Delegation and the Regulation of Finance in the United States Since 1950*

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1 Introduction

What determines the extent and structure of financial regulation? This question matters for two reasons. First, it matters because, as North and Shirley (2008, 287) note: “A country’s financial institutions significantly determine the extent of new investment and firm entry, and through them, the rate of economic growth, disparity of income distribution, and incidence of poverty.” Second, it matters because the recent financial crisis has fueled unprecedented government involvement in the economy. Industries including autos, mortgages, and the nation’s largest financial institutions are, to varying extents, now publicly owned and directed. Even if some of these entanglements prove to be short-lived, it seems likely that the 21st century will usher in a fundamental change in the role of government in markets.

This paper seeks to understand the determinants of financial market regulation in the United States since 1950. Toward this end, we first build a formal model of the

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policy-making process in which government regulates financial risk at both the firm and systemic levels. Firms have the opportunity to undertake a risky investment, and returns to the investment can be correlated across the industry. Congress can decide whether to allow or discourage the investment through specific legislation, or it can delegate discretionary authority to executive agencies. Agencies have informational advantages when assessing the degree of correlation across firms, but their preferences over firm profits as opposed to the social costs of bank failure may differ from those of Congress. In deciding whether to delegate regulatory authority to the agency, then, Congress trades off executive branch expertise against the principal-agent problem of differing policy goals.

We find that Congress delegates more discretionary authority: 1) as the policy preferences between Congress and the executive become more similar; 2) as firm investments become riskier; and 3) as Congress becomes more uncertain of the level of systemic risk. As a result, financial markets are more heavily regulated when firm-specific and systemic risks are high. But when inter-branch preferences differ, Congress may allow risky investments to be made that, \textit{ex post}, it wished it had regulated.

To test these predictions, we assemble a comprehensive data set on all financial regulatory laws passed by Congress since 1950. Following Epstein and O’Halloran (1999), we code each financial law for the amount of discretionary authority delegated to executive branch actors and the administrative procedures constraining this delegated authority. We combine these data with data sets on the performance of financial markets, agency rule making, agency budgets and workload, and congressional voting.

We first survey the relevant literature, then present the formal model, detail the data collection enterprise, and provide some preliminary results. The final section
2 Relevant Literature

When discussing government regulation of financial markets, a threshold question is the necessity of regulation in the first place. Efficient market theory (Fama 1965; 1970) suggests that regulation is not only unnecessary but is necessarily harmful. The strong form of the efficient market hypothesis (EMH) states that asset prices reflect all public and private information concerning the asset; hence, price changes reflect changes in information, and asset bubbles do not exist.\(^1\) If this is an accurate description of reality, then large-scale government intervention can only skew prices away from the efficient benchmark.

However, there are good reasons for regulating financial intermediaries, on two levels. At the firm level, it has been long known that since banks and bank-like institutions borrow short-term and lend long-term, they may encounter liquidity crises leading to bank runs and panics. Since the Great Depression, the antidote to this phenomenon has been to regulate individual institutions for safety and soundness by establishing capital reserve requirements, enforcing prudential lending practices, and instituting direct oversight by regulators, as well as providing insurance funds to repay investors in the case of bank failure.\(^2\)

At a system level, the case for regulation has been made stronger by the spectacular failure of the efficient market hypothesis over the past decade and more. Beginning

\(^1\)Weaker versions of EMH assert merely that future prices cannot be determined from past prices, so future earnings conform to a random walk. But asymmetric information and herd behavior can lead to deviations between an asset’s current price and its long-term underlying value. And even EMH advocates agree on the need for regulation to prevent fraudulent practices and insider trading. See Harris (2003, 240) for an overview, and Fox (2009) more generally for a discussion of EMH.

