hurt Wall Street computer models*, N.Y. TIMES, Oct. 23, 2008, available at <http://www.nytimes.com/external/idg/2008/10/23/23idg-Greenspan-Bad.html>.

The first way is to improve the real performance of their company, for instance by making better products or increasing productivity, both of which expand the production possibility frontier. This is the social justification for performance-based pay.

The second way is to redistribute economic rents from either workers (most of whom lack unions to protect them) or consumers (most of whom do not read the fine print of financial contracts) to the firm. It is striking that on the order of seventy-five percent of the credit card industry's consumer-fee income comes from overdraft and insufficient-funds charges, which at least in part represent consumer ignorance of the cost of those charges.⁸⁶ The industry's opposition to a consumer financial protection agency reflects the fear that protection against fraudulent or misleading financial products will squeeze profits and executive pay. This redistribution does not directly harm national output but enriches executives and shareholders at the expense of others in the economy.⁸⁷

The third mode of response is to game the compensation system. Since stock options are more valuable when share prices are more variable, one way to increase the value of options is to make riskier decisions than may be in the interest of the firm. Wm. Gerard Sanders and Donald Hambrick found that firms whose CEO compensation was loaded with options had greater variation in performance than other firms.⁸⁸ If the gains to the winners exceed the losses to the losers, this would raise total output and would likely be in the interest of the broader economy. But Sanders and Hambrick found that riskier behavior produced more big losses than big gains.⁸⁹ Another way to game the system is to report transactions on company income statements and balance sheets in ways that produce short-run profits that put options in the money. Another way is to rewrite and back-date stock options. In a simple maze-solving laboratory experiment with modest stakes for persons solving more mazes, Alexander Gelber and I found that greater incentives for coming higher in a tournament induced participants to misreport the number of mazes they had solved.⁹⁰ The massive sums available in finance provide far greater incentive for misrepresenting performance.

86. Jane J. Kim, *Bank Suspends Overdraft Fee Increase*, WALL ST. J., Apr. 14, 2009, available at <http://online.wsj.com/articles/SB123967277269015845.html>.

87. It may indirectly affect economic stability by increasing inequality, which leads consumers to take on greater debt and high earners to take on greater risks to reach the top of the income distribution.

88. Wm. Gerard Sanders & Donald C. Hambrick, *Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance*, 50 ACAD. OF MGMT. J. 1055, 1076 (2007).

89. *Id.*

90. Richard B. Freeman & Alexander M. Gelber, *Prize Structure and Information in Tournaments: Experimental Evidence*, 2 AM. ECON. J.: APPLIED ECON. 149 (2010).

For the most part, as Harvard's Rakesh Kurana and Andy Zelleke have stated, during the 1990s–2000s management seemed to operate corporations “for the purpose of creating vast wealth for senior executives.”⁹¹ Just as Bernard Madoff knew he was running a Ponzi scheme, the big Wall Street firms knew what they were doing when they packaged sub-prime mortgages and earned their fees by selling them quickly to others; as one portfolio manager put it, “a lot of people knew this was bogus, but the money was too good.”⁹² In 2008, the then-chairman of the SEC testified before Congress that “if honest lending practices had been followed, much of this crisis quite simply would not have occurred.”⁹³ In the lead-up to the collapse of the subprime mortgage market, Goldman Sachs and other banks sold collateralized debt obligations based on those mortgages to pension funds and other clients while they themselves bet against the securities.⁹⁴ This is the moral equivalent of a doctor giving medicine to a patient while taking out insurance on the patient's life. The head of AIG, Hank Greenberg, resigned in 2006, not because the firm inputted the wrong data into its risk models, but because it had acted fraudulently under his leadership.⁹⁵ The large banks that funded Enron's off-the-books deals *knew* that Enron's book-keeping was a shell game designed to make the firm appear profitable when it wasn't, but the banks kept making loans to it because it earned the banks and their directors huge profits.⁹⁶ Enron's directors should have questioned the practices, but management appointed them to support its decisions—not to challenge them on behalf of shareholders. Directors who challenged management would likely lose any chance that other firms would select them for their boards.⁹⁷

91. Rakesh Khurana & Andy Zelleke, *You Can Cap The Pay, But The Greed Will Go On*, WASH. POST, Feb. 8, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/02/06/AR2009020602794.html>.

92. Jill Drew, *Frenzy*, WASH. POST, Dec. 16, 2008, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/15/AR2008121503561.html>.

93. Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Testimony before the Committee on Oversight and Government Reform of the U.S. House of Representatives: Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation (Oct. 23, 2008), available at <http://www.sec.gov/news/testimony/2008/ts102308cc.htm> (agreeing with the earlier testimony of the SEC's former chief accountant).

94. Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 23, 2009, available at <http://www.nytimes.com/2009/12/24/business/24trading.html>.

95. Jenny Anderson, *Greenberg and A.I.G. Sever Ties*, N.Y. TIMES, Mar. 29, 2005, available at <http://www.nytimes.com/2005/03/29/business/29insure.html?ex=1269752400&en=50eeec86b4d23051d&ei=5090&partner=rssuserland>.

96. BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM* (2003).

97. THE WASHINGTON POST cites Fabrizio Ferri of Harvard Business School as noting that if you're a director and you go along with generous chief executive pay, “you get to sit on more boards.” David S. Hilzenrath, *Executive Pay*, WASH. POST Dec 21, 2008 available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/20/AR2008122000096.html>.

As criminal investigators, business reporters, and economic historians probe the behavior behind the financial implosion, I anticipate that they will find less incompetence or ignorance of what banks were doing with their shadow operations and more conscious venality, chicanery, and financial crime motivated by the chance to make huge sums of money.⁹⁸

Economics stresses conscious responses to incentives, but incentives can affect behavior unconsciously as well. Scientists whose research is supported by drug firms report more favorably on drugs than scientists whose research is funded elsewhere.⁹⁹ Some recipients of drug company support may consciously distort their results, but most presumably come up with the “right” answers through unconscious decisions made during their experiments. It is for this reason that the gold standard in clinical trials are double-blind studies in which neither the researcher nor the subjects know who is in the control or treatment groups and in which an independent lab that does not know which specimens come from which group does assays. I surmise that some of the amoral “greedy” decisions made by the bankers and financiers reflected unconscious responses to incentives as well as purposive policies to enrich themselves at the expense of shareholders, consumers, or workers.

