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**Conclusion** ........................................................ 74
Untamed: How to Check Corporate, Financial, and Monopoly Power outlines a policy agenda designed to rewrite the rules that shape the corporate and financial sectors and improve implementation and enforcement of existing regulations.

The policies we propose specifically address rules that have distorted private sector behavior and provided benefits to multinational corporations and rich individuals at the expense of average workers and the economy. If taxed and regulated properly, big business, banks, and wealth-holders can contribute to broadly shared prosperity. But tailoring the rules to serve their interests—in essence, leaving these powerful forces untamed—promotes rent-seeking and greater inequality and leads to weaker long-term growth and a less productive economy.

Untamed builds on recent analysis of economic inequality and on our 2015 report, Rewriting the Rules, in which we argued that changes to the rules of trade, corporate governance, tax policy, monetary policy, and financial regulations are key drivers of growing inequality. Where Rewriting identified the problem and began to outline a policy response, Untamed delves deeper on a specific set of solutions to curb rising economic inequality and spur productive growth. We start from the assumption that inequality is not inevitable: It is a choice, and, contrary to many opinions on both the left and the right, we can choose differently without sacrificing economic efficiency.

Since the release of Rewriting, the political debate has increasingly focused on the rules of the economy and how they have failed average Americans. As such, the next president has an opportunity to use the 2016 election as a mandate for economic progress and a rebuke to four decades of trickle-down economics. Our rules-focused agenda is not meant to stand alone; it is designed to complement traditional progressive agendas that advocate for increased investment in public goods and social insurance, expanded labor rights, and anti-discrimination policies. However, we believe any successful progressive economic agenda must include some mix of the policies detailed in this report.

There are three core components of our agenda to check corporate, financial, and monopoly power. In the first chapter, we examine how corporate power has grown since the 1980s, increasing monopoly-like concentration domestically and globally while avoiding taxes. We explore how to fix the rules of the corporate sector and identify key policy solutions to address unfair market concentration, inequitable tax policies, and the unintended economic consequences of the trade deficit.

In the second chapter, we address the growth of the financial sector. Despite the monumental financial reform passed in response to the 2008 crisis, regulation remains insufficient to curb the risks, complexities, and challenges of our modern, global financial system. We identify key congressional and regulatory actions to strengthen the safety and soundness of the largest institutions and discourage risky activities that remain under-regulated in the shadow banking system. We also explore the impact of the financial system on the real and political economy, including the rise of corporate short-termism and the financial struggles of our municipal governments and public investments.

Finally, the third chapter focuses on how the next administration can use its authority and leverage the administrative rulemaking process to make the proposed corporate and financial reforms a reality. With the knowledge that the next president may be constrained by an intransigent Congress, we identify key agency and executive actions that could improve regulatory independence, inclusiveness, and effectiveness.
The Untamed Policy Agenda

TAMING THE CORPORATE SECTOR

1. Restoring Competition in the U.S. Economy
   » Revise the merger guidelines.
   » Reinvigorate agency action.
   » Pass a new antitrust law.
   » Reduce platform power and prevent discrimination and dominance arising from data consolidation.
   » Employ public utility regulation.

2. Restructuring the Tax Code for Fairness and Efficiency
   » Equalize capital and personal income tax rates.
   » Limit the size of tax-free retirement accounts.
   » End the “stepped-up basis” at death.
   » Mark derivatives to market for tax purposes.
   » Explore a system of formulary apportionment for multinational corporations.
   » Raise rates on financial passthroughs.
   » Institute a nuisance tax on inter-partnership dividends.
   » Increase funding for the IRS.

3. Dealing with the Trade Deficit
   » Increase federal borrowing.
   » Shift from monetary policy to credit policy.
   » Increase borrowing by state and local government.
   » Provide loan guarantees for qualified private borrowers.
   » Establish a national infrastructure bank.
   » Focus on public and private “green” investment.
   » Build toward a new Bretton Woods.