\(^2\)The standard theory of financial regulation to prevent bank runs and panics is detailed in Goodhart, et. al. (1998).
with the failure of Long Term Capital Management, extending through the Asian and Argentinean financial crises, and on through the great mortgage-fueled global meltdown of 2008, there is abundant evidence that asset prices are far more volatile than EMH would predict, leading to bubbles whose collapse can affect national and global economic activity.\textsuperscript{3} Even if individual institutions are properly regulated for safety and soundness, then, the cumulative risk present in the system as a whole may lead to large-scale failure.\textsuperscript{4}

Given the potential benefits of regulation, how can we understand the supply of regulation by government actors? Two classic theories have addressed government’s role in the regulation of markets. The public interest approach assumes: 1) the existence of monopoly power, externalities, and informational asymmetries create a potential constructive role for government interventions; 2) official supervisors have the capacity to ameliorate those market failures (e.g. via a Pigouvian tax, where a firm’s negative externalities are internalized); and 3) these officials have incentives to efficiently regulate markets and foster national economic prosperity.\textsuperscript{5}

Second is the private interest view, which asserts that, although in theory government regulation may be able to correct market imperfections, actual regulation may do more harm than good. Administrative agencies may be designed to protect the very industries that they regulate—this is the “original sin” hypothesis, advanced by Stigler (1971). Similarly, “iron triangles” or subgovernments may form, in which con-

\textsuperscript{3}A recent article reviewing evidence against the strong form of the EMH can be found in “Efficiency and Beyond,” The Economist, July 16, 2009, online at http://www.economist.com/displaystory.cfm?story_id=14030296.

\textsuperscript{4}For a recent discussion of systemic risk in the financial industry see Epstein and O’Halloran (2009).

\textsuperscript{5}The public interest theory of regulation is often cited but rarely advanced as a realistic description of government actions and motivations. In reality, it is more of a restatement of welfare economics and the possibility of efficient government intervention. See Hantke-Domas (2003) for a review of the intellectual history of public interest theory and Shleifer (2005) for an excellent review of the regulatory literature.
gressional committees, interest groups, and bureaucrats combine in an unholy trinity to deliver benefits to the interest group’s members at public expense. This line of reasoning, then, dovetails with Lowi’s (1979) attack on delegation as an abdication of legislative responsibility.

Private interest fears are especially prevalent in discussions of banking regulation for a number of reasons. First, banking policy delivers concentrated benefits to a well-organized and affluent industry, while the costs of ill-advised or badly administered regulation are spread throughout society. Second, governments often need to borrow from banks, especially in developing economies. They thus may be reluctant to impose efficient levels of discipline for fear that a source of much-needed funds may disappear. Third, to the degree that banking regulations ensure depositors against adverse events, they create a moral hazard problem: bank managers may take actions that are too risky, knowing that if they fail, the government will step in.\(^6\)

Despite these difficulties, it is clear that the financial sector is indeed regulated, often quite extensively, and that in many cases these regulations contribute to the smooth functioning of financial markets. Without insider trading statutes and anti-fraud protections, for example, stock exchanges and the mutual fund industry that they support could not have such broad participation. The question, then, becomes not whether governments are capable of regulating financial markets, but under which circumstances they will have the incentive and ability to do so effectively. That is, one needs a theory relating the structure of political and economic institutions to regulatory outcomes and, further, to market development and performance.

One line of research examines these issues from a comparative, cross-national perspective. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) assert that the extent of a country’s financial development can be explained by their inheritance of the

\(^6\)Freixas and Rochet (1997) summarize the issues surrounding bank regulation.
English common law system as opposed to the French civil law system. The authors argue that common law systems afford greater protection to minority shareholders and better protect creditor rights, thus fostering broader financial market development. These findings are supported in Beck, et. al. (2001), who argue that legal origin offers a stronger explanation of financial development than political checks and balances.

In a recent study Keefer (2008) asserts, to the contrary, that legal origin has less explanatory power than a country’s governmental institutions. In particular, Keefer shows that separation of powers and competitive elections are correlated with strong investor protection and lending to the private sector. Competitive governmental structures, in this view, are linked with competitive markets. Barth, Caprio, and Levine (2006) collect a comprehensive data set on banking regulation in over 150 countries. Their analysis shows that those developing countries that regulate by encouraging private enforcement of banking laws (e.g., through litigation) rather than direct control or no regulation at all, saw the highest rates of financial sector development.

Kroszner and Strahan (1999) engage in a different sort of cross-sectional exercise, examining the timing of branching deregulation across states in the U.S. Their results support what they term an “interest group” theory: the relative strength of winners from deregulation (large banks and smaller, bank-dependent firms) and the losers (small banks and insurance firms) explains patterns in the data better than does public interest theory. Similarly, Rajan and Zingales (2003) argue that financial sector development across countries is impeded when incumbent banking firms lobby government actors in an attempt to restrain competition.