Factors beyond incentives are also likely to have contributed to the amoral behavior by the leaders of finance. Many observers blame excessive risk-taking and financial crime on the decline of moral standards in society—the advent of Gordon Gecko morality that extolled greed and profits above all else.¹⁰⁰ In December 2009, Jeff Imhelt of General Electric at-

98. Not until four years after the 1929 Crash did investigators arrest Charles Mitchell, a leading banker, for evasion of income tax and not for another five years did they arrest the former head of the Stock Exchange, Richard Whitney, for grand larceny. See JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929* (7th ed. 1961).

99. Thomas E. Finucane & Chad E. Boulton, *Association of Funding and Findings of Pharmaceutical Research at a Meeting of a Medical Professional Society*, 117 *AM. J. MED.* 842, 843 (2004) (reporting that none of the 30 industry-supported studies that they examined gave a result unfavorable to the drug studied whereas one-third of studies that were not industry-supported had unfavorable findings); Joel Lexchin et al., *Pharmaceutical Industry Sponsorship and Research Outcome and Quality: Systemic Review*, 326 *BMJ* 1167, 1168 (2003) (reporting that systematic bias favors products made by the company funding the research); Veronica Yank, Drummond Rennie & Lisa A. Bero, *Financial Ties and Concordance Between Results and Conclusions in Meta-analyses: Retrospective Cohort Study* 335 *BMJ* 1202 (2007) (reporting that meta-analyses show that research with financial ties to one drug company are not associated with favorable results but with favorable conclusions).

100. John McCain spoke of “greed, corruption and excess” as “Wall Street treated the American economy like a casino.” Rick Klein, *McCain Blames Greed for Wall St. Mess; Obama Blames GOP*, ABC NEWS, Sept. 16, 2008, <http://abcnews.go.com/Politics/5050/story?id=5812268&page=1>. Charles Colson, the Watergate criminal who found new life as an evangelical prison ministry leader, declared that the problem was “greed unchecked by any moral restraint.” Charles Colson, *Topsy on Wall Street: A President’s Candid Comment*, <http://www.crosswalk.com/news/commentary/11579703/> (July 29, 2008). Greenspan referred to “an infectious greed [that] seemed to grip much of our business community” as if greed was not the putative motivating force for market capitalism. Harry Binswanger, *Green-*

tacked the executive class, of which he is a leading member: “We are at the end of a difficult generation of business leadership . . . tough-mindedness, a good trait, was replaced by meanness and greed, both terrible traits. Rewards became perverted. The richest people made the most mistakes with the least accountability.”¹⁰¹ Because the crime rate in the U.S. fell substantially in the same period,¹⁰² it is difficult to blame this behavior on any broad trend toward amoral or illegal actions. No roaring twenties Prohibition culture was sweeping the country. The meanness and greed was concentrated where those forms of behavior were most rewarded.

Another possible contributing factor to the behavior of financial bosses was that Wall Street attracted persons with less moral reservations about acceptable money-making behavior than it had in the past.¹⁰³ Selectivity is an important part of labor supply behavior. If one takes Bill Black’s title “The Best Way to Rob a Bank is to Own One”¹⁰⁴ seriously, it may be that the increased money at the top attracted persons with a greater criminal mentality to banking industry than in the years when the sector was less lucrative. Given the behavior of S&L bankers in the 1980s and of tobacco firm executives from the 1960s through the 1990s, however, I doubt that business leaders were any less moral in the run-up to the 2008 financial implosion than in earlier periods. It was simply that the incentives for amoral behavior were greater.

Another proposed explanation for the high risk-taking in financial markets is the “animal spirit” that Keynes viewed as a major force in speculative booms.¹⁰⁵ Recent studies that relate risk-taking to endocrines in

*span on “Infectious Greed”, CAPITALISM MAGAZINE, <http://www.capmag.com/article.asp?ID=1825> (Aug. 30, 2002). Playing the Clinton mantra, one religious leader explained “it’s the morality, sinner.” Ed Stoddard, *Evangelicals see moral decline in Wall St. woes*, REUTERS, Oct. 1, 2008, <http://www.reuters.com/article/idUSTRE4905RF20081001>.*

101. See Francesco Guerrera, *GE Chief Attacks Executive ‘Greed’*, FIN. TIMES, Dec. 9, 2009, available at http://www.ft.com/cms/s/0/fe1e3f7c-e507-11d0-9a25-00144feab49a.html?ncklick_check=1.

102. See FED. BUREAU OF INVESTIGATION, CRIME IN THE UNITED STATES 2005: TABLE 1, http://www.fbi.gov/ucr/05cius/data/table_01.html.

103. Laboratory studies of public goods games found that business students made fewer socially desirable investments than students in other fields. Lorenz Goette, David Huffman & Stephan Meier, *The Impact of Group Membership on Cooperation and Norm Enforcement: Evidence Using Random Assignment to Real Social Groups*, 96 AM. ECON. REV. 212 (2006). Stephan Meier and Bruno Frey reported that selectivity was the main factor explaining the less socially responsible behavior of Swiss business students than others. Bruno S. Frey & Stephan Meier, *Social Comparisons and Pro-social Behavior: Testing “Conditional Cooperation” in a Field Experiment*, 94 AM. ECON. REV. 1717 (2004). By contrast, Elizabeth Maynes and Charles Bram Cadsby reported that nurses made socially desirable decisions. Charles Bram Cadsby & Elizabeth Maynes, *Choosing between a socially efficient and free-riding equilibrium: Nurses versus economics and business students*, 37 J. OF ECON. BEHAV. & ORG. 183 (1998).