TAMING THE FINANCIAL SECTOR

4. Tackling Too Big to Fail
   » Preserve Dodd-Frank.
   » Regulate the whole balance sheet.
   » Continue to push for credible living wills.
   » Coordinate international derivatives.

5. Reining in the Shadow Banking System
   » Prudentially regulate money-market mutual funds.
   » Regulate leverage and realign incentives.
   » Overhaul the bankruptcy regime.
   » Enhance transparency and access to information across the chain of transactions.

6. Curbing Short-Termism
   » Limit share repurchases.
   » Investigate pension obligations.
   » Reform private equity.
   » Reform CEO pay.
   » Establish proxy access.
   » Allow alternative share approaches.
   » Affirm board power.

7. Promoting Fairness in Public Finance
   » Create a Municipal Financial Protection Bureau.
   » Explore Federal Reserve lending to municipalities.
   » Require disclosure of pension fund fees.
   » End guilt-free and tax-free fines and settlements.
   » Fix the fiduciary loophole for municipal advisors.

FIXING THE REGULATORY STATE

8. The Levers of the Executive
   » Institutionalize stakeholder representation.
   » Strengthen enforcement mechanisms.
   » Reform the use of cost–benefit analysis (CBA).
   » Fund regulators appropriately.
GROWTH AT THE TOP AND WHY IT MATTERS TO US ALL

Untamed: How to Check Corporate, Financial, and Monopoly Power builds on the analysis and agenda contained in Rewriting the Rules, the 2015 report in which we argued that changes to the rules of trade, corporate governance, tax policy, monetary policy, and financial regulations were key drivers of growing inequality. By rules we mean the laws, regulations, institutions, norms, and protections that create, define, and structure our economy. The policy agenda detailed in Untamed stems from the belief that we cannot reduce economic inequality and spur productive growth in America unless we rewrite and properly enforce the rules shaping the corporate and financial sectors. Currently these rules drive an ever-greater share of national income to the largest corporations and the wealthiest, whose untamed power and success comes at the expense of average workers. This is not only unfair and unnecessary but can lead to weaker growth and a less productive economy.

In Rewriting the Rules, we argued that just as the current slow-growth, high-rent economy was the result of decisions made over the course of decades, efforts to restructure the economy would also require comprehensive and long-term actions. There is no silver bullet. However, because the concentration of wealth so often leads to a concentration of power, we believe any comprehensive reform agenda must substantially curb the ability of the powerful and privileged to write the rules on their own behalf. We argue that, if the next president is serious about constructing an economy that provides broadly shared growth and opportunity, he or she must advocate for an agenda that will check the growing power of multinational corporations, financial firms, and monopolies. Untamed outlines key pieces of a policy platform that will do just that.

Where Rewriting the Rules identified the problem and sketched the outline of a response, the purpose of Untamed is to deepen our policy analysis, distilling the best existing research and combining it with new data and original observations. Our goal is to begin a conversation with an expert audience including policymakers, economists, and public leaders so that together we can decide on the best possible policies that will move the economy forward and drive inclusive growth.

Untamed has three core components.

» First, we explore how to fix the rules that have allowed corporate power to become increasingly concentrated in recent decades. We identify key drivers of this problem, including the failure to adapt monopoly regulations to the 21st century, numerous tax loopholes and benefits that allow large corporations to evade taxes, and a trade policy primarily concerned with corporate interests rather than workers. We propose a set of policies to rewrite these rules for more broadly shared gains.

» Second, we take a deeper look at the rules of the financial sector. Despite the monumental financial reform passed in 2010, financial regulation remains insufficient. While concentrated pressure from the financial services lobby has helped to stymie implementation of Dodd-Frank and other regulations, we identify key agency actions, in addition to congressional action, that could strengthen oversight of the largest financial institutions and risky activities that remain beyond the scope of bank regulation.

