Our next constitutional crisis is likely to differ from those that have come before. While prior crises have been caused by economic dislocations (the period under the Articles of Confederation, the Great Depression, and the 2008 financial crisis) or national security concerns (the Civil War and the War on Terror) the next crisis will likely result from collapse from the accumulated expense and debt of the welfare state. While the nature of the crisis itself will be novel, prior crises provide a window on the rule of law and constitutional change in times of crisis. Why is it that in some instances crises produce a strengthened constitutional order and in others they do not?

This essay explores the rule of law in times of economic crisis. First, it develops the case for why adherence to the rule of law is important during times of crisis: first, because it is useful to create economic stabilization during the crisis but second, because deviations from the rule of law are typically ratified not reversed after the crisis abates. Second, I turn to the question of what factors determine whether the rule of law and constitutional government survive during a period of crisis. Finally, I conclude with some thoughts on the applications of these lessons to anticipate the constitutional consequences of our looming fiscal crisis.

I. Constitutional Crisis and Constitutional Opportunity

Moments of constitutional crisis can also be moments of constitutional opportunity. In the crucible of crisis, constitutions can emerge strengthened or weakened.
Although the claim is open to contestation, America’s first two constitutional crises are generally regarded to have produced beneficial results from a constitutional perspective. In 1787, faced with concerns about rising economic chaos at home and continued foreign threats, the Founders scrapped the Articles of Confederation and replaced it with the Constitution. The purpose of the Constitution was to “provide for the common defense” and create the institutional conditions to build a modern commercial society. In particular, the Constitution aimed at two interrelated principles: first, to promote individual liberty and second, to frustrate the power of factions (i.e., interest groups) that might seek to commandeer the power of government to promote their private interests rather than the “public interest,” however vaguely defined.

The Framers sought to attain these goals through the erection and maintenance of certain “auxiliary precautions,” namely separation of powers, checks and balances, and federalism, eventually backed by the adoption of a Bill of Rights to enumerate protected individual rights. For example, the Constitution composed the various branches of individuals selected by different constituency bases—the House of Representatives directly by the people (eventually via districts) for two year terms, the Senate was elected by state legislatures via staggered six year terms, the President indirectly via the novel arrangement of the Electoral College for a four year term, and the Judiciary was appointed by the President subject to the advice and consent of the Senate to serve for “good behavior.” In addition, the election of Senators by state legislatures (rather than by the people) was thought to be a necessary and sufficient condition for the protection of federalism. Indeed, so trustworthy was it assumed that the Senate would be in protecting the states from overreaching by the federal government, that this provided the
opportunity for the Supreme Court to adopt a definition of the Constitution that permitted a relatively expansive interpretation of the commerce clause and other grants of federal power, secure in the knowledge that Congress would rarely find it politically plausible to actually press federal power to those constitutional limits.

And, in fact, aside from the obvious and unforgivable exception of blacks and less egregious, tariffs, the original Constitution succeeded admirably in achieving its stated goals of preserving individual liberty, building a robust interstate market, and frustrating faction. Faced with the War of 1812, the Constitution proved robust to foreign threat—subsequent wars such as the Mexican-American War were offensive wars, not defensive, in nature. Moreover, the scope of the federal government remained relatively constrained and while interest-groups frequently succeeded in obtaining favorable tariff legislation, they largely failed to capture the federal government to their advantage. Most notably, the federal judiciary provided a firm hand on the tiller, defending and strengthening the Contracts clause, protecting federal commerce against state protectionism, and preserving the rule of law against populist pressures. For example, through Justice Storey’s far-seeing decision in *Swift v. Tyson*, the federal judiciary created a modern system of commercial law in the federal courts that facilitated not only interstate commerce but international commerce as well, providing security for foreigners that invested in the United States.

Inevitably, however, the issue of slavery had to be resolved, which it finally was with the Civil War. And while the Civil War marked an expansion of the federal government, it did so by aiming to expand individual liberty and by reducing the ability of majoritarian factions at the state and local level to exploit minorities. In that sense, the
constitutional structure that emerged from the Civil War was an extension of the principles of the original Constitution and an application of those principles. In particular, the grotesque institution of slavery and the treatment of blacks generally reflected Madison’s particular concern in Federalist 10 regarding the power of majority factions to oppress permanent minorities. At the same time, of course, the Civil War constitution contained within it the seeds of the subsequent expansion of power by the federal government and the later ability of factions to commandeer the central government for their advantage.

As railroads and other improvements in transportation and information technology promoted the growth of national markets, local special interests became increasingly aggressive in trying to erect new barriers to interstate competition from more efficient producer and to favor local interests at the expense of out-of-staters. As Michael Greve demonstrates, the role of the federal judiciary was especially important during this period to police these protectionist impulses at the state and local level. Through aggressive and relentless oversight, the federal courts struck down state protectionism and facilitated the growth of national markets and economic dynamism.

On other fronts, however, the federal judiciary acquitted itself less admirably. In particular, the Supreme Court’s unfortunate decision in the *Slaughter-House Cases* eliminated the most powerful tool for freed slaves and others to challenge protectionist legislation at the local and state level. Thus, much of the promise of the 14th Amendment to enable individuals to challenge rent-seeking legislation at the state and local level was swept aside by the Supreme Court.
Still, the Supreme Court found other tools for protecting individual liberty from the predations of interest groups, as best exemplified in the now-notorious case of *Lochner v. New York*. As shown first by Bernard Siegan and more recently shown in much more elaborate detail by David Bernstein, the law in *Lochner* that regulated the working hours and conditions of bakers appears to have been a classic “Baptists and Bootleggers” law, combining the well-intentioned efforts of public health reformers for more sanitary working conditions and product safety with the narrow economic self-interest of large corporate bakeries and their unionized workforce to stifle competition from small, family-owned, Eastern European immigrant bakeries. While Bernstein argues that in fact the *Lochner* court was not a roving commission self-deputized to strike down rent-seeking laws wherever they were found, their advocacy in favor of liberty of contract had the effect of limiting the ability of interest groups to capture state legislatures and regulators for their private benefit. Meanwhile, at the national level, while rent-seeking existed, it was largely contained.

The onset of the Great Depression, however, created a new constitutional crisis. The foundations of the new constitutional order were actually laid during the Progressive Era and World War I. For example, 1913 saw the enactment of the 16th Amendment permitting a federal income tax and the 17th Amendment providing for direct election of Senators. While the 16th Amendment unleashed the taxing power of the federal government the 17th Amendment eroded one of the most important institutional bulwarks of federalism and bicameralism in the original Constitutional structure. More important, while the 17th Amendment stripped the states of their only institutional protection for

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federalism (which, had in any event been attenuated as a protection for federalism by that
time anyway), no new institutional protection for federalism was added to take its place.
The combined effect of the Progressive Era constitutional amendments was to weaken the
“auxiliary precautions” for federalism that the Framers had seen as protecting individual
liberty and restraining special interest faction. And while the political leadership of the
Harding and Coolidge years restrained the working out of these principles to their logical
effect, there was even during that period a creeping growth in rent-seeking legislation at
the national level. As is well-known, the defining characteristic of administrative
agencies is the combining of legislative, executive, and judicial powers in one body, and
the supposed substitution of non-political agency expertise for political decision-making.
In short, whereas the Framers saw the structures of the separation of powers and
federalism as the institutional safeguards of individual liberty and good government, the
Progressive Era saw them as obstacles to achieving their political goals.