104. WILLIAM K. BLACK, *THE BEST WAY TO ROB A BANK IS TO OWN ONE* (2005).

105. “The instability proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic . . . can only be taken as the

the brain and that measure which parts of the brain “light up” when people take financial risks provide a scientific underpinning for this hypothesis. Studying floor traders in London, J.M. Coates and J. Herbert reported that the traders’ morning testosterone levels predicted trading results, while their levels of cortisol rose with the variance of trading results.¹⁰⁶ They speculate that the steroids could shift risk preferences over time and affect a trader’s ability to make rational choices in risky situations. Apicella reported that men with higher testosterone levels take greater risks in a financial investment game,¹⁰⁷ which led one news columnist to claim that “the greedy architects of the new recession—can’t help themselves.”¹⁰⁸ Zald found that persons with fewer mid-brain dopamine receptors are more likely to take risks.¹⁰⁹ Camelia Kuhnen and Brian Knutson related brain regions innervated by serotonergic and dopaminergic neural pathways to individuals’ financial risk-taking behavior.¹¹⁰ Knutson showed that the parts of the brain that light up with erotic pictures also light up with financial gambles and that young men make greater gambles after seeing sexually arousing pictures.¹¹¹ Evidence that the genes that regulate dopamine and serotonin are also significant in risk-taking in investment decisions carries the biology story a step further.¹¹² Still, it is hard to generalize from the brain activity of individuals to the aggregate market behavior of thousands or tens of thousands of people. Excessive testosterone or insufficient dopamine receptors may contribute to high risk-taking and short-termism, but, as with morality, my guess is that this is of second order importance.

The famous Milgram social obedience¹¹³ and Zimbardo Stanford Prison¹¹⁴ experiments shocked social science by showing how easy it is to

result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* 161 (1936).

106. J. M. Coates and J. Herbert, *Endogenous Steroids and Financial Risk Taking on a London Trading Floor*, 105 PNAS 6167 (2008).

107. Coren L. Apicella et. al, *Testosterone and Financial Risk Preferences*, 29 EVOLUTION AND HUMAN BEHAVIOR 384 (2008).

108. Shannon Rupp, *Could We Blame the Financial Crisis on Too Much Testosterone? Harvard Researchers Say Yes*, ALTERNET, Oct. 20, 2008, available at http://www.alternet.org/economy/103502/could_we_blame_the_financial_crisis_on_too_much_testosterone_harvard_researchers_say_yes/.

109. David H. Zald et al., *Midbrain Dopamine Receptor Availability Is Inversely Associated with Novelty-Seeking Traits in Humans*, 28 J. OF NEUROSCIENCE 14372 (2008).

110. Camelia M. Kuhnen & Brian Knutson, *The Neural Basis of Financial Risk Taking*, 47 NEURON 763 (2005).

111. Brian Knutson et al., *Nucleus Accumbens Activation Mediates the Influence of Reward Cues on Financial Risk-Taking*, 19 NEUROREPORT 509 (2008)

112. Camelia M. Kuhnen & Joan Y. Chiao, *Genetic Determinants of Financial Risk Taking*, 4 PLOS ONE, Feb. 2009, at 1 (2009).

113. STANLEY MILGRAM, *OBEDIENCE TO AUTHORITY: AN EXPERIMENTAL VIEW* (1974).

induce people to behave reprehensibly.¹¹⁵ They also provide insight into the behavior in finance in the 1990s–2000s. Financial firms have a culture in which the sole goal is to make money. If it is relatively easy to motivate people to give huge electric shocks to others in an experiment or to treat “prisoners” badly in a fake prison situation, it is presumably even easier to motivate people to exploit regulatory loopholes and take advantage of shareholder or consumer ignorance or worker weakness to make money in institutions devoted to money-making. Just as the pretty lady in the apocryphal Groucho Marx story could see herself sleeping with the man for one million dollars but not for one dollar,¹¹⁶ I imagine that if the earnings from financial crime were lower, Ken Lay, Bernard Madoff, and the other leaders of finance and business who betrayed their responsibility to society might have behaved honorably, whereas with sufficiently high stakes even presumptively honest folk like you or me could find ourselves selling risky securities as if they were safe, reporting revenues and costs in ways that put our options in the money, or betting against collateralized debt obligations that we sold to clients as safe investments.

In short, the hypothesis that seems most relevant to understanding the behavior that led Wall Street to disaster is the orthodox economic “every man has his price”¹¹⁷ theorem that stresses the power of incentives to induce people to undertake actions they might not otherwise do. The implication of this analysis is the opposite of the usual supply-side claim that huge inequalities are needed to motivate those at the top to make the best decisions. To the contrary, it suggests that smaller rewards at the top are needed

114. PHILLIP G. ZIMBARDO, *QUIET RAGE: THE STANFORD PRISON EXPERIMENT* (1971).

115. Dominick Packer reports that about two-thirds of the participants in the Milgram experiment went beyond 150 volts where the person being shocked yelled “Stop, let me out” while about half kept administering the punishment to the 450 volts at which the experiment ended. Dominic J. Packer, *Identifying Systematic Disobedience in Milgram’s Obedience Experiments: A Meta-Analytic Review*, 3 *PERSPECTIVES ON PSYCHOL. SCI.* 301, 302 (2008). Burger replicated the finding that two-thirds went beyond the 150 volts. See Jerry Burger, *Replicating Milgram: Would People Still Obey Today?*, 64 *AMERICAN PSYCHOLOGIST* 1 (2009). The economics experiment would be to see how such behavior responded to monetary incentives: would more people go to the 450 volts if paid to do so.

116.

Groucho Marx to some film starlet: Would you sleep with me for a million dollars?

Actress: Yes.

Groucho: Would you sleep with me for a a dollar?

Actress: No! What do you think I am?

Groucho: I thought we had established that and we’re now haggling over the price.

See <http://forums.joltonline.com/archive/index.php/t-428624.html>; see also <http://letters.salon.com/mwt/broadsheet/2008/09/09/virginity/view/?show=all>. This story is also attributed to George Bernard Shaw, Winston Churchill, and Mark Twain. See Wikipedia, George Bernard Shaw, http://en.wikiquote.org/wiki/George_Bernard_Shaw (last visited Apr. 19, 2010).