» Finally, because many of these proposals require policymakers to balance and distinguish between the public good and private special interests, we focus on mechanisms by which the next administration can defend against regulatory capture.

The release of Untamed comes at a pivotal moment for American politics in general and the study of inequality in particular. Since the release of Rewriting the Rules, a wave of new data and research has bolstered our argument that the “rules” of our economy have been a major driver of both rising inequality and declining investment in long-term growth. News stories and recent research have shed new light on the current status of monopoly power, tax avoidance, continuing financial risk, and regulatory capture. Both the political debate
and the academic debate have shifted focus from the deficit and skills toward rules and market power. These recent findings inform our agenda.

This report is also designed to complement other explicitly progressive agendas aimed at boosting growth, building a strong middle class, and supporting the most vulnerable through investment in public goods and social insurance, labor rights, and anti-discrimination laws. We consider this traditional progressive approach to be one blade of a scissor designed to cut through the barriers that weaken the economy and drive inequality. However, we argue that this approach alone will not be sufficient to improve the economic outcomes of average Americans. The “rules” agenda provides the second blade of the scissor.

Because trickle-down economics still influences much of our public debate, efforts to rewrite the rules are often dismissed as “envy economics” or “class warfare.” We instead view Untamed as an agenda to rebalance the economy, restore overall economic health, and deepen our thinking about regulations and rule-making in the fast-moving 21st century economy. The policies we propose complement other important projects, such as raising revenues, increasing public spending for schools, and investing in infrastructure, but there is very little increased spending associated with our proposals.

Because our current economy has been shaped by policy choices, this agenda starts with the assumption that inequality is not inevitable; economic markets and individual outcomes are not uncontrollable forces but are in fact structured by manmade rules. For the past several decades, experts have tried to explain growing inequality largely in terms of globalization and changes in technology. However, we believe that the rules are just as, if not more, important to the explanation. And, contrary to many arguments on both the right and the left, we believe there is no necessary trade-off between economic efficiency and efforts to reduce inequality.

While the chief aim of our proposals is to improve economic outcomes for all Americans, the challenges we address are not only economic but also deeply political. The monetary rewards of a distorted policy regime give corporate and financial actors an incentive to fight efforts to level the playing field. Unless we first rewrite the rules that confer power and privilege on a small set of actors, overall policy change will remain incremental.

THE PAST YEAR IN INEQUALITY

Recent inequality research provides further evidence that economic gains are concentrated among the largest companies and funneled to the richest individuals at the expense of investment or innovation. Mainstream economic debates are increasingly centered on rent-seeking and regulation. Economists have documented the rise in “super-firms,” an emerging trend in which the profitability of corporations appears to be linked to the firms’ size and age. News stories on corporate inversions and the leaked “Panama Papers” have publicized the massive rewards for tax dodging. The Democratic presidential primary has, at times, focused on which candidate could best regulate the financial sector, and candidates from both parties have expressed concern that the rules of the economy no longer work for average Americans. Even the International Monetary Fund (IMF) has questioned the basic tenets of neoliberalism. The agenda we propose in the following pages could not be more essential given recent research on the nature of inequality and the overall transformation of the economy.

Super-Firms
One of the key worries has been around the size and scale of market concentration, specifically monopoly power. According to estimates from the Council of Economic Advisers (CEA), corporate profits are up and becoming more concentrated. This is true whether you look at the distribution of returns to equity or the returns to invested capital. Between 1996 and 2014, equity returns from the S&P 500 increasingly went to the largest
Changes to the rules have increased opportunities for what’s known as rent-seeking. Rents are defined as payments in excess of what would be needed to elicit the supply of a given factor, i.e., income derived from the power of suppliers rather than the value of their goods or services. The idea of rents comes initially from land rents. More land cannot be produced no matter how high the rent goes, so higher rent payments do not lead to productive economic activity. Landlords have been able to double rents in San Francisco in recent years because the land on which their property sits is increasingly desirable, not because they have built better buildings or because their land has become more productive. If a San Francisco landlord lobbied the city to prevent new building that would expand the supply of housing, that landlord would be trying to preserve his privileged place in the market, i.e., rent-seeking.