With the constitutional foundations thus weakened, the transformation of the
Constitution during the Great Depression and New Deal was little more than a mopping
up operation. While the Supreme Court half-heartedly tried to hold the line against more
egregious rent-seeking such as the National Recovery Act, the judicial gavel proved little
resistance to the presidential pen. Eventually judicial resistance collapsed, opening the
door to an unprecedented assertion of power by the federal government over the economy
but also the acceleration of the rise of the administrative state that had begun during the
Progressive Era. Moreover, political favoritism for particular firms and industries and
other powerful interest groups (such as labor unions) were woven into the political and
regulatory structure and thereby implicitly into the constitutional structure.
As Mancur Olson has shown, this political bargain between the government and powerful interest groups grew during the post-War era until the political and economic systems were choking on rent-seeking legislation and regulation. And while the Reagan era, like the earlier Harding-Coolidge era, pared back some of the political excesses of post-War era, it did little to restore the underlying constitutional foundations. Thus, by the time of national security crisis during the War on Terror hit in 2001 and the financial crisis hit in 2008, the government response followed the pattern established during the New Deal—massive executive discretion, followed by promises to create constitutional rules that would constrain executive discretion in future crises. In fact, as detailed below, legislation adopted in the wake of the financial crisis has done nothing to restrain future executive decision making and in fact has essentially just codified and expanded the vast range of discretion seized by Presidents Bush and Obama and the Federal Reserve during that period.

II. Maintaining the Rule of Law in Times of Crisis

Because the history of the financial crisis is so recent, understanding its dynamics provides a useful framework for anticipating future similar crises and their constitutional stresses. Yet a close examination of the most recent crisis as well as those of the past reveals the exact opposite truth: adherence to the rule of law is actually more important during periods of economic crisis, both to restore short-term economic prosperity during the crisis as well as for the long-term systemic impact.

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4 While the national security crisis associated with the 9/11 terrorist attacks would be worthy of study as well, I will focus on the response to the financial crisis. First, because I know more about it. And second, it seems likely that a future constitutional crisis in the United States will be economic in nature whether caused by a financial panic or a fiscal crisis, such as 1787 and the Great Depression.
There are four reasons why this is so. First, adherence to the rule of law is necessary for economic prosperity in general, but even moreso during economic crisis. Second, adherence to the rule of law is necessary to restrain the opportunism of politicians and special interests that use the opportunity presented by the crisis to piggyback their own narrow interests, often with no relationship to the real problems. Third, once discretion is unleashed during the crisis history tells us that the dissipation of the crisis does not promote a return to the rule of law—in fact, there is a “ratchet effect” of government discretion as the post-crisis period brings about a consolidation of governmental discretion rather than new limits on it. And finally, the mere potential for discretionary action promotes moral hazard, thereby creating the conditions for still further rounds of intervention. Thus, while little is lost in the short run by tying the government’s hands from discretion, more importantly the only way to promote long-term economic growth and preserve freedom in the long run, and to avoid precisely the circumstances that then justify future arbitrary government intervention is to constrain government discretion in the short-run. Consider each in turn.

A. The Rule of Law and Economic Recovery

First, adherence to the rule of law is necessary for long-term economic growth; indeed, this was the feature that animated the 1787 Constitutional Convention. Established rules of contract, property, bankruptcy, corporate law, and the like provide the institutional infrastructure for economic growth. It is a trite and obvious statement that the modern global economy is an incredibly complex system. But that should still not distract us from how miraculous it is that milk appears in our refrigerators every morning.
For the economy is a system in constant flux. From missed planes in Toledo to hail storms in Oslo the underlying conditions of economic prosperity are in constant flux and of bewildering complexity. As Hayek noted, the miracle of the modern economy is the ability of individuals to coordinate their affairs amidst this constant system of flux and uncertainty. The backbone of that system is the rule of law, which enables parties to coordinate their affairs by enabling them to predict how others will act. Thus it is little wonder that economists have identified the presence of the rule of law as one of the key determinants of economic prosperity in the developing world.

But this also means that adherence to the rule of law is even more important during periods of economic dislocation. It is precisely because other variables of the economic system are in even greater flux than usual that adherence to the bedrock predictability of the rule of law takes on special institutional significance. Yet many believe exactly the opposite—that the government’s discretion and arbitrary power should be greater, rather than lesser, during periods of economic dislocation.

I suspect that this justification rests in part on an intellectual error that confuses the appropriate responses to a national security crisis with that of an economic crisis. In a national security crisis government discretion may be necessary in order to anticipate and respond to threats and to seize tactical opportunities. But that is not what is needed following an economic crisis. What is necessary is reestablish coordination among billions of people. The problem is one of reestablishing decentralized coordination rather than centralized prevention of threats. Political uncertainty about the integrity of contracts and regulatory policy undermines investor confidence and raises interest rates. Thus, for every job supposedly saved through arbitrary intervention there may be many others that
are never created as a result of the uncertainty created by government intervention in the economy.

Thus, for example, scholars have argued (convincingly in my mind) that the depth and duration of the Great Depression were worsened by the constant, erratic economic interventions promulgated by the government and supposedly intended to fight the crisis.\(^5\) It has been similarly argued that the chaotic and pell-mell nature of the government’s interventions during the 2008 financial crisis slowed recovery from the banking panic.\(^6\)

Most notably, the government’s unprincipled decision making whether to bail out particular financial institutions bred unpredictability and moral hazard about government policy which made the financial crisis much worse than it would have been had the government acted according to a principled approach. For example, in the period preceding the bankruptcy of Lehman Brothers the bank had the opportunity to merge with other banks that could have saved Lehman.\(^7\) Yet Lehman rejected those offers as insufficiently generous. Why did it do so? Because just months earlier the Bush-Paulson team had bailed out Bear Stearns, a much smaller and systemically less-important bank.

\[\text{B. The Need to Adhere to the Rule of Law is Stronger in Times of Crisis}\]

Because the Threats It is Designed to Protect Against are Greater

Second, adherence to the rule of law is especially important during periods of crisis because that is when potential for political opportunism by politicians and interest groups to pervert government power for their private ends is most dangerous. In focusing on the potential for government intervention to do good things, Pollyannaish political

\(^{5}\) Robert Higgs
\(^{6}\) Roger Koppl
\(^{7}\) David Skeel, The New Financial Deal
analysts ignore the potential of politicians and interest groups to abuse the target-rich environment presented by the crisis to further their own self-interests. President Obama’s then-chief of staff summed the mentality when he observed that you should “Never let a serious crisis go to waste,” a mantra which the President invoked in order to ram through a number of unrelated pieces of legislation and pet political projects. Indeed, every act taken by the Obama administration in response to the financial crisis, from the initial $1 trillion stimulus, to the Dodd-Frank financial reform legislation and the auto bailouts, evidences this theme of piggybacking special interest and other provisions on the back of the purported crisis.

In the auto bailouts, for example, the administration used the narrow excuse that the reduced availability of debtor-in-possession financing as a result of the continued impact of the financial crisis on lending markets justified government support for post-petition financing. But even if that is true, it hardly justifies the government’s heavy-handed and arbitrary intervention in the process, including the plundering of secured creditors in Chrysler, the massive wealth transfers to the United Auto Workers, the rigged bidding processes that foreclosed rival plans, and the political interference with General Motor’s business decisions and operations while under government ownership. None of those activities in any way contributed to the rehabilitation of the auto companies and indeed they were largely adverse to that goal.