117. See e.g., Sir Robert Walpole, 1st Earl of Orford, in 10 *NOTES AND QUERIES: A MEDIUM OF INTERCOMMUNICATION FOR LITERARY MEN, GENERAL READERS, ETC.* 368 (1907).

to reduce the amount of “bogus” money-making and unscrupulous risk-taking that underlay the Wall Street implosion. Lower pay at the top, which means less inequality overall, is better for the economy, at least at the levels of earnings that preceded the implosion of Wall Street and that, at this writing, are still found among the bankers and executives running major U.S. public corporations.¹¹⁸

3. What Went Wrong: The Incentives to Regulate

All economies have legal rules and regulations to protect property and regulate economic transactions. The limited liability corporation did not develop in an Arrow-Debreu vacuum but arose as a product of corporate law with rights, privileges, and liabilities distinct from those of its members.¹¹⁹ Legal protection of property rights is widely viewed as one of the necessary elements for a free-market, capitalist economy.¹²⁰ In finance, the U.S. and other countries regulate transactions in diverse ways, such as limiting margin purchases of shares, outlawing insider trading, and requiring that banks and insurance companies meet certain capital requirements to conduct their business.¹²¹ The crash of the stock market and collapse of commercial banking in 1933 led Congress to enact the Glass-Steagall Act to separate commercial banking from the riskier investment banking; to create the Federal Deposit Insurance Corporation to insure deposits; and to establish the SEC a year later to monitor securities firms, brokers, investment advisers, rating agencies, and private regulatory organizations. Myriad other federal agencies are involved in monitoring and regulating finance. In addition, state attorney generals have the right to enforce state “fair lending” laws and regulations—a right recently upheld by the Supreme Court in *Cuomo v. Clearing House Association, L.L.C.*¹²² over the objections of the Obama Administration. At the top of the financial sector, the Federal Reserve is responsible for maintaining the stability of the financial system and containing systemic risk in financial markets.

Deregulation weakened the authority of federal agencies over banks and financial houses, but regulators still had sufficient power to influence

118. Edmund L. Andrews & Vikas Bajaj, *U.S. Plans \$500,000 Cap on Executive Pay in Bailouts*, N.Y. TIMES, Feb. 4, 2009, <http://www.nytimes.com/2009/02/04/business/04pay.html/>.

119. Similarly the trade union is a product of labor law with rights, privileges, and liabilities distinct from its members.

120. JAMES GWARTNEY & ROBERT LAWSON, ECONOMIC FREEDOM OF THE WORLD: 2009 ANNUAL REPORT 6 (2009), available at http://www.freetheworld.com/2009/reports/world/EFW2009_ch1.pdf.

121. See, e.g., U.S. Sec. & Exch. Comm’n, *How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* (Jan. 20, 2010), <http://www.sec.gov/about/whatwedo.shtml>.

122. *Cuomo v. Clearing House Ass’n, L.L.C.*, 129 S.Ct. 2710 (2009).

the behavior of those firms had they acted aggressively. Prior to the financial implosion, however, the top regulators showed no desire to do their job. In 2000, Federal Reserve Commissioner Ned Gramlich expressed concern over rising house prices and urged Fed examiners to investigate mortgage lenders affiliated with national banks.¹²³ Greenspan ignored him. In 2001, “Treasury official Sheila C. Bair tried to persuade subprime lenders to adopt a code of ‘best practices.’”¹²⁴ They shrugged her off and the Bush Administration’s Treasury Department did nothing.¹²⁵ From 2000 through 2008, certified fraud examiner Harry Markopolous presented the SEC with evidence that Bernard Madoff was running a Ponzi scheme.¹²⁶ To make the point crystal clear Markopolous’s 2005 report was titled “The World’s Largest Hedge Fund is a Fraud.”¹²⁷ The agency did nothing.

B. *Why Did Regulators Abscond from their Responsibilities?*

Some regulators had an ideological opposition to intervening in markets. Federal Reserve Chairman Alan Greenspan, whose agency had the greatest responsibility for maintaining a stable banking system, seems to have been ideologically blind to reality. Though he had defended Charles Keatings’ Lincoln Savings and Loan bank during the 1980s S&L disaster¹²⁸ and saw LTCM collapse during his watch at the Federal Reserve, Greenspan ignored multiple warnings to address the dangers posed by subprime lending. He believed that the market embodied all of the relevant

123. Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, available at <http://www.nytimes.com/2007/12/18/business/18subprime.html>.

124. *Id.*

125. *Id.*

126. Harry Markopolous, Chartered Financial Analyst, Certified Fraud Examiner, Testimony before the House Comm. on Fin. Servs. (Feb. 4, 2009), available at <http://online.wsj.com/public/resources/documents/MarkopolousTestimony20090203.pdf>.

127. Michael Richardson, *Madoff’s \$50 billion swindle was Reported to SEC for years by Boston watchdog with no agency action*, EXAMINER.COM, Jan. 8, 2009, <http://www.examiner.com/x-1969-Boston-Progressive-Examiner~y2009m1d8-Madoffs-50-billion-swindle-was-reported-to-SEC-for-years-by-watchdog-with-no-agency-action>.

128. In 1985 Greenspan sought to gain Lincoln Savings an exemption from a rule forbidding substantial investments in risky activities. Nathaniel C. Nash, *Greenspan’s Lincoln Savings Regret*, N.Y. TIMES, Nov. 20, 1989, available at <http://www.nytimes.com/1989/11/20/business/greenspan-s-lincoln-savings-regret.html>. When the bank went bankrupt and Keating was found to be a crook, Greenspan was “thoroughly surprised by what has happened to Lincoln.” *Id.* Later, as head of the Federal Reserve, Greenspan worked with the first Bush Administration to bail out the S&L sector, agreeing to pump billions of dollars in loans into threatened thrifts if necessary. John H. Berry, *Fed Pledges Temporary Aid to S&Ls; Funds Promised Until Bailout Plan Is Law*, WASH. POST, Feb. 24, 1989, available at

[http://pqasb.pqarchiver.com/washingtonpost/access/73780076.html?FMT=ABS&FMTS=ABS:FT&date=Feb+24%2C+1989&author=John+M.+Berry&pub=The+Washington+Post+\(pre-1997+Fulltext\)&edition=&startpage=f.01&desc=Fed+Pledges+Temporary+Aid+to+S%26Ls%3B+Funds+Promised+Until+Bailout+Plan+Is+Law](http://pqasb.pqarchiver.com/washingtonpost/access/73780076.html?FMT=ABS&FMTS=ABS:FT&date=Feb+24%2C+1989&author=John+M.+Berry&pub=The+Washington+Post+(pre-1997+Fulltext)&edition=&startpage=f.01&desc=Fed+Pledges+Temporary+Aid+to+S%26Ls%3B+Funds+Promised+Until+Bailout+Plan+Is+Law).

information and, accordingly, he believed that it was impossible for a regulator to do any better.