Historical studies of financial development in the United States tell similar stories. Haber (2008), for instance, argues that governments free from outside political competition will do little to implement regulations in the banking sector. He uses the
examples of Mexico and the United States to argue that institutionalized competition through electoral suffrage, political parties, separation of powers, and/or federalism is a necessary precursor to broad financial development. And Wallis (2008) reviews the history of early banking in the U.S., showing that the system of state-chartered banks that predominated throughout most of the nineteenth century was by and large a failure: states acted like traditional despotic regimes, using banks as sources of revenue and limiting competition.

The overall lesson from this literature is that effective financial regulation evolves in two stages: first, states need to develop strong enough political institutions so that executive branch actors face competition and are actively monitored; and second, legislatures must resist capture by the financial industry and delegate authority to regulatory agencies. As the United States in the postwar era has cleared the first of these hurdles, effective banking regulation should be correlated with authority delegated to executive branch actors.

3 Model

Our model of delegation of financial regulation thus emphasizes the tradeoff of executive branch expertise against the principal-agent problems of imperfect control. This tradeoff is the subject of some of our earlier work (Epstein and O’Halloran 1994; 1996; 1999), and has since been elaborated in a series of interesting studies examining the politics of delegation with an executive veto (Volden, 2002), civil service protections for bureaucrats (Gailmard and Patty, 2006), and executive review of proposed regulations (Wiseman, 2009), among others.\(^7\) The application of these models to the financial sector would seem to be well-motivated. Banking is certainly a complex area

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\(^7\)See also Bendor and Meirowitz (2004) for contributions to the spatial model of delegation and Volden and Wiseman (2009) for an overview of the development of this literature.
where bureaucratic expertise would be valuable; Morgan (2002), for instance, shows that rating agencies disagree significantly more over banks and insurance companies than over other types of firms. Furthermore, continual innovation in the financial sector means that older regulations become less effective, or “decay,” over time. If it did not delegate authority in this area, Congress would have to continually pass new legislation to deal with the new forms of financial firms and products, which it has shown neither the ability nor inclination to do.

Our work also overlaps with economic literature on the location of policy making, as in Maskin and Tirole (2004) and Alesina and Tabellini (2007), both of which emphasize the benefits of delegation to bureaucrats or other non-accountable officials (like courts) when presented with technical policy issues about which the public would have pay high costs to become informed. We also draw parallels with Hiriart and Martimort (2009), who study the regulation of risky markets and show that when firms cannot be held individually responsible for the consequences of their actions \( ex \ post \), regulators will be faced with an \( ex \ ante \) moral hazard problem of firms’ engaging in overly risky behavior. Finally, we draw inspiration from agency-based models of corporate finance, as summarized in Tirole (2006).

Our model examines strategic interactions among two firms, Congress, and the President. The firms can each make an investment requiring an up-front payment of $1, which will return $r$ with probability $p$ and $0$ otherwise. These returns may be correlated; in particular, with \( ex \ ante \) probability $\theta$ the correlation $\rho$ between investments is $1$, and with probability $(1 - \theta)$ they are uncorrelated, so that $\rho = 0$.

Should either or both ventures succeed, then there is no social cost to the investments. If, however, both fail then there is a social cost $2c$ to bailing out the banking
system. Congress then has utility:

\[ EUC_{\rho=0} \equiv p^2 * 2r + 2p(1-p)r - (1-p)^2 \alpha(2c) \]

if the correlation between the firms’ returns is zero, and

\[ EUC_{\rho=1} \equiv p * 2r - (1-p)\alpha(2c) \]

if the correlation is one, where \( \alpha > 0 \) is the weight Congress places on bailout costs relative to industry profits. The executive’s utility is the same as Congress’s but the multiplier on the bailout costs is \( \beta \) rather than \( \alpha \).

The government can allow the investment \( r \) to be made or disallow it through, for instance, capital reserve requirements that would make the investment too expensive for the firms to undertake. All parameters of the model are common knowledge, but Congress knows only the value of \( \theta \), whereas the executive knows the exact value of \( \rho \). Congress can either make policy itself (\( D = 0 \)) or delegate (\( D = 1 \)) to the executive to take advantage of that branch’s superior expertise.