Some rents do promote long-term economic performance by incentivizing socially beneficial behavior. For example, once a new drug has been developed, rents from intellectual property rights ensure the drug developer does not face immediate competition from generics. But when the total return exceeds what is necessary to incentivize the development of the drug, the excess payments to the developer are unproductive rents.

Rents become particularly destructive when they divert productive resources (such as human capital, labor, and wealth) to unproductive activities, such as lobbying for land-use restrictions to protect real estate monopolies or litigating against new entrants in a pharmaceutical market.

This becomes a “vicious cycle” in which the more rents are available for the taking, the more incentive there is to rent-seek. Private incentives increasingly conflict with social outcomes, and the short-term gains for the privileged rent-seekers are countered by long-term losses for the economy as a whole.

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1 For an excellent explanation of rent-seeking, see Adam Davidson’s “What Donald Trump Doesn’t Understand about the Deal,” from which this is quoted.
2 In The Price of Inequality and Rewriting the Rules, Nobel laureate Joseph E. Stiglitz has argued that rent-seeking has become a growing part of the U.S. economy.

The CEA documents a second change in the structure of corporate profits: The most profitable firms in 2003 had an 83 percent chance of being profitable in 2013, up from 50 percent in previous decades. Along with this we have seen less market dynamism. The makeup of firms is increasingly older, with fewer startups and young firms; this is true whether looking at number of firms, employment by firms, or investment among firms. As a recent study argued, “evidence accumulating from multiple datasets and methodologies suggests that the rate of business startups and the pace of employment dynamism in the U.S. economy has fallen over recent decades and that this downward trend accelerated after 2000.”

In addition to high profits, large firms seem to be increasing market share. There has been a wave of mergers totaling $10 trillion in value since the Great Recession, greatly increasing the concentration of major sectors of the economy. A tenth of economic activity takes place in industries where the top four firms control more than 66 percent of the market. Between 1997 and 2012, the 50 largest firms in the majority of industries increased their total revenue share. And, according to estimates from McKinsey & Company and The Economist, in industries where the four largest firms control between 33 and 66 percent of the market, those firms have increased their share of industry revenue from 24 percent to 33 percent. Economists and legal scholars in the past year have begun to focus on anticompetitive pressures coming from consolidated shareholder ownership by large asset managers, which can lead to higher prices and other anticompetitive behaviors.

Further research in the past decade has increasingly identified intra-firm inequality in terms of productivity, both in the U.S. and across countries. This data consistently shows that there is a substantial range of productivity among firms within narrowly defined industries and these differences are persistent over time. To take one notable example, a manufacturing plant at the higher end of the productivity distribution (90th percentile) makes almost twice as much with the same inputs as a firm at the lower end (10th percentile). A recent review looked at 21 different studies, all attempting to relate wages to a measure of employer profitability and rents. In general, they find that a 10 percent increase in value added per worker leads to a wage increase of 0.5–1.5 percent.
High corporate profits are not necessarily a bad sign, as they could be the result of innovations and corporate strategies that would soon be competed away by other firms. More research is required to understand the specific factors driving the increased returns to large, incumbent firms and their employees; however, the traditional literature would suggest four alternative hypotheses: First, knowledge diffuses slowly, so some leaders in firms will always have “ability rents” resulting from superior capacity. Second, reputation may serve as a barrier to entry (like learning), and those who establish reputation can thus earn persistent supernormal profits. Third, monopoly power allows for abusive, exclusionary practices, with obvious examples include airlines engaging in predatory pricing or the amplifying power associated with networks such as Amazon or Google. Fourth, having established monopoly power, firms can maintain dominance by preempting rivals.