In other cases it was the politicians who sought to prevent regulators doing their job. In 2005, the head of the Securities and Exchange Commission, William Donaldson, resigned after criticism from the Bush administration when he sought to have the agency take a more active regulatory role.¹²⁹ They replaced him with Christopher Cox, a former Republican congressman ideologically committed to do as little regulation as possible.¹³⁰

But in the failure to regulate there is also a large role for economic self-interest. Top government officials often work for the sectors that they regulate. Some come from the sector, which usually makes them sensitive to its interests. Some obtain lucrative jobs in the sector when they leave the government. Robert Rubin and Henry Paulson were Goldman Sachs chairmen before becoming Secretary of Treasury.¹³¹ Rubin went from Secretary of Treasury to Senior Counselor and Chairman of Citigroup—which benefited from the repeal of Glass-Steagall that he had championed—where he earned \$115 million for the advice and leadership that eventually brought Citigroup to the brink of bankruptcy.¹³² Prior to becoming chief economic advisor to President Obama, Larry Summers received millions of dollars from the hedge fund D.E. Shaw and huge speaking fees from other Wall Street firms.¹³³ Leaving the Federal Reserve, Greenspan took a job with the investment management firm PIMCO—which has close ties with the Treasury and the Federal Reserve—and joined the advisory board of the hedge fund Paulson & Co.¹³⁴ And so on. Someone paid huge sums in the

129. Stephen Labaton, *S.E.C.'s Chairman Is Stepping Down From Split Panel*, N.Y. TIMES, June 2, 2005, available at http://www.nytimes.com/2005/06/02/business/02sec.html?_r=1&pagewanted=print.

130. Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, available at <http://www.nytimes.com/2008/09/27/business/27sec.html?pagewanted=print>. This produced Calvin Trillin's limerick: "Though Donaldson came from the Street, He plainly was policing his beat. And so they replaced him with Cox. The henhouse goes back to a fox." Calvin Trillin, *William Donaldson is Replaced . . .*, THE NATION, June 27, 2005, available at <http://www.thenation.com/doc/20050627/trillin>.

131. Fred Lucas, *In Goldman Sachs We Trust: How The Left's Favorite Bank Influences Public Policy*, FOUND. WATCH, Oct. 2008, 1, 3, available at <http://www.capitalresearch.org/pubs/pdf/v1222698871.pdf>.

132. Eric Dash & Julie Creswell, *The Reckoning: Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, available at <http://www.nytimes.com/2008/11/23/business/23citi.html?pagewanted=all>; Ken Brown & David Enrich, *Rubin, under Fire, Defends His Role at Citi—'Nobody Was Prepared' for Crisis of '08*, WALL ST. J., Nov. 29, 2008, available at <http://online.wsj.com/article/SB122791795940965645.html>.

133. John D. McKinnon & T.W. Farnam, *Hedge Fund Paid Summers \$5.2 Million in Past Year*, WALL ST. J., April 5, 2009, available at <http://online.wsj.com/article/SB123879462053487927.html>.

134. Sree Vidya Bhaktavatsalam, *Greenspan Helped Pimco Make Billions, Gross Says (Update3)*, BLOOMBERG.COM, May 21, 2008, available at

past or likely to receive huge sums in the future by the firms that he/she regulates or sets policy for is likely to make decisions more favorable to that group than someone with no such monetary links.

The technical word for officials becoming so entwined with the group they regulate that they are more likely to represent the interests of that group than that of the public is “regulatory capture.” Galbraith described the process in life cycle terms: “In youth [regulatory agencies] are vigorous, aggressive Later they mellow, and in old age—after a matter of ten or fifteen years—they become, with some exceptions either an arm of the industry they are regulating or senile.”¹³⁵ There is a psychological component to this, as regulators invariably spend lots of time with the people they are regulating and begin to see things from the perspective of those people, per the Stockholm or Patty Hearst syndrome in which kidnap victims sympathize and identify with their kidnappers.¹³⁶ But many persons in top executive branch jobs have no need to “go native” as they were themselves former Wall Street operatives. The Obama administration—like the Bush administration, Clinton administration, and other administrations before it—appoints former employees of Wall Street to important jobs in the Treasury Department and elsewhere in the government, presumptively because of their expertise in the industry. The Wall Street firms encourage their top employees to accept such jobs, presumably as a way to give them influence over decisions.

Arguably more important than regulatory capture of agencies, however, is what might be called the political capture of politicians. This occurs through the interested groups making large campaign contributions and deploying armies of lobbyists to argue their case with Congress and agencies. Between 1998 and 2008, the financial sector—finance, insurance, and real estate—contributed \$1.74 billion to political campaigns and spent \$3.44 billion on lobbying for a total investment in political capture of \$5.18 billion.¹³⁷ In 2007, the financial sector employed 2,996 lobbyists—many of whom were previously high-ranking officials or employees in the Executive Branch or Congress.¹³⁸ Wall Street firms contributed disproportionately to politicians on banking and finance committees. THE NEW YORK

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aifsOWlwkqYM&refer=home;> Devin Leonard, *Treasury's Got Bill Gross on Speed Dial*, N.Y. TIMES, June 21, 2009, available at <http://www.nytimes.com/2009/06/21/business/21gross.html>.

135. GALBRAITH, *supra* note 98, at 171.

136. Laura Fitzpatrick, *Stockholm Syndrome*, TIME, Aug. 31, 2009, available at <http://www.time.com/time/nation/article/0,8599,1919757,00.html>.

137. ROBERT WEISSMAN & JAMES DONAHUE, SOLD OUT: HOW WALL STREET AND WASHINGTON BETRAYED AMERICA, 103 (2009), available at http://www.wallstreetwatch.org/reports/sold_out.pdf.

138. *Id.* at 100.

TIMES noted that before the financial implosion Senator Schumer of New York “embraced the industry’s free-market, deregulatory agenda more than almost any other Democrat in Congress, even backing some measures now blamed for contributing to the crisis.”¹³⁹ Finance is an important New York industry, and financial firms contributed heavily to the Democratic Senatorial Campaign Committee which Schumer headed. In 2009, Wall Street donated \$1.65 million to Schumer —nearly twice that of any other senator.¹⁴⁰

Finally, there is the capture of regulators by the mood of the times. The American saying is “If it ain’t broke, don’t fix it.” The British say “Leave well enough alone.” The Evita song is:

When the money is rolling in you don’t ask how When the money keeps rolling out you don’t keep books. You can tell you’ve done well by the happy grateful looks. Accountants only slow things down, figures get in the way Rolling, rolling, rolling.¹⁴¹

From the late 1990s through the mid 2000s, the country applauded Greenspan for letting things roll. The same pressures to let things roll operate inside firms. A CEO who tried to stop investment managers from selling lucrative toxic assets to clients at the height of the Wall Street bubble would have found the managers shifting to firms where they could sell those securities and make lots of money. The loss of investment managers and short term profits would have put the CEO’s career in jeopardy.