In addition, the government used its leverage during the auto bailouts to further its political agenda of promoting the manufacture of “green cars,” supposedly environmentally-friendly alternative fuel-powered vehicles and those that get higher gas mileage. For example, one special incentive provided to Fiat as part of its sweetheart

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8 See Todd J. Zywicki, The Auto Bailouts and the Rule of Law, NATIONAL AFFAIRS
acquisition of Chrysler was a special financial incentive that benefited Fiat if its total fleet reached a certain MPG level by a particular date.\textsuperscript{9} Ironically, while Chrysler and General Motors have returned to profitability since emerging from bankruptcy, they have done so \textit{despite} the government’s incentives to produce fuel-efficient cars, not because of it. In particular, while American car makers continue to lag in sales of small cars, they have experienced a massive surge in demand for light trucks and other similar larger vehicles.\textsuperscript{10} Nor is there any reason that given the high union-imposed labor costs in the United States, that the U.S. can ever profitably manufacture and market small cars and compete with lower-wage countries, nor does it seem to even be desirable to do so.

More to the current point, all of this government pushing and prodding was done completely “off the books” with no formal regulatory action or the like. In short, like the housing GSE’s (Fannie Mae and Freddie Mac) which melted down in part because of government pressure to engage in affordable housing policies without the government directly bearing responsibility for them, the government essentially used Chrysler and GM as quasi-GSE’s to promote its preferred environmental policies?

The allocation of bailout funds from the Troubled Asset Relief Fund (TARP) also illustrates the confluence of special interest favor-seeking and political provision during times of crisis. Studies of how the government distributed TARP funds consistently and strongly show that political connections and campaign contributions were crucially important factors in determining which banks received bailout funds.

Couch, Foster, Malone, and Black found that campaign contributions from the financial services sector played a significant role in explaining which politicians voted for

\textsuperscript{9} Skeel
\textsuperscript{10} cite
the taxpayer-funded bailouts. They argue that the funds were not directed in a way consistent with increasing liquidity but rather were funneled “to financial institutions with political clout.” Similarly, Dorsch found that contributions from the financial services sector had a significant impact on the probability that legislators supported the bailout, on average.

Duchin and Sosyura examined the role of political connections in determining which firms received bailout funds from the Capital Purchase Program (CPP). The authors estimated that, controlling for other factors, banks with an executive on the board at the Federal Reserve were 31 percent more likely to receive CPP funds, and a bank’s connection to a House member on a key finance committee was associated with a 26 percent increase. The authors also found that these effects were strongest for the banks with lower liquidity and poorer performance, suggesting that “political ties shift capital allocation toward underperforming institutions.”

Igan, Mishra, and Tressel examined the relationship between financial institution lobbying and firm performance using an event study, and found that higher levels of lobbying were associated with more risk-taking by firms before the crisis and worse performance after. Firms that lobbied more intensively also experienced positive abnormal returns after TARP was announced, “implying that the market anticipated

14 Id. at 6.
lobbying lenders to be more connected to the policymakers and have higher chances of benefiting from the bailout.”

Duchin and Sosyura used data on firms’ applications for TARP funds to test the role of banks’ political influence on how TARP funds were distributed. The authors found that, controlling for other factors, banks that employing a director who worked at the Treasury or one of the banking regulators were 9 percentage points more likely to be approved for government funds. Firms headquartered in the election districts of House members on key finance committees were 6 percentage points more likely to be approved. The authors also found that the politically-connected banks that received bailouts underperformed other TARP recipients that were not similarly connected.

Blau, Brough, and Thomas examined the role of both lobbying and political connections on a firm’s likelihood to receive TARP support. The authors estimated that firms that lobbied Congress were 42 percent more likely to receive a bailout than firms that did not lobby, while politically-connected banks had a 29 percent higher chance of receiving TARP support than non-connected firms. Similarly, the authors found that firms that lobbied and politically-connected firms received larger bailouts than non-lobbying and unconnected peers. The authors estimate that, “for every dollar spent on lobbying during the 5 years prior to TARP, firms received between $486 and $586 in TARP support.”

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Thus, as these examples demonstrate, once discretion is unleashed in the midst of a crisis, it is almost inevitable that it will be used to favor and enrich favored interest groups and by politicians to gain political support.

C. **Short-Term Suspensions of the Rule of Law During Crisis are Codified, Not Reversed, After the Crisis Abates**

Third, the cessation of the crisis does not produce a retrenchment from the discretion that accompanied it. Instead, the post-crisis period produces a codification and consolidation of the government’s discretion, making it a long-term element of the economy. The massive, 2,400 page Dodd-Frank legislation, for example, entrenches much of the lawless and discretionary activity taken by the President and Federal Reserve during the financial crisis, although vesting it in other authorities. For example, it gives the government virtually unreviewable authority to seize what the government deems to be failing financial institutions and to deem certain institutions but not others to be “systemically risky”—although it nowhere defines the criteria that marks such institutions as such.\(^{18}\) Indeed, under the statute, a firm may not even challenge a designation that it is a systemically risky institution. Similarly, the law places strict limits on the ability of a bank to challenge a conclusion by regulators that it is insolvent, essentially depriving the bank of effective judicial review to challenge the judgment of regulators.

Moreover, once constitutional constraints and the rule of law are overridden the new regime creates clear winners and losers and the winner have little incentives to support a return to the rule of law. It is often overlooked that the value of the rule of law

\(^{18}\) cite
is to benefit ordinary citizens. Wealthy, powerful special interests can hire the lawyers and lobbyists that enable them to thrive in a system defined by loopholes and arbitrary government decision-making. Ordinary citizens, however, are excluded from these back-room deals. Thus, this post-crisis period reinforces the dynamics that emerge during the crisis.

Despite the reality that large multinational banks and investment banks provided the catalyst for the financial crisis, one ironic legacy of the subsequent legislative response is that smaller banks have borne the brunt of the new regulatory costs imposed by Dodd-Frank and the other regulatory responses to the financial crisis. Empirical studies of the impact of Dodd-Frank have found that the costs of its regulations have fallen proportionally more heavily on small banks than larger banks, reflecting the well-known fact that many costs of regulatory compliance (such as paperwork obligations) are not related in a linear manner to the size or output of the regulated firm; or, in other words, there are economies of scale in regulatory compliance such that many of the costs of regulation can be borne relatively more cheaply by larger firms than by smaller ones.\textsuperscript{19}

Thus, while regulation may raise the costs of all firms in an industry, it may disproportionately impact some firms more than others, providing larger firms with a competitive advantage.

Dodd-Frank appears to be consistent with this understanding of regulation. While Dodd-Frank has raised the regulatory compliance costs of all firms, it has raised costs proportionally more on community banks than larger banks. A study by scholars at the Kennedy School of Government found that in the period since Dodd-Frank was enacted, the asset bases of smaller banks has shrunk twice as fast as large banks, a result that they

\textsuperscript{19} See Pashigian and other cites
attribute to the comparatively high regulatory costs imposed by Dodd-Frank on small banks relative to larger banks.\textsuperscript{20} A survey by the Mercatus Center study of the impact of Dodd-Frank on smaller banks has found that the law has imposed huge compliance costs on small banks and that they have been relatively less able to bear those costs than large banks.\textsuperscript{21} As a result, small banks are reducing their product offerings (such as exiting the home mortgage market) to reduce their regulatory compliance costs or considering merging into larger banks.

