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# The Gulf Spill, the Financial Crisis and Government Failure

*Both Republicans and Democrats fail to see the limits of centralized regulation in a modern market economy.*

By GERALD P. O'DRISCOLL JR.

The Gulf oil spill and the global financial crisis both demonstrate the failings of big government. Partisan politics obscures the linkage, with the consequence that each political party repeats the mistakes of the other as its turn to govern arrives.

First, consider the oil spill. BP and its contractors are surely responsible for the accident. They may also be responsible for a poor response. The nature and scope of legal culpability is yet to be determined. What is the government's role? Offshore drilling is a dangerous activity with potential undesirable consequences now actualized. For this reason, as we have learned, it is heavily regulated. The agency directly responsible for regulating the activity is the Minerals Management Service (MMS) of the Department of the Interior.

Government regulation is intended to protect the public interest against bad or irresponsible behavior by private parties. In the case of offshore drilling, the federal government has assumed the role of solving a collective action problem. Potentially all Americans benefit from the drilling, but those living in coastal areas suffer disproportionate harm from mishaps. The government theoretically negotiates on their behalf and establishes rules to protect them.

Obviously, regulation failed. By all accounts, MMS operated as a rubber stamp for BP. It is a striking example of regulatory capture: Agencies tasked with protecting the public interest come to identify with the regulated industry and protect its interests against that of the public. The result: Government fails to protect the public. That conclusion is precisely the same for the financial services industry.

Financial services have long been subject to detailed regulation by multiple agencies. In his book on the financial crisis, "Jimmy Stewart is Dead," Boston University Professor Laurence Kotlikoff counts over 115 regulatory agencies for financial services. If more hands in the pot helped, financial services would be in fine shape. Few believe such is the case.

Advocates of heavy regulation promise that risky behavior by banks can be controlled and limited by regulators. There are two major reasons such efforts fail. I have already discussed the first: regulatory capture.

The second source of regulatory failure is the knowledge problem identified by Nobel Laureate Friedrich Hayek. The knowledge required by regulators is dispersed throughout the industry and broader economy. For regulation to work, that dispersed knowledge must be centralized in the regulatory agency. To successfully accomplish this requires central planning of the industry, if not the economy. But the local knowledge of specific circumstances of time and place cannot be aggregated in one mind or agency. We know that is impossible, and that impossibility was the reason for the collapse of the Soviet Empire and the transformation of the Chinese economy.

Regulatory practice represents islands of central planning in otherwise decentralized market economies. If we add back in the problem of regulatory capture, then we get industries coddled and protected by government. When business and politics become intertwined we move from market economies to crony capitalism.

What is the missed lesson from all this? When President George W. Bush had his Katrina moment, the federal government's bumbling response was blamed on him, on the Republicans, and on conservatives. Now it is President Obama's turn. His administration's faltering response to the disaster in the Gulf is attributed to his personal failings, staff ineptitude, communication failures, etc. And, of course, the two administrations have shared responsibility for the poor handling of the financial crisis.

A big-government conservative administration failed in crisis, as has a big-government liberal administration. The regulatory state did not prevent excessive risk taking whether in financial services, nor perhaps in offshore oil drilling. Government response to crises once they occur is slow and inept. All this is not because either Republicans or Democrats are in power, but because big government doesn't work. It can't deliver on its promises. Big government overpromises and underdelivers. In reaching to do more, big government accomplishes less. That is not an ideological statement, but an empirical observation.

In the case of financial services, virtually all the proposed regulatory reform offers more of the same. Additional regulations will be added to existing ones without addressing why existing ones failed to prevent the crisis. The same process will likely happen with respect to offshore drilling.

Einstein famously defined insanity as the belief that, if we repeatedly do the same thing, we will eventually get a different result. The response to the financial crisis, as to others, is policy insanity.

University of Chicago law professor Richard Epstein has observed that we need simple rules for a complex world. The complexity of rules is self-defeating, because that complexity requires more knowledge than can be acquired. Brazil has a simple rule for directors of failed banks: They are personally liable. That concentrates the mind of directors on reining in risk-taking by management more effectively than would creating a systemic-risk regulator.

The Obama administration and Congress propose more of the same failed approach to regulation. Instead they should heed Hayek, who observed that "the curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

*Mr. O'Driscoll is a senior fellow at the Cato Institute. He was formerly vice president at the Federal Reserve Bank of Dallas and later a vice president at Citigroup.*

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