Congress’s expected utility from making policy itself is 0 if it disallows the investment and

\[ EUC_{(D=0)} = \theta EUC_{\rho=1} + (1-\theta) EUC_{\rho=0} \]

\[ = 2(-c\alpha + p(r + c\alpha(p(\theta - 1) - \theta + 2)) - 1) \]

if it allows the investment. Solving the above, Congress will allow a particular invest-

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8For instance, a central depository institution may have reserves \( R = 2 - 2c \), where \( c < 1/2 \). Banks can costlessly borrow from the central bank if needed, up to the total reserves in the bank. Then a double failure will necessitate costly borrowing of \( 2c \) to insure the depositors at both institutions.
ment with return \( r \) if

\[
r \geq \tilde{r} \equiv \frac{1 + \alpha c(1 - p)(1 - (1 - \theta)p)}{p}.
\]  

(1)

Note that firms, if left to their own devices, would make the investment as long as \( r \geq 1/p \). But this ignores the possible social cost of a financial crisis if both firms’ investments turn out badly. Hence Congress would rationally set higher requirements than the market alone would: from the numerator in Equation 1, Congress requires an extra return of \( \alpha c \delta \), where \( \delta = 1 - p \) if \( \theta = 1 \) (and hence returns are correlated) and \( \delta = (1 - p)^2 \) if \( \theta = 0 \). Put another way, this result illustrates a common pool problem: all firms might agree that lower overall risk is preferable, but individually each firm has incentives to add to the common risk pool, until an adverse event is likely to strike.

Define \( \underline{r}_C \equiv \frac{1 + \alpha c(1 - p)^2}{p} \), define \( \bar{r}_C \equiv \frac{1 + \alpha c(1 - p)}{p} \), and similarly define \( \underline{r}_P \) and \( \bar{r}_P \) for the president, substituting \( \beta \) for \( \alpha \) in the definitions. Then Congress would prefer to disallow all investments with returns \( r < \underline{r}_C \) and allow those with \( r > \bar{r}_C \). For return levels \( r \in [\underline{r}_C, \bar{r}_C] \), legislators would allow the investment if \( \rho = 0 \) but not if \( \rho = 1 \).

Similarly, the executive would base its decision on the value of \( \rho \) for \( r \in [\underline{r}_P, \bar{r}_P] \). Congress can gain this expertise by delegating to the executive, and will do so for those values of \( r \) in which these two ranges overlap. For \( \alpha \leq \beta \), meaning that Congress places weakly less weight on the costs of a bailout relative to the executive, the ranges overlap when:

\[
\frac{1 + \beta c(1 - p)^2}{p} \leq \frac{1 + \alpha c(1 - p)}{p} \leq \frac{1}{(1 - p)\beta} \leq \alpha.
\]
Similar calculations apply for $\beta \leq \alpha$. Equilibrium actions and outcomes are thus given by:

**Proposition 1.** For the delegation game in financial regulation,

1. *Congress delegates if* $(1-p)\beta \leq \alpha \leq \beta$ *and* $r \in [\bar{r}^P, r^C]$, *or if* $(1-p)\alpha \leq \beta \leq \alpha$ *and* $r \in [r^C, \bar{r}^P]$.

2. *Otherwise, Congress makes policy itself and allows the investment if and only if* $r \geq \bar{r}$.

Note that Congress always delegates whenever $\alpha = \beta$, and the region of delegation shrinks as the two parameters diverge. Thus Congress delegates more as the preferences of the two branches align. Furthermore, delegation becomes more likely as the riskiness of the venture increases; that is, as the likelihood of success $p$ falls.

The delegation region has length:

\[
\bar{r}^C - r^P = \frac{1 + \alpha c(1-p)}{p} - \frac{1 + \beta c(1-p)^2}{p} = \frac{c(1-p)(\alpha - (1-p)\beta)}{p}
\]

\[
\frac{\partial (\bar{r}^C - r^P)}{\partial p} = -\frac{c(\alpha + (1-p^2)\beta)}{p^2} < 0,
\]

so more policies are delegated as $p$ gets smaller. Finally, note that the value of executive expertise increases the closer $\theta$ is to $1/2$, so Congress delegates more as it becomes less certain about the level of systemic risk.
4 Data and Results

Although many excellent histories of financial regulation are available,\(^9\) and despite the popular argument that deregulation of the financial sector played a key role in the recent economic crisis, there is as yet no consistent measure of banking regulatory policy over time. Indeed, Philippon (2009), in a recent study of wages in the financial sector over time, was forced to invent his own index of financial deregulation, built around summary measures of bank branching restrictions, separation of commercial and investment banks, interest rate ceilings, and the separation of banks and insurance companies.