Moreover, despite all of these regulatory costs, there is little reason to believe that Dodd-Frank actually eliminated the “Too Big to Fail” (TBTF) problem and the problem of bank bailouts, but more likely actually entrenched it. The problem of TBTF institutions is not just the risk of having to invest taxpayer money in bailing out large banks. It is also that the implicit government guarantee given to TBTF institutions reduces the risk of lending to such firms, thereby enabling them to access capital markets at relatively less-expensive cost than smaller firms.

The existence of a TBTF subsidy prior to the enactment of Dodd-Frank is well-established. Kelly, Lustig, and Nieuwerburgh (2012) compare risk-adjusted crash insurance prices at US financial institutions and found that the insurance premiums for large banks were significantly lower than for smaller banks during the 2007-2009 financial crisis. The authors attribute this divergence to an implicit government bailout guarantee that favored equity holders of the 90 largest financial institutions in the US. They estimate the value of this crash insurance subsidy at an average of $50 billion during the financial crisis (37).

\textsuperscript{21} http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank: see also
Acharya, Anginer, and Warburton (2014) compared the risk profiles of US financial institutions and the credit spreads on their bonds, and found that between 1990 and 2012 the risk-to-spread relationship was significantly weaker for the largest US institutions than for small and medium-sized firms. The authors attribute this distortion to the perceived subsidy provided to too-big-to-fail institutions, allowing them to borrow at more favorable rates. The authors estimate an average funding cost advantage for the largest institutions of about 30 basis points per year from 1990-2012, which they value about $30 billion per year on average during that period (4). Balusubraminia and Cyree estimated a TBTF subsidy of 133 basis points in the period preceding the financial crisis.22

Evidence remains mixed as to whether Dodd-Frank actually eliminated the TBTF subsidy. A report by the Government Accountability Office, for example, concluded that while Dodd-Frank may have reduced the size of the so-called “TBTF subsidy” for large banks it probably did not eliminate it, indicating that large banks still retain an implicit government guarantee. Similarly, a study by the International Monetary Fund concluded that the subsidy to TBTF banks in the United States amounts to some $70 billion per year in lower capital costs and that in turn the existence of an implicit government guarantee promotes the moral hazard problem of greater risk-taking by large banks.23 By contrast,


other studies have concluded that the TBTF subsidy has shrunk substantially\textsuperscript{24} or has been eliminated.\textsuperscript{25}

In addition, once the premise is established during the crisis of arbitrarily picking winners and losers, those habits persist after the abatement of the crisis. Consider also the so-called Durbin Amendment to Dodd-Frank, named after its primary sponsor, Democratic Illinois Senator Dick Durbin.\textsuperscript{26} Added at the last moment to Dodd-Frank as a floor amendment with no hearings and little discussion, the Durbin Amendment imposed price controls on the interchange fees of debit cards issued by banks with more than $10 billion in assets, requiring that those fees be “reasonable and proportional” to the incremental cost of processing debit card transactions. Under the terms of the Federal Reserve’s rule implementing the Durbin Amendment, the average interchange fee charged on debit cards issued by covered banks was slashed in half. It is estimated that once implemented, the Durbin Amendment will reduce interchange fee revenues for covered banks by approximately $6 billion per year.

While there are many theories about the causes of the financial crisis, the idea that it resulted from overuse of debit cards is not one of them. Nor does it seem likely that sucking $6 billion out of the revenue stream of banks is likely to actually increase their financial stability and help them to avoid future crises. Why then was the Durbin Amendment inserted into the Dodd-Frank financial legislation? At the lobbying of Walgreen’s and other big box retailers that saw an opportunity to reduce the amounts that

\textsuperscript{24} See Lester and Kumar, \textit{supra} note (finding difference in funding costs of 18 basis points and arguing that it may not be attributable to an implicit TBTF subsidy).


\textsuperscript{26} See Todd J. Zywicki, Geoffrey Manne, and Julian Morris, \textit{Price Controls on Interchange Fees: The U.S. Experience}, cit.
they were paying on payment card processing fees (they failed, however, to impose price controls on credit cards). Empirical studies indicate that the Durbin Amendment will save big box retailers some $1-$3 billion annually in debit card interchange fees. And while economic theory predicts that some of these savings eventually should be partially passed on to their customers in the form of lower prices or higher quality, after two-and-a-half years there was still no evidence of any pass-through, meaning that big box retailers and their shareholders have pocketed the windfall. Meanwhile, at that time, there was no indication that smaller businesses had received any reduction in costs and some merchants actually saw their fees increase. Overall, however, one study estimated that over its expected lifespan the Durbin Amendment would result in a net transfer of some $20 billion to big box retailers and their shareholders.27

Forced to offset this loss in revenues, banks responded by raising banking fees on customers and reducing access to free checking. The percentage of bank accounts eligible for free checking fell in half, from 76% to 38% of all accounts, in just three years after the Durbin Amendment was enacted.28 For those accounts charged a monthly maintenance fee, the average size of the fee doubled, other fees increased as well, and the minimum average balance necessary to be eligible for free checking increased as well. But not only did bank customers pay more and get less as a result of the Durbin Amendment, those who were unable to afford the higher fees were driven out of the mainstream banking system completely, as the number of unbanked Americans rose by about one million between 2009-2011. While there are many possible explanations for these fee increases and increased numbers of unbanked individuals, the Durbin Amendment

27 Cite Evans et al
28 Zywicki, Manne, and Morris, supra note.
Amendment and the increased bank fees that in led to for consumers was an important factor—indeed, the decline in access to free checking occurred only at large banks that were subjected to the Durbin Amendment; smaller banks demonstrated no reduction in access to free checking.

Did “high” interchange fees charged to big box retailers have anything to do with the financial crisis or the systemic risk issues or the consumer protection concerns that spawned Dodd-Frank? Of course not. Yet given the feeding frenzy of anti-bank sentiment in the air following the financial crisis, politicians and organized interest groups saw in the Dodd-Frank legislation an opportunity to attach their wish list for financial services regulation to the law. Like hoboes hitching a ride on a freight train as it roars through town, politicians and their interest-group supporters saw an opportunity to use the legislation as a vehicle to attach their own rent-seeking legislation.

**D. Moral Hazard**

Finally, discretion invariably produces problems of moral hazard and the inevitable production of the conditions for further future interventions. Precisely because the government can exercise discretion when it believes necessary, this creates an incentive to force the government to exercise discretion by foreclosing alternatives. For example, one reason the bankruptcy of Lehman Brothers was so catastrophic and disruptive was because Lehman Brothers rejected government efforts to broker a bargain to save it in the anticipation of holding out for a better bargain, or alternatively, a Bear Stearns-style bailout. Similarly, when General Motors was spiraling toward insolvency, management refused to make plans for a bankruptcy filing, thereby effectively
guaranteeing the self-fulfilling prophecy of a disorderly bankruptcy unless the
government acquiesced to a bailout.

Moreover, now that President Obama has touted the auto bailouts as a successful
exercise of governmental industrial policy, this will likely embolden still more moral
hazard. For example, several states face impending financial calamities as the result of
overly-generous salary and benefit plans for state employees. In light of the political
success that Obama claims for the auto bailouts, there will be little incentive for states
such as California facing massive budget shortfalls to repair their fiscal houses rather
than to careen toward a fiscal cliff in the hope that the Obama administration will bail
them out on the basis that the state is “too big to fail.”