In 1961, President Eisenhower warned the U.S. about the industrial-military complex: “In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex. The potential for the disastrous rise of misplaced power exists and will persist.”¹⁴² Today, he would warn the country about the “financial-political complex” and possibly add additional commentary on the difficulty of reducing that influence once the complex has gained it.

139. Eric Lipton & Raymond Hernandez, *The Reckoning: A Champion of Wall Street Reaps Benefits*, N.Y. TIMES, Dec. 14, 2008, available at <http://www.nytimes.com/2008/12/14/business/14schumer.html>. Schumer led Democratic support for the Gramm-Leach-Bliley Bill, sought to limit efforts to regulate credit-rating agencies, stopped a proposal to double taxes on executives at hedge funds and private equity firms, and helped enact legislation that cut fees from Wall Street firms to the SEC, thereby limiting the agency’s ability to fund regulatory activities. *Id.*

140. National Journal.com, *Schumer Gets The Most Money From Wall Street*, NAT’L J.’S UNDER THE INFLUENCE, Sept. 28, 2009, available at <http://undertheinfluence.nationaljournal.com/2009/09/schumer-gets-the-most-money-fr.php>.

141. TIM RICE & ANDREW LLOYD WEBBER, *And The Money Kept Rolling In (And Out)*, on HIGHLIGHTS FROM *EVITA* (MCA Records 1976).

142. Dwight D. Eisenhower, President, Farewell Address to the Nation (Jan. 17, 1961), available at <http://www.americanrhetoric.com/speeches/dwightdeisenhowerfarewell.html>.

C. *Reforming Finance: Countervailing Power of Labor to the Rescue?*

After the collapse of the U.S. financial market in 2008 and the massive bailout of the sector and stimulus of the real economy, I anticipated that the U.S. would move decisively to reform banking and finance, as the Roosevelt Administration had done in the early 1930s.¹⁴³ There could be no more propitious time to fix the Achilles heel of capitalism and rebuild the American economic model.¹⁴⁴ Given what Wall Street had done to the economy, what politician would dare oppose reforming finance? Surely the bankers saved by government moneys would lie low in Washington debates over the direction of reforms. To my surprise, the opposite has occurred. Once government moneys restored stability to financial markets, the bankers went back to their usual business. After the federal government promised billions to bail out AIG, the company spent \$444,000 for executives to party at an exclusive California spa.¹⁴⁵ Nearly half a million for a party paid by bailout moneys? Chickenfeed. The head of AIG complained about efforts to rein in its pay on the grounds that the firm would have trouble attracting and retaining “the best and the brightest . . . if employees believe that their compensation is subject to continued and arbitrary adjustment by the U.S. Treasury.”¹⁴⁶ In 2008, nine Wall Street investment banks that relied on TARP money and government support for their survival managed to find nearly \$33 billion to pay in executive and employee performance bonuses.¹⁴⁷ In 2009, reveling in the huge profits that Goldman Sachs made after government guarantees, access to cheap money, and the favorable treatment its friends in Washington had given the firm, Goldman’s CEO, Lloyd Blankfein, declared that the bank was “doing God’s

143. In its first year, it enacted Glass-Steagall Act and the Securities Act of 1933 to protect purchasers of shares. BASIL RAUCH, *THE HISTORY OF THE NEW DEAL* 57, 82–83 (1944). In year two it established the SEC and the Federal Housing Administration to provide mortgage insurance for home purchases. *Id.* at 137, 170.

144. In 2009, seventy-five percent of Americans were dissatisfied with banking. Press Release, Alix Partners, thirty-six percent of Likely Voters Say Attitude Toward Banks Will Affect their Vote (Dec. 15, 2009), available at <http://www.alixpartners.com/en/MediaCenter/PressReleases/tabid/58/language/en-US/ItemID/29/Default.aspx>. Trust in banking fell more than trust in any other industry between 2008 and 2009. EDELMAN, 2009 EDELMAN TRUST BAROMETER 11 (2009), http://www.edelman.com/trust/2009/docs/Trust_Book_Final_2.pdf.

145. Associated Press, *AIG Draws Fire for Executives’ \$440,000 Post-Bailout Retreat at Posh California Resort*, Oct. 7, 2008, available at <http://www.foxnews.com/story/0,2933,434223,00.html>.

146. Gene Bloch, *Treasury pressure leads to AIG scaling back bonuses*, CNN.COM, Mar. 15, 2009, <http://www.cnn.com/2009/US/03/14/aig.bonuses/index.html>.

147. Susanne Craig & Deborah Solomon, *Bank Bonus Tab: \$33 Billion*, WALL ST. J., July 31, 2009, available at <http://online.wsj.com/article/SB124896891815094085.html>.

work.”¹⁴⁸ Public outrage forced the heads of Goldman, JP Morgan, and Citigroup, among others, to forgo or reduce the bonuses for themselves, but they still paid massive amounts to others in their firms and gave themselves options and shares that would benefit from increased share prices in place of their regular bonuses.¹⁴⁹ And nothing stopped the banks from using their recovered profitability to contribute to politicians and lobby against reforms that might reduce their power and income. In 2009, financial institutions gave some \$78 million to federal candidates and party committees—more money than any other sector—and signed up seventy former members of Congress as lobbyists.¹⁵⁰

Despite widespread concern about the moral hazard of banks “too big to fail,” not until the Democrats lost the January 2010 Massachusetts election did the Obama Administration begin to address ways to shrink the remaining big banks or separate commercial and investment banking.¹⁵¹ Neither the Administration nor Congress sought to reform the credit-rating industry that had failed abysmally to differentiate safe from risky securities, presumably in part because the industry got its income from the firms that issue securities. Similarly, at this writing, there is no effort to regulate hedge funds, put derivatives trades on a regular exchange, or consider more radical ideas such as requiring that new financial products meet some risk standards before being issued (just as new drugs must meet U.S. Food and Drug Administration tests before approved for sale) or of limiting the investment of tax-privileged moneys such as pensions in relatively safe vehicles. Seemingly less subject to political and regulatory capture, the head of the United Kingdom’s Financial Services Agency, Adair Turner, and the head of the Bank of England, Mervyn King, pressed for their government to undertake more dramatic changes, such as taxing financial transactions or breaking up the big banks.¹⁵²

148. John Arlidge, *I’m Doing ‘God’s Work’. Meet Mr. Goldman Sachs*, THE TIMES, Nov. 8, 2009, available at http://www.timesonline.co.uk/tol/news/world/us_and_americas/article6907681.ece.