We therefore create a new dataset on financial regulation since 1950.\(^{10}\) The unit of analysis is laws enacted governing financial markets. We define the universe of finance and financial institutions as including state- and federally-chartered banks, bank holding companies, thrifts/savings and loan associations, credit unions, investment banks, financial holding companies, securities, commodities, and mortgage lending institutions.

Following Epstein and O’Halloran (1999), and consistent with the findings of the previous literature reviewed above, for each law we code the amount of authority delegated to executive agencies and the procedural constraints circumscribing the executive’s use of delegated authority. In addition, we list the agencies receiving delegated authority (e.g., Securities Exchange Commission, Commodities Future Trade Commission, Treasury) and the location of the agency within the administrative hierarchy (Executive Office of the President, cabinet, independent agency, or government corporation).

\(^9\)See for example, Macey, Miller and Carnell (2001).
\(^{10}\)The analysis begins in 1950 because in that year Congressional Quarterly began providing consistent reviews of the key provisions of enacted legislation.
4.1 Selecting the relevant laws

We identify relevant legislation in a three-sweep process. First, we included all laws mentioned in *Congressional Quarterly’s* policy trackers for the categories of Banking, Savings and Loan Industry, Federal Reserve, Stock Market and Financial Services, Insurance, and Mortgages. In the second sweep, we reviewed a comprehensive survey of banking law (Macey, Miller and Carnell, 2001) as well as the websites of the federal banking regulators and added any laws not already included in the first sweep. The third sweep included recent laws not yet available in *CQ*. Here Thomas’ “Legislation in Current Congress” provides summaries of post-2005 financial laws.\(^{11}\)

In total, we identified so far 123 federal laws that meet these criteria. For each law we recorded the year in which it was passed, the Congress number, the public law number, the bill’s title, and a short description of its content.

4.2 Coding Discretion

As in Epstein and O’Halloran (1999), the primary source for coding each bill’s contents was *Congressional Quarterly Almanac’s* year-end summary of major legislation (86 laws). Where data was not available from the *CQ Almanac*, we referred to the Library of Congress’s *Thomas* database (32 laws). Where neither source contained detailed data on a specific law, we referred to the U.S. Statutes (4 laws) and the Federal Deposit Insurance Corporation website (1 law). Each law was classified as belonging to one or more categories: depository institutions; securities; commodities; insurance; interest rate controls; consumer protection; mortgage lending/government sponsored enterprises; and state-federal issues.

Each law was read independently, its provisions numbered, and all provisions that

\(^{11}\)The Thomas database is available at:[http://thomas.loc.gov/](http://thomas.loc.gov/).
Delegated substantive authority to the executive were identified. Delegation was defined as giving discretionary authority to an executive entity to move policy away from the status quo. The executive includes the president, cabinet, independent agencies and commissions, government corporations, and federally-mandated private corporations.

Executive discretion depends not only on the amount of authority delegated but also on the administrative procedures that constrain executive actions. Accordingly, we identified which of fourteen possible types of procedural constraints, associated with the delegation of authority were contained in a particular bill. These constraints on discretion, along with their definition, are given in Table 1.

Each law was also coded for whether it increased, decreased or left unchanged the regulatory stringency on financial market participants. This was done by noting disclosure rules, capital requirements, and/or increased oversight of products and firms. This enables us to construct a regulation-deregulation index, beginning in 1950 and running to the present day.

In addition, we plan to construct a database of roll call voting records over all bills in our database. For the 123 laws identified so far, we have captured 246 votes in the U.S. House of Representatives and 217 votes in the Senate, totaling 463 votes. Of these votes, however, 110 House votes and 143 Senate votes are either voice votes or unanimous consent and hence do not have individual roll call data associated with them.