The only way to preserve the rule of law in the long run is to also preserve the
rule of law in the short run. Short-run expedients in the midst of a financial crisis rarely
assist in addressing the crisis and open the floodgates to future arbitrary governmental
action. One fears, however, that the opposite lesson has been absorbed by the public and
the political class, with dire consequences for the nation.

For example, it has been found that bailing out banks or creating an implicit
government guarantee for certain banks will promote moral hazard by the benefited
interests. For example, Duchin and Sosyura examined the behavior of banks that received
TARP money and found that there was a “robust increase” in risk-taking by banks
approved for government assistance.\(^{29}\) TARP recipients originated 5.4 percentage points
more higher-risk mortgages (defined by the loan-to-income ratio) than banks that were
denied federal assistance. And while the authors admit that the increase in risk-taking at

government-supported banks is attributable to a number of factors, they conclude that moral hazard likely contributed to that increase. They also observed that bailout recipients shifted toward higher-yield retail and corporate loans, rather than expanding credit volume.

Black and Hazelwood examined the average risk ratings on commercial and industrial (C&I) loans originated at banks after the bailouts and identified a relationship between reception of TARP funds and bank risk-taking. But the results differed by bank size: the average risk rating for loans originated at large TARP recipients increased relative to large non-TARP banks, while the average risk rating of C&I loans at small TARP recipients did not. The authors also note that loans outstanding at large TARP banks decreased relative to non-TARP banks decreased, suggesting that the increase in risk-taking “did not correspond to expanded lending.”

III. What Determines Whether Constitutional Crises Lead to Good or Bad Outcomes

The government response during and after the 2008 financial crisis paints a picture similar to that which occurred during the New Deal. A major political crisis that was also a constitutional crisis, testing the boundaries of the structural protections of the Constitution and the Bill of Rights. In 1787 and following the Civil War, the constitutional order emerged strengthened by the crucible of the crisis. During and following the New Deal and most recent financial crisis, by contrast, the Constitution and the rule of law emerged permanently damaged, crystallizing the special-interest

preferences that emerged during the crisis and consolidating rather than reversing the 
infringements on the constitutional order. What explains the different outcomes of these 
different eras?

A. Accident

One possible explanation is merely the exigencies of chance and character. In 
establishing the first Constitution, the United States had the inestimable blessing of being 
led by George Washington. While social scientists often ascribe great social outcomes to 
patterns and generalizable forces, it is impossible to discount the unique role of George 
Washington in consolidating the original Constitution—not only in how he governed as 
President but probably more important, his willingness to walk away after just two terms 
rather than establishing himself as a de facto king. He thereby established the important 
precedent of de facto two term limit on the President, a precedent that held until Franklin 
Roosevelt. Similarly, while it can never be known what Lincoln would have done had he 
lived, his succession by the weak President Andrew Johnson had the incidental effect of 
reestabishing the balance of power between Congress and the President. While a mixed 
blessing in the short run, the ascendancy of congressional power relative to the President 
tends to have the effect of dispersing decision-making and decentralizing power, 
especially in the pre-17th Amendment era.

By contrast, Roosevelt was presented with the twin crises of the Great Depression 
followed by the outbreak of World War II. In his hands, both crises proved centralizing 
factors that reinforced one another in terms of promoting greater executive discretion and 
authority and seeing the Constitution as little more than a nuisance. At the same time, of
course, Roosevelt lacked Washington’s inherent humility—while Washington was able to step away after two terms in office, Roosevelt persisted in being elected four times before dying in office. The government’s response to the 2008 crisis reflected this same confluence of factors, simply in reverse order: a national security crisis (the War on Terror) followed by the financial crisis. Thus, while I am aware of no direct evidence that would support this claim, it seems plausible that the extraordinary and unprecedented actions that President Bush took during the War on Terror provided the context and milieu for the extraordinary and unprecedented actions he later took during the financial crisis, including legally questionable bailouts of banks in the first place, followed by legally dubious use of TARP funds to recapitalize banks (rather than buying “troubled assets” as authorized under the state), to the illegal diversion of TARP funds to fund the auto bailouts. Would President Bush have been so cavalier about the legality of his actions during the financial crisis had he not become accustomed to exercising extreme discretion in fighting the War on Terror? It is not clear, but it is at least plausible that both he and others became comfortable with extreme executive discretion that provided a foundation for later actions. And, of course, Barack Obama has subsequently extended executive power and arbitrary discretion beyond the breaking point, despite numerous reversals in the Supreme Court ranging from his abuse of the recess appointments clause to particular regulatory initiatives.

Thus, it may be that there is little that can be generalized from these earlier instances and that no lessons can be learned for future crises. Still it is worth considering alternative explanations that do not rest on good luck or the happenstance of coincidence.

B. Elites

Scholars who have examined the resiliency of Constitutions to crises has argued that the most important factor in determining how a Constitution withstands a crisis hinges not on the institutional details of the Constitution but the faith of societal elites in it.\(^3^2\) Under this theory, elites establish the contours of constitutional and political order are established by the prevailing consensus of opinion among elites as to the appropriate processes for resolving crises as they arise. Typically theories of elite governance of institutions rest on the premise that the framework of \emph{de jure} formal rules, such as constitutional structures, do not determine the processes by which conflicts are resolved, but that \emph{de facto} informal processes of consensus and negotiation among elites. Thus, while elites might converge on agreement that formal constitutional processes should be followed in resolving crises, it is the underlying extra-legal commitment to formal legal processes that matters, not the formal existence of constitutional rules themselves. Thus, where elites believe in and are committed to supporting and operating within the established constitutional order, this belief system reinforces the order itself and constrains those who would like to act outside of legally-sanctioned structures. On the other hand, where elites lack faith in the formal rules, they will instead move to extra-legal mechanisms for resolution of crises. The peculiar role played by elites in sustaining constitutional government has been particularly studied in the context of countries that are transitioning to democratic self-government after periods of totalitarianism or dictatorship but the lessons are equally applicable to countries such as the United States that are in the process of transitioning from democratic self-government to governance by

executive *fiat*, or what can be now referred to as “pen and phone” lawmaking in the terminology advanced by President Barack Obama.\(^{33}\)

The positive role that elites can play in using crises to sustain the rule of law are evidenced in the constitutional crises in 1787 and 1865. Gathering in Philadelphia in 1787, the delegates to the Constitutional Convention were aware of the need to create institutions that would protect contracts, property rights, and internal free trade against the populism of the masses. Elite opinion recognized that the United States would not be taken seriously on the world stage without a system of laws and courts that was forceful enough to protect the necessary conditions for commerce and to defend the country from external threats. As such, a primary purpose of the Constitution was to protect propertied interests from the populist redistributive impulses of democratic excess. Indeed, the Constitution itself reflected this desire to distance the new government from the democratic masses, such as, for example, providing that the document would be ratified by the votes of special state conventions convened for the occasion, rather than putting the matter in the hands of state legislatures.

Similarly, the post-Civil War constitutional system rooted in formal legal equality for freed slaves, reflected the views of political elites in providing for equality and the extension of legal rights of citizenship to freed slaves.