149. Michael Shnayerson, *The Economic Crisis, Wall Street’s \$18.4 Billion Bonus*, VANITY FAIR, March 2009, available at <http://www.vanityfair.com/politics/features/2009/03/wall-street-bonuses200903>.

150. Elizabeth Newlin Carney, *Big Banks Are Back In The Lobbying Game*, NAT’L J.’S UNDER THE INFLUENCE, <http://undertheinfluence.nationaljournal.com/2009/12/big-banks-are-back-in-the-lobb.php>.

151. Michael Hirsch, Web Exclusive, *The Politics of Hubris*, NEWSWEEK, Jan. 20, 2010, available at <http://www.newsweek.com/id/231674>. Senators McCain and Cantwell proposed reinstating Glass-Steagall which the Obama Administration Treasury dismissed derisively: “going back to Glass-Steagall would be like going back to the Walkman.” Michael Hirsch, Web Exclusive, *An Odd Post-Crash Couple*, NEWSWEEK, Dec. 15, 2009, <http://www.newsweek.com/id/226938>.

152. Adair Turner, Chairman, Fin. Servs. Agency, Mansion House Speech (Sept. 22, 2009), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml; Jill Treanor, *King calls for banks to be ‘cut down to size’*, GUARDIAN, June 17, 2009, available at <http://www.guardian.co.uk/business/2009/jun/17/king-in-bank-reform-call>.

The high water mark for reform in 2009 was the House of Representatives' bill that establishes a Consumer Financial Protection Agency (CFPA) to protect consumers against unfair practices in mortgages and credit cards and imposes greater oversight and capital requirements for the largest banks and Wall Street firms.¹⁵³ At the same time, however, the bill took a step backwards by including a federal preemption clause that forbids states from adding greater protections for consumers.¹⁵⁴ At year's end, the U.S. Chamber of Commerce and other business groups began a major media campaign to derail the CFPA.¹⁵⁵ If they weaken it enough and keep states from acting independently to protect citizens, the Consumer Financial Protection Agency might end up actually strengthening their ability to deceive consumers about their products. Given that the Senate seems less attuned to financial reform, the final outcome is likely to be something far weaker than the House bill in any case.

To the extent that my analysis that "the money made them do it" is a correct reading of what produced the risk-taking, chicanery, and financial crime or near-crime that led to the Wall Street implosion, the failure to seek reforms in executive pay packages suggests that much the same behavior will continue. It is not a matter of lack of policy instruments to regulate compensation. There are ways in which government actions can pressure firms to alter executive compensation.¹⁵⁶ Congress could use the tax system to change executive compensation, for instance, by allowing firms to deduct bonus pay or options as costs of business only if that pay is tied to long-term performance or includes claw-back provisions. It could seek changes in corporate governance to strengthen the position of shareholders on executive compensation. It could make backdating options illegal. It could introduce non-compete clauses for top government officials to constrain the financial-political complex. The Treasury's special master for compensation, Kenneth Feinberg, has sought to limit pay in firms with

153. Shahien Nasiripour & Jeff Muskus, *House Passes Wall Street Reform Bill With Zero GOP Votes*, HUFFINGTON POST, Dec. 11, 2009, http://www.huffingtonpost.com/2009/12/11/house-passes-financial-re_n_389267.html.

154. Arthur Delaney, *Melissa Bean: A Democrat Bankers Bank On*, HUFFINGTON POST, Feb. 10, 2010, http://www.huffingtonpost.com/2010/02/02/melissa-bean-a-democrat-b_n_400993.html?view=print. The amendment was introduced by Representative Melissa Bean of Illinois, who received considerable campaign contributions from Wall Street. *Id.*

155. Peter H. Stone, *Chamber Guns for CFPA*, NAT'L J.'S UNDER THE INFLUENCE, Dec. 17, 2009, available at <http://undertheinfluence.nationaljournal.com/2009/12/chamber-plans-cfpa-attacks.php>.

156. Lucian Bebchuk and Jesse Fried provide one analysis but others also address the issues. LUCIAN A. BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); see also GIAN LUCA CLEMENTI ET AL., *WHITE PAPERS, CHAPTER 8: EXECUTIVE SUMMARY, RETHINKING COMPENSATION IN FINANCIAL FIRMS 1-2*, available at http://whitepapers.stern.nyu.edu/docs/white_papers_ch08.pdf.

TARP moneys, though seemingly with limited success.¹⁵⁷ Many of the firms have repaid the moneys rapidly so that the top executives can once again cash in big time.¹⁵⁸ Others have pressed back at restrictions, leading one observer to compare the pay czar to a puppy up against a bunch of nasty alley cats.¹⁵⁹ The United Kingdom seems to have been more successful, at least in 2009, in addressing compensation issue. It raised its top marginal rate by ten percentage points so that the wealthy would pay more of the cost for saving the bank sector.¹⁶⁰ A more progressive income tax almost surely reduces incentives at the top. The United Kingdom also imposed a fifty percent tax on banks paying staff bonuses of more than £25,000, despite the complaints and threats from the industry.¹⁶¹ Barring a second collapse of the U.S. financial sector, there seems little likelihood that the U.S. will undertake major reforms in its mode of compensation or operation, unless new powerful groups emerge to challenge Wall Street and its minions on the appropriate rules and regulations to reduce the incentives for risk-taking, chicanery, and financial crime that endanger the real economy. In my Piper Lecture in March 2009, I suggested that the only way such a challenge could emerge would be if groups concerned with the well-being of workers, from trade unions to NGOs, placed both financial reform and building a new financial architecture for sustainable growth at the top of their agenda. From the perspective of standard economics, the notion that unions and public interest groups, be they on the right or left of the political spectrum, might improve the operation of the economy by providing a “balance” or “countervailing power” to the forces of capital is a radical one. Standard models generate desirable market outcomes through competition among agents on the same side of the market. These models have no place for third parties or competition between groups on opposite sides of the market.