\footnote{In omnibus legislation, when there was a financial subpart, we code only the relevant provisions; this occurred in only 4 cases.}

\footnote{See McCubbins, Noll and Weingast (1987).}
<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appointment Power Limits</td>
<td>Are there any constraints on appointment powers that go beyond the advice and consent of the Senate?</td>
</tr>
<tr>
<td>Time Limits</td>
<td>Are there sunset limits? That is, does the delegated authority expire after a certain fixed time period? spending limits Does the act define a maximum amount that the agency can allocate to any activity or set of activities, either stated explicitly or in a formula?</td>
</tr>
<tr>
<td>Legislative Action Required</td>
<td>Do agency determinations require the action of Congress to take effect?</td>
</tr>
<tr>
<td>Executive Action Required</td>
<td>Do agency determinations require the action of another agency or the President to take effect?</td>
</tr>
<tr>
<td>Legislative Veto</td>
<td>Does Congress retain an ex post veto (of some kind) over the enactment of agency regulation?</td>
</tr>
<tr>
<td>Reporting Requirements</td>
<td>What specific reporting requirements are imposed on agency rulemaking? Studies are included in this category as is making information publicly available through a website/ free phone line etc.</td>
</tr>
<tr>
<td>Consultation Requirements</td>
<td>Are consultations with any non-agency actor required prior to final agency actions?</td>
</tr>
<tr>
<td>Public Hearings</td>
<td>Are public hearings explicitly required?</td>
</tr>
<tr>
<td>Appeals Procedures</td>
<td>Is there a procedure explicitly stated in the act for a party adversely affected by agency actions to appeal?</td>
</tr>
<tr>
<td>Rulemaking Requirements</td>
<td>Do explicit mandates require rulemaking or adjudicatory processes to be carried out in a certain manner (beyond the requirements of the Administrative Procedure Act?</td>
</tr>
<tr>
<td>Direct Oversight</td>
<td>Is there a procedure defined in the implementing legislation by which a non-agency actor reviews agency’s activities—i.e. a GAO audit of the agency, or congressional hearings?</td>
</tr>
<tr>
<td>Exemptions</td>
<td>Is any particular group, product, or affected interest exempt from any aspect of regulation for a given period of time?</td>
</tr>
<tr>
<td>Compensations</td>
<td>Are any groups, industries, or states given a specific compensation? In particular, does the act mention any group as receiving either additional time to adjust to the new regulations or some concession because of the costs that may be imposed?</td>
</tr>
</tbody>
</table>

Table 1: Categories of Constraints on Executive Discretion
4.3 Preliminary Findings

For the 123 laws in our database, we calculated an overall delegation ratio as the ratio of the number of provisions that delegate to the executive over the total number of provisions. We then analyzed the correlation matrix of constraint categories in Table 1 using principle components factor analysis. As only one factor was significant, first dimension factor scores for each law were calculated and termed the constraint index. Third, total discretion was defined as delegation minus constraints — that is, the amount of unconstrained authority delegated to executive actors. Fourth, the average number of regulators per law was determined; this shows the degree to which authority is being divided across executive branch actors. And fifth, the degree of autonomy of regulators is measured by the relative mix of independent regulatory actors receiving authority, as opposed to actors and executive agencies under more direct presidential control.

A first look at the results is illuminating. As illustrated in Figure 1, the trend in recent decades has been for Congress to give executive branch actors less discretion in financial regulation. Since the Great Society era of the 1960’s, and on into the early 1970’s, the total amount of new executive branch authority to regulate the financial sector has generally declined. The exceptions are a few upticks in discretion which coincide with the aftermaths of well-publicized financial crises and scandals, including the Savings and Loan crisis, the Asian crisis, and the Enron scandal.

Otherwise, the government has been given steadily less authority over time to regulate financial firms, even as innovations in that sector have made the need for regulation greater than ever, and even as the importance of the financial sector in the national economy has greatly increased. Figure 1 also shows the size of the financial services sector as a percentage of GDP, which has risen from 3% in 1950 to over 8%
in 2008. As industries innovate, new challenges arise, and older forms of regulation may no longer be sufficient to address current marketplace conditions. Yet new laws have given executive branch actors less discretionary authority than before to address these rapidly evolving issues.

What has caused this decrease in discretion? As shown in Figure 2, the amount of authority delegated to oversee the financial sector has remained fairly constant over time, perhaps decreasing slightly in the past decade. The trends in Figure 1, though, are due mainly to a large and significant increase in the number of constraints placed on the regulators’ use of this authority. In addition, we find that the number of actors receiving authority has risen significantly over the time period studied, as also shown in Figure 2. And the location of these agencies in the executive hierarchy has changed as well, away from more independent agencies to those more directly under the president’s control.

Overall, then, our preliminary analysis suggests that the current morass of regu-
Figure 2: Delegation, constraints, and the number of agencies receiving authority.