It can be difficult to distinguish the relative importance of the role played by elite norms in preserving constitutional government versus the role played by formal legal institutions. A detailed discussion is not necessary in the context of the United States, however, as American elites are, if anything, more hostile to the values of the rule of law

\(^{33}\) See Todd J. Zywicki, *The Legacy and Continued Relevance of Bruno Leoni*, _J. PRIVATE ENTERPRISE_ —.
and constitutional government than are ordinary democratic citizens, at least during periods of Democratic governance. Since the Progressive era, intellectual sophisticates have denigrated the rule of law and formal constitutional procedures, advocating for executive-centered government that ignores the restraints of Congress and the Constitution.\textsuperscript{34} The long-standing hostility to the rule of law was exacerbated by subsequent arguments by “critical” legal scholars that the rule of law was not only undesirable but also impossible, owing to the ambiguities of language. In this sense, the excesses of “pen and phone” lawmaking under President Obama represent simply an extreme strain of the mindset, exaggerated by the absence of any effort at principled explanation.

To the extent that elite opinion is seen as a component of the maintenance of the rule of law in times of crisis, therefore, it appears that elite opinion is by and large hostile to the ideas of the rule of law and especially so when executive discretion is exercised by Democratic Presidents, for which elites provide very little opposition.

\textbf{C. Inevitability}

Law professors Eric Posner and Adrian Vermeule launch a more direct attack on the argument for the importance of adhering to the rule of law in times of crisis, making the case that assertion of executive authority during times of crisis is both appropriate and inevitable in the modern world.\textsuperscript{35} Ironically, many of their arguments for unleashing

\textsuperscript{34} See Todd J. Zywicki, \textit{The Rule of Law, Freedom, and Prosperity}, __ S. CT. ECON. REV. __ (discussing opposition of left-wing law professors to the values of the rule of law).

executive discretion in times of crisis mirror the arguments made above against the same. Before analyzing their argument, therefore, it is useful to understand it.

The core of Posner and Vermeule’s argument is an effort to dismiss the position that they refer to as “liberal legalism,” which is essentially the position described above, namely an executive constrained by rules and processes established by the legislature and interpreted by the judiciary. Posner and Vermeule’s assault on liberal legalism is comprehensive: it is unwise, unrealistic, and unnecessary. Consider each in turn.

They argue that legalistic restraints on the executive are unwise because crises, whether national security or economic crises, necessitate government action to address the crisis and only the executive holds sufficient will and focus to respond quickly to stabilize matters. As Posner and Vermeule tellingly put the point describing the onset of the financial crisis in 2008, “The Fed and Treasury did not simply apply general norms established by a policymaking Congress. The nature of the crisis, including the overwhelming uncertainty, forced these two agencies to take an ad hoc approach.”  

Moreover, they argue that only the Executive could act, as Congress was too cumbersome and scattered and courts were irrelevant as “Judicial review or other oversight would slow down the process when quick action was essential.” In their telling, when faced with the purported threat of a collapse of the economy, Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke acted to restore confidence and predictability to markets when Congress and the courts could have only obstructed those actions.

36 Id. at 38 (emphasis added).
37 Id. at 39.
Second, Posner and Vermeule argue that even if assertion of executive authority is unwise, it is nevertheless inevitable. As they put the matter, “We live in a regime of executive-centered government, in an age after the separation of powers and the legally constrained executive is now a historical curiosity.” 38 In short, crises demand swift action and only the executive can respond with sufficient speed and force to meet the public demand for action. “Legislatures and courts … are continually behind the pace of events in the administrative state; they play an essentially reactive and marginal role, modifying and occasionally blocking executive policy initiatives, but rarely taking the lead. And in crises, the executive governs alone, at least so far as law is concerned.” 39 As a result, “liberal legalism” (i.e., rule of law constraints on executive discretion) cannot work in the modern state and cannot constrain the executive in times of crisis.

Third, they argue that formal restraints on the executive are unnecessary, because informal restraints on the President are both more effective and more useful than legal rules. The executive is not constrained by laws but by “politics and public opinion.” 40 Posner and Vermuele argue that proponents of legal liberalism fallaciously equate “a constrained executive with an executive constrained by law.” 41 In turn, they argue that the loosening of legal constraints on the executive cause proponents of liberal legalism to develop “tyrannophobia, or unjustified fear of dictatorship.” 42 This fear is unjustified, they argue, because it ignores the “de facto constraints that have grown up and, to some degree, substituted for legal constraints on the executive. As the bonds of law have

38 Id. at 4.
39 Id. at 4.
40 Id. at 4.
41 Id. at 5.
42 Id. at 5.
loosened, the bonds of politics have tightened their grip.” They add, “The executive, ‘unbound’ from the standpoint of liberal legalism, is in some ways more constrained than ever before.” Indeed, not only is tyrannophobia unjustified, they argue that its presence in American politics may actually unintentionally promote the virus of tyranny that it is intended to restrain.

Yet while Posner and Vermeule may be correct that the lawless expansion of executive authority may be inevitable in times of crisis, their normative justification is badly flawed. Most significant, their justifications for the extraordinary actions taken by the Treasury and Fed during the financial crisis rests on a string of dubious arguments. They claim, for example that “overwhelming uncertainty” in the market “forced” the government to take “ad hoc” actions to restore confidence to the market—yet they provide no explanation for how “ad hoc” interventions and bailouts were supposed to reduce uncertainty rather than exacerbating it. They rehash the myth that “allow[ing]” Lehman Brothers to fail resulted in “disastrous short-term consequences because many other firms had accounts with Lehman” when in fact there is no evidence that Lehman’s failure did or would have resulted in the failure of any other banks because of their interconnectedness with Lehman. More important, they ignore the gross moral hazard that led to Lehman’s collapse and resulted in the entirely avoidable failure of Lehman rather than its absorption by a healthier firm. Finally, as economist John Taylor has convincingly demonstrated, there is no evidence that Lehman’s failure itself spooked markets—it was Hank Paulson’s panicked response to Lehman’s failure that spread

43 Id. at 5.
44 Id. at 202-03.
45 Id. at 38.
46 Cite Peter Wallison
47 See discussion supra.
contagion through the markets. In short, Paulson created the very panic that Posner and Vermeule claim that Paulson’s panicked and erratic behavior supposedly stemmed.

Posner and Vermeule are also on shaky ground in dismissing what they consider to be overwrought and unrealistic fears of tyrannophobia and their belief that formal institutions are irrelevant to controlling the abuse of discretionary powers in the President. While it is undoubtedly true that public opinion plays an important role in restraining excessive and abusive (i.e., politically-motivated) actions by the President, it is unwise to dismiss the role of institutions in restraining excessive and abusive action by the President. Moreover, there is good reason to believe that many of the informal constraints that have restrained the President in the past have become sufficiently dessicated that they no longer bind, and in many situations, may actually empower.

First, while it is difficult to contest Posner and Vermeule’s assertion that liberal legalistic rules do little to constrain executive action today, their importance should not be completely dismissed. For example, in recent years the Supreme Court has on several occasions nullified examples of egregious executive overreach, often by 9-0 votes. Perhaps most notable, the Supreme Court invalidated President Obama’s illegal recess appointments, despite support from Democratic leaders in Congress willing to surrender Congress’s constitutional power to vote on nominees for partisan advantage. Courts have also invalidated several other examples of extreme executive action from property rights to religious freedom to criminal procedure. In virtually all of these cases, the Democratic partisans in Congress and the mainstream media raised no objection to the President’s actions.