157. Bob Cusack & Silla Brush, *Pay Czar: You're worth less than you think*, THE HILL, Feb. 24, 2010, available at <http://thehill.com/homenews/administration/83323-pay-czar-youre-worth-less-than-you-think>.

158. Wyatt Andrews, *Why Did Banks Pay Back Bailout Money?*, CBSNEWS.COM, Dec. 14, 2009, <http://www.cbsnews.com/stories/2009/12/14/eveningnews/main5979279.shtml>.

159. Brent Dyer, *'Pay czar' watchdog looks like puppy*, AUSTIN BUS. J., Jan. 1, 2010, available at <http://www.bizjournals.com/austin/stories/2010/01/04/editorial2.html>.

160. HM Revenue & Customs: Rates & Allowances—Income Tax, <http://www.hmrc.gov.uk/rates/it.htm> (last visited Mar. 18, 2010); Ashley Seager & Kathryn Hopkins, *Budget 2009: Rich face 50% top tax rate above £150,000*, GUARDIAN, April 22, 2009, available at <http://www.guardian.co.uk/uk/2009/apr/22/budget-2009-alistair-darling-taxation>.

161. Sara Schaefer Munoz et al., *France Joins U.K. Bonus Tax; Not Germany, U.S.*, WALL ST. J., Dec. 14, 2009, available at <http://online.wsj.com/article/SB10001424052748704193004574588223449160530.html>.

But the problem of reforming a sector is not the same as the problem of reaching an appropriate market solution conditional on a given set of legal rules and regulations for the operation of the market. When the rules for the way markets operate are at stake, countervailing power between parties on different sides of a market—labor and capital—may be not only important in generating good social outcomes, but potentially necessary. It is even possible that countervailing power can produce economic outcomes closer to the free-market ideal than outcomes generated by a system in which one side of the market—capital—writes its own rules.

Calling for countervailing power from labor to reform the financial sector and build a new U.S. economic model may seem unrealistic to many. Just one year after the Wall Street Journal declared the death of Wall Street,¹⁶² the surviving banks seem as powerful in Washington as before while, by contrast, the strength of labor has seemingly fallen. In 2009, the share of workers in private sector unions dropped to a bare 7.2 percent.¹⁶³ The Service Employees International Union, one of the country's most dynamic organizations, is engaged in internal strife with its workers.¹⁶⁴ The union movement has largely given up on the Employee Free Choice Act, on which it had pinned great hopes for limiting employer opposition to unionism.¹⁶⁵

At the same time, however, there is an increasing recognition that reform of finance for the benefit of citizens outside of Wall Street requires greater activism on the part of groups outside of the small world of finance and financial experts. In 2009, nearly 200 U.S. organizations, of which the AFL-CIO is among the most prominent, formed the Americans for Financial Reform to spearhead a campaign for reform in banking and finance. The statement below from the group's website is the clarion call for new voices and influences in reforming the U.S. financial sector:

For too long, the rules of Wall Street have been written by the bankers themselves. This year, that has to change. . . . The reckless and greedy behavior of big Wall Street banks caused a financial crisis that is costing

162. Opinion, *The End of Wall Street*, WALL ST. J., Sept. 23, 2008, at A28.

163. James Sherk, *Majority of Union Members Now Work for the Government*, WALL ST. J., Jan. 22, 2010, available at <http://online.wsj.com/article/SB10001424052748704509704575019552907349936.html>.

164. See Mark Brenner, *Service Employees Vote to Split United Healthcare Workers-West. Members calls for Disaffiliation*, LABORNOTES, Jan. 9, 2009, <http://www.labornotes.org/node/2025>; Steven Greehouse, *California: Union Wins Damages*, N.Y. TIMES, Apr. 9, 2010, http://www.nytimes.com/2010/04/10/us/10brfs-UNIONWINS/DAM_BRF.html; Mike Parker, *SEIU vs. NUHW: Who Owns the Union?*, LABORNOTES, Apr. 11, 2010, <http://labornotes.org/blogs/2010/04/seiu-vs-nuhw-who-owns-union>.

165. Wikipedia, *Employee Free Choice Act*, http://en.wikipedia.org/wiki/Employee_Free_Choice_Act#111th_Congress (last visited Apr. 19, 2010).

us millions of jobs, billions of dollars in taxpayer funded bailouts, and trillions of dollars in lost homes and lost savings. We cannot afford to let this behavior continue. . . . Through a coordinated campaign, we are working to clean up Wall Street's mess and ensure that the job of rewriting the regulatory rulebook is not left to the inside players and financial predators who caused the problems we now face. Our goal is to see real financial reform legislation this year, during this unprecedented opportunity to win a more secure financial future.¹⁶⁶

III. CONCLUSION

The 2008–2009 financial meltdown and ensuing economic developments have shown three things about modern capitalism:

1) Unfettered financial markets remain the Achilles heel of capitalism with the capability of destroying economic stability and bringing misery to all. Letting Wall Street be Wall Street in the belief that the market will police itself has proven to be an ideological pipe dream.

2) High-powered incentives paid to “talent” in finance are a fundamental cause of the excessive risk-taking, chicanery, and financial fraud that contributes to instability. Without a new compensation system that rewards banking and finance for contributing to sustainable economic progress rather than for economic rent-seeking and a renewed regulatory system that punishes chicanery and financial crime and near-crime, there is unlikely to be any change in the behavior of the financial world.

3) In the wake of the implosion of *laissez faire* finance, labor and allied groups have to participate in rewriting the rules and regulations governing banking and finance so that finance serves the real economy rather than the reverse. If Wall Street insiders make the key policy decisions without our input, as they have in the past thirty or so years, banking and finance will remain a loose cannon on the good ship Capitalism, sure to crash the ship yet again.

¹⁶⁶ Americans for Financial Reform, About, <http://ourfinancialsecurity.org/about/> (last visited Mar. 18, 2010).