Delegation creates a web of interlocking and conflicting mandates, making it difficult for regulators to innovate the rules and standards governing the financial industry, while at the same time opening regulatory agencies to industry capture. The problem is not lack of regulation, then, but that regulators have little discretion. Modern laws delegate less, constrain more and split authority across more agencies than their predecessors. This has created a situation where many areas of financial activity are heavily regulated by the Federal government, but those charged with oversight are hamstrung by overlapping jurisdictions, the need for other actors to sign off on their policies, or outright prohibitions on regulatory actions by Congress.

Testing the predictions generated from our theoretical model, we would expect Congress to delegate greater levels of authority to executive branch actors with preferences closer to their own. As Barth, Caprio, and Levine (2006) report, policymaking in this area tends to be uni-dimensional, separating actors with more pro-industry preferences from those placing more emphasis on consumer protection. In the United
States over the period studied, Republicans have represented the former viewpoint and Democrats, the latter. We also posit that presidents will tend to be less pro-industry than legislators, as their national constituency would lead them to weigh more heavily consumer interests and the stability of the banking system at large.

Two patterns of delegation are consistent with these constraints. If partisan differences are stronger than inter-branch differences, then delegation should be higher under unified government as opposed to divided government; this was the pattern of delegation found in Epstein and O’Halloran (1999). If interbranch differences predominate, then delegation will actually be highest from a Democratic Congress to a Republican president, lowest from a Republican Congress to a Democratic president, and intermediate for the other two combinations.

Table 2 shows the results from our preliminary data set, with the top figure in each cell giving the average delegation ratio for each configuration and the bottom figure, the constraint index. As indicated, the data most nearly fit the second pattern described above. The delegation ratio is indeed highest with a Democratic Congress and a Republican president, and lowest in the opposite case. And the constraint index is highest with a Republican Congress and a Democratic president and much lower in the opposite case. The only inconsistency is that Democratic Congresses constrain Democratic presidents even less than they constrain Republic presidents. Though not decisive, this evidence points to some level of consistency in the shape of delegation and discretion in financial policy over time, and to the importance to interbranch differences in policymaking.

\[\text{This is consistent with the findings of Kroszner and Strahan (1999), who analyze rollcall votes on bank branching deregulation.}\]
Table 2: Average delegation ratio (top) and constraint index (bottom), by partisan control of Congress and the presidency.

<table>
<thead>
<tr>
<th>Congress</th>
<th>President</th>
<th>Republican</th>
<th>Democrat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republican</td>
<td>0.38</td>
<td>0.89</td>
<td>0.37</td>
</tr>
<tr>
<td>Democrat</td>
<td>0.45</td>
<td>0.42</td>
<td>0.42</td>
</tr>
</tbody>
</table>

5 Conclusion

This paper analyzed the political and economic determinants of financial regulation. We first developed a formal model where legislators can either regulate firms directly or delegate authority to executive branch actors who have greater expertise, and are therefore better able to assess the true social costs of investment activities. The analysis indicated that agencies have more discretion, and regulation is more effective, when the preferences of Congress and the executive more nearly overlap. Conversely, interbranch conflict leads to no regulation, or to regulation in which the executive is so tightly constrained that they have little latitude to respond to changing market conditions.

We tested the implications of this model with data drawn from the regulation of the financial sector in the United States since 1950. We identified every law regulating state and federally chartered banks, bank holding companies, thrifts/savings and loan associations, credit unions, investment banks, financial holding companies, securities, commodities, or mortgage lending institutions.

For each law, we coded the amount of authority delegated to executive branch actors, the location of these actors in the executive branch hierarchy, and the admin-
istrative procedures that constrain agencies’ use of delegated authority. This allowed us to test the proposition that domestic political factors affect the degree of financial regulation, and the patterns in the data so far are consistent with our delegation model, assuming that interbranch differences outweigh partisan differences in these policy areas.

Overall, this project will cast light on current policy debates concerning the revision of national structures of financial market regulation. To know what will work in the future, it would be helpful to know what has been tried in the past, and to what effect.

On a larger scale, we hope to advance our understanding of the interaction between governments and markets. In particular, under which conditions will regulation interfere with the smooth operation of markets, and when is regulation market-enhancing? These questions remain for future research.
REFERENCES

References


REFERENCES