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48 NLRB v. Noel Canning
Formal restraints may also provide a context for reinforcing informal constraints, serving as a sort of focal point or coordinating device for preventing constitutional transgressions.\(^5^0\) For example, in response to the 1921 recession, then-Commerce Secretary Herbert Hoover sought to engage in an early form of the economic interventionism that he later conducted so disastrously in the aftermath of the stock market crash of 1929, but felt that he was not legally empowered to do so and so resisted (producing, of course, a much shorter recession than he and Roosevelt caused in the Great Depression).\(^5^1\) The tendency of modern Presidents to ignore the legality of their actions unless ordered by a court seems to be largely a modern tendency, not one that suggests any inherent limits in liberal legalism—although, as suggested above, the deterioration of legal constraints on the executive is consistent with changing elite attitudes over time.

In addition, their appeals to politics and public opinion as constraints on the executive are flaccid and ill-defined. As noted above, one important function of the rule of law is to constrain politicians and special interests intend on capturing government power for their own purposes. Under Mancur Olson’s well-understood theory of the dynamics of collective action in politics, government tends to the production of laws that provide concentrated benefits to well-organized interest groups at the expense of the dispersed public. There is certainly no reason to believe that this tendency is less pronounced in times of crisis—indeed, as discussed, the disproportionate distribution of TARP funds to politically-connected banks demonstrates that interest-group politics are not suspended in times of crisis. More generally, the belief that constraints of politics and


\(^5^1\) James Grant
public opinion will constrain runaway executive discretion is simply unrealistic and even naïve: the crony capitalist enterprise is bipartisan in nature, as the TARP legislation itself was proposed by a Republican President and passed into law by predominantly Democratic votes. The illegal diversion of TARP funds to bail out General Motors and Chrysler—a decision that was made by the Bush Administration immediately after Congress voted down an appropriations proposal to provide bailout funds to the carmakers—was met by nothing more than a feeble letter of protest by several United States Senators.\textsuperscript{52} Meanwhile, public opinion polls taken at the time of the bank bailouts identified widespread public opposition to providing tax money to bail out banks, suggesting that public opinion provides little constraint on opportunistic politicians in times of crisis.

If dismissal of the importance of formal constraints on the executive is anachronistic then their confidence in the constraining power of informal constraints is archaic. While in the past considerations of public opinion and especially the watchdog function of an independent and free press may have constrained executive excess in the past, these forces appear much weaker today, at least with respect to Democratic Presidents.

Posner and Vermeule point to several examples to support their claim that informal constraints, such as public opinion, render concerns about tyrannophobia ungrounded, such as the failure of Roosevelt’s court-packing plan and the impeachment of Richard Nixon for abuse of power. Yet to the extent that these historical examples

\footnote{\textsuperscript{52} According to Steven Rattener’s book on the auto bailouts, when General Motors originally proposed to Treasury Secretary Henry Paulson that he divert TARP funds to the carmakers Paulson told him that he was not authorized to do so and that GM would need a special appropriation from Congress. Yet when Congress voted down the appropriation Paulson provided TARP funds—he did not, however, provide any explanation for why all of a sudden he believed his actions to be legal.}
support their argument they also reveal the different circumstances that prevail today and cast doubt about the validity of these examples.

Consider first the public rejection of Roosevelt’s effort to pack the court in response to the early judicial defeat of his New Deal programs. This is, of course, a questionable example because while the causes of the Supreme Court’s “switch in time that saved nine” are open to dispute, in the end the Supreme Court relented on its opposition to Roosevelt’s program, essentially mooting Roosevelt’s need to pack the court. Still, to the extent that this historical example supports Posner and Vermeule’s thesis, it is not clear that similar circumstances prevail today among the public or elites to resist such an action.

In large part, skepticism about the constraining power of informal structures follows from the weakened consensus among American elites regarding the importance of following constitutional practices in law-making. While presidential attacks on the Supreme Court have recurred over time in the United States, few recent Presidents have so directly attacked the independence of the Supreme Court as much as President Obama. Obama’s preemptive attacks on the Supreme Court prior to its ruling on *Sibelius v. NFIB* (regarding the constitutional challenge to the Affordable Care Act) or his direct criticism of the Court’s ruling protecting political speech under the First Amendment in the *Citizen United* case were different in both motivation and tone from comments by most sitting Presidents who disagreed with the Supreme Court’s rulings. Not only has the ostensibly independent media not questioned these attacks, in many instances they have endorsed and emboldened them.
Analogies to the impeachment of Richard Nixon may provide an even clearer illustration of the degraded state of the media and elites in policing overreach by Democratic Presidents. For example, when President Clinton committed perjury before a grand jury, the media and elite opinion were aghast that an impeachment proceeding would result. And while a Republican majority in the House of Representatives voted out Articles of Impeachment, Democrats in the Senate voted on a party line vote not to convict him and remove him from office, despite the obvious fact that perjury in testimony before a grand jury quite plainly constitutes a “high crime or misdemeanor” under the Constitution and that the President of the United States is the nation’s chief law enforcement official. Indeed, not only were the media and elite opinion silent with respect to the President’s crimes, they attacked the Republican leaders who brought the case.

Posner and Vermeule’s argument also fails to address a larger question: even if the short-term benefits of violating the rule of law exceed the costs, is that true in the long-term? While acknowledging many of the critiques made above, namely that short-term deviations from the rule of law typically are ratified and often even enlarged after the crisis abates, they never address the question of whether, on net, these short-term deviations are justifiable. Moreover, because they essentially ignore arguments about moral hazard (that the potential for executive discretion compels executive discretion) and minimize the risks that discretion will be used for favored special interests rather than the public, they do not seem to even consider the potential that the long-term costs of abandoning the rule of law exceed the benefits.
They do, however, inadvertently support the thesis advanced above—that in a world where elite support for the rule of law is weak and potential for political opportunism is high, the expansive assertion of executive authority is more or less inevitable. The recognition of the forces pushing in favor of executive authority in times of crisis, combined with the weakened formal and informal restraints on the government of recent years, suggests that for those concerned about the preservation of the rule of law, solutions must lie elsewhere.

IV. The Rule of Law and the Next Crisis

The foregoing discussion presents a somber diagnosis about the prospects for the survival of the rule of law during the next major constitutional crisis. Unlike prior crises, the genesis of the next crisis is likely to be a fiscal crisis caused by the implosion of the entitlements and rent-seeking states under the twin weights of exploding obligations for middle-class entitlements combined with continued slowing economic growth caused by the burden of regulatory overreach and the distortions of crony capitalism.

Although precise estimates vary, estimates of America’s unfunded entitlements liabilities run into the tens of trillions of dollars. The United States cannot and will not repay these debts. Chronic deficits have become a standard way of life in the United States, with the only question being their size, not their existence. It is well-known that the impending retirement of the baby boom generation will put further strain on entitlement programs. Ironically, while most hand-wringing about government activity is focused on the distortions introduced by rent-seeking by well-organized interest groups, the genesis of the American fiscal crisis is easily recognized by a reader of Federalist
Number 10—the problem of majority faction. Today, the most potent faction in the United States is not Wall Street banks or green energy welfare recipients, it is the mass of middle class voters who drive government policy, including major entitlements, and for which politicians of both parties engage in a bidding war for support. As the old cartoon says, “We have met the enemy, and it is us.”

The prospect for reform of middle class entitlements before a fiscal crisis occurs is weak. Politicians are unwilling to risk proposed reductions in entitlements for fear of attack by other politicians. Indeed, astoundingly, at the time this is being written (spring 2015) leading Democratic Party politicians such as Elizabeth Warren are actually advocating for an increase in Social Security benefits. Illustrating the point, state and local governments have been largely unsuccessful in reigning in the excessive obligations of public employee pension programs, even as the obligations owed to current and future retirees exacts an increasingly large toll on local budgets and current services.

At the same time that middle class interest-group politics has been loading increasingly unsustainable expense burdens on to the public fisc, economic dynamism has been suffocating under the accumulating weight of regulation and the crony capitalist political and economic structure. Much as Mancur Olson predicted, interest groups have increasingly sunk their tentacles into the spending and regulatory powers of the federal government, securing special interest benefits, absorbing taxpayer subsidies, and erecting barriers to entry for new rivals (or using government to bring down more-efficient rivals). The accumulation of this regulatory weight of institutionalized rent-seeking and the crony capitalist symbiotic relationships between big government, big

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53 See Todd J. Zywicki, Rent-Seeking, Crony Capitalism, and the Crony Constitution
54 See Mancur Olson, The Rise and Decline of Nations
business, and big labor, have conspired to stifle economic growth and dynamism. Indeed, for the first time in recent history—including periods of recession—last year the number of American businesses that failed exceeded the number of new businesses created.  

With respect to some aspects of constitutional government during times of crisis, history does provide some lessons. For example, it is evident that the claim that the United States government cannot create a credible commitment not to bail out financial institutions in the midst of a financial crisis, especially in light of the received conventional wisdom that Lehman Brothers failed because of the government’s reluctance to bail it out. It is significant that underneath all of the bail outs in 2008, in the end Henry Paulson decided to bail out banks because it was “expected” by the markets—in short, expectations of a government bailout became a self-fulfilling prophecy that generated bailouts.  

Given the inability of the government to credibly commit to not bailing out big banks during a financial crisis, in the world of the second-best it may be that the best possible approach is to forcibly break up big banks and to restrict them from growing to the degree of size or complexity that bailouts in times of crisis become inevitable. Pursuing that policy would require an assessment of the costs of artificially limiting the size of banks in terms of any lost efficiencies of size or scope and weighing those costs against the benefits of avoiding the externalities imposed on taxpayers by bank bailouts.  

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57 See Todd J. Zywicki, *Anti-Fragile Banking Regulation*  
58 Most studies suggest that while there are increasing marginal returns to size, eventually the marginal returns level off and become zero at some point below the size of modern mega-banks, suggesting that banks could be reduced in size without suffering major losses in efficiencies.
A financial system grounded in the rule of law that created binding restraints on the power of the government to bail out large banks would be the ideal solution, as formally neutral rules would allow banks to compete on equal terms and to find their own efficient sizes, but given the inability to enforce formal rule of law constraints, avoidance of the situation may be the best available option, rather than the naïve belief that Dodd-Frank will actually work to eliminate bail outs.

Are there similar lessons that can be applied for fiscal policy in the world of the second-best? James Buchanan argued for his entire career for a balanced budget amendment to the Constitution that would constrain the ability of the government to run chronic deficits. At the end of his career he supplemented this with a call for a “monetary constitution” to isolate monetary authorities from the pressure of political authorities to monetize the debt and to otherwise compensate for bad fiscal policy.59

Recent history suggests that constitutional rules the prohibited budget deficits or currency inflation would be little more than parchment barriers in the face of any crisis, which is when they were most needed. For example, the United States Constitution already likely prohibits the issuance of paper money with “legal tender” status that must be accepted by private parties in payment of private debts.60 Yet the United States government issued “greenbacks” to fund the Civil War and further declared them to hold the status of legal tender. Following the conclusion of the Civil War, in 1870 the validity of the legal tender law was challenged, which the Supreme Court originally sustained by a 4-3 vote. Following the appointment of two new Justices, however, the Supreme Court reversed itself in 1871, upholding the legal tender laws.

59 See James M. Buchanan, The Constitutionalization of Money, 30(2) CATO JOURNAL 251 (Spring/Summer 2010).
60 See Todd J. Zywicki, The Coinage Clause, in THE HERITAGE GUIDE TO THE CONSTITUTION
The case involving the legal tender laws, therefore, followed the standard rules for the deterioration of constitutional constraints—a crisis (in this case the Civil War) which the government met by an extralegal exigency. Following the abatement of the crisis, however, it was thought too disruptive to restore the Constitution to its original rules and as a result the exercise of exigent power was eventually ratified by the Supreme Court and Congress rather than reversed. It seems likely that a balanced budget amendment to the Constitution similarly would be rendered a dead letter in a time of crisis. Thus, one suspects that constitutional constraints on the ability to accumulate or monetize the debt would likely prove unenforceable in times of crisis.

Similarly, the 14th Amendment, Section 4, provides that the “validity of the public debt of the United States … shall not be questioned.” Yet it hardly takes a great deal of imagination to recognize that this provision would provide little constraint on a federal government determined to repudiate its debts. For example, the government could argue that as its debt burden increases, parties should have declining expectations that their debts will be paid at face value, and that the validity of their debt was limited to what they could reasonably expect in payment on the debt. Thus, it seems doubtful that a court would be likely to try to enforce this constitutional provision against the federal government.

This argument, in fact, mirrors the argument that was made to reject the claims of the secured creditors in the Chrysler case that they were entitled to be paid in full before the payment of the unsecured creditors in Chrysler. And, indeed, it may be that the auto bankruptcy cases provide the most likely template for what would happen in the event of a fiscal crisis in the United States. The Bankruptcy Code provides a well-established set
of rules to deal with a firm’s financial distress, specifying the procedures, creditor priorities, and how to sell assets and distribute proceeds in bankruptcy. Yet in the auto bankruptcies, the political intervention of the government ran roughshod over the established rules, violating virtually every established rule of bankruptcy. The Chrysler case ignored standard rules of priorities and bidding procedures, engaging in a sub rosa plan of reorganization outside of the rules of the Bankruptcy Code, all designed to transfer taxpayer monies to a politically-powerful interest group, the United Auto Workers. Moreover, when aggrieved secured creditors of Chrysler challenged the kangaroo-court processes, the Obama Administration browbeat the Supreme Court into not reviewing the case, arguing that Chrysler was like a “melting ice cube” and that if the plan was not approved the company would collapse imminently. The Supreme Court obliged, refusing to stay the sale of the company to Fiat or to review the case. Eventually, however, the Supreme Court did take the case on cert, only to dismiss it as moot—the only effect of which was to vacate the lower court opinion approving the sale. The dynamics of the Chrysler case have many of the features of the typical constitutional crisis—a powerful interest group, a group of self-interested politicians, a breach of the rule of law, and courts that in the end are unwilling to stand up and enforce the rule of law. If the federal government chooses to repudiate its debts, one suspects that the story will be similar. The government will not likely simply repudiate or write down its debts wholesale, but will instead pick and choose, honoring some debts and not others, depending on the political influence of competing interest groups.

Can anything be done to try to hope that the next constitutional crisis turns out more like 1787 than 2008? If so, then I am not aware of it. Without a commitment of
societal elites to the Constitution and the rule of law, it seems that politicians can act largely unconstrained by the rule of law. Indeed, as Posner and Vermeule’s book nicely illustrates, elite opinion has concluded that adherence to the rule of law, especially in times of crisis, is at best not even feasible and at worst an antiquated formalism.