The general inequality research has tended to look at market-level skill trends, such as education and human capital, as opposed these firm-specific ones, in determining inequality trends. But this new research on firm-level dynamics casts further doubts about market-level skill-based inequality stories. Instead, we focus on the third and fourth hypotheses mentioned above: emerging monopoly power that could be tackled by reinvigorating antitrust policy and adapting utility regulations for the platform economy.

**Tax Avoidance**

The recent release of the Panama Papers has drawn new attention to offshore tax havens and the international challenge of tax avoidance. These 11.5 million documents leaked from the Panamanian law firm Mossack Fonseca document a vast web of more than 320,000 offshore entities over a span of 40 years. But domestic tax challenges are just as significant as those abroad.

A landmark study in October 2015 confirmed much of what we already knew about business income and taxes: Effective rates fall well below statutory rates and profits go overwhelmingly to the wealthy. But the study also revealed the startling extent to which this gap is driven by “passthrough” businesses, which include financial partnerships like hedge funds and private equity firms, that now account for more than half of all business income. A “passthrough” is a legal business structure that is subject to the individual tax rate as opposed to the higher corporate tax. While the primary logic behind the passthrough structure is to reduce the administrative burden on small businesses, larger enterprises have increasingly adopted the passthrough structure to benefit from a lower tax rate. In 2011, for example, partnership owners paid an average tax rate of just 15.9 percent—far less than the effective rate on income from C-corporations, which was taxed at 31.6 percent. The study also found that income from these businesses disproportionately benefits the wealthy, even by U.S. standards; 69 percent of passthrough income accrues to the top 1 percent, compared with just 45 percent of C corp income.

Of course, passthroughs are just one structure that allows businesses and individuals to take advantage of underlying tax loopholes. The structure of the U.S. tax code strays from the principles on which one would build an efficient tax system—for example, taxing unproductive activity such as speculation and pollution and rewarding productive activity such as investment and work. In this report we identify a few key proposals that will better align incentives to drive positive private sector behavior instead of rewarding firms and individuals with the resources to navigate these intricacies.

**The Financial Sector**

The public, regulators, and policymakers remain concerned about incentives in the financial sector and continued riskiness of financial activities. In April, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) declared that many of the largest banks still fail their so-called “living wills”—the plans meant to provide clear and contagion-proof steps toward bankruptcy in case of bank failure. Many of these banks had living wills that were “not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code.” In short, these “living wills” have not solved the problems of “Too Big to Fail” (TBTF). More broadly, extensive concerns still exist about the so-called “shadow banking system,” or the network of bank-like activities that take place outside traditional commercial banking. The best way to regulate the financial sector emerged as a key topic of debate in the Democratic presidential primary, providing evidence that nearly eight years after the financial crisis, much more work on reform remains. Our policy agenda is built to tackle these, and many other, problems.
TWO BLADES OF THE SCISSOR

As noted, the policy agenda promoted in these pages is just one part of a concerted effort to level the playing field. There are many policy initiatives centered on government revenues and spending, which include raising taxes to fund the social safety net, and the core progressive agenda of social insurance, economic security, and public goods paid for through progressive taxation remains as essential as it has ever been.

But those issues form the whole of the debate as it is currently structured, when in truth they are only half of the progressive project—one blade of the scissor. The other half involves the rules that govern the market economy and the investments and projects that, in the words of political scientists Jacob Hacker and Paul Pierson, construct the mixed economy. The mixed economy is designed “to overcome failure of the market and to translate economic growth into broad advances in human well-being—from better health and education to greater knowledge and opportunity.”

Rather than being an invention of the New Deal era, recent research has emphasized that the project of building a mixed economy goes back to the very founding of the U.S. and is central to our prosperity. Moreover, so are efforts to manage the rules of the economy through regulations and regulatory actions. During the 19th century, the government debated how to set up regulatory actors and how to pay regulators, all with an eye toward preventing corruption and ensuring a fair and just economy.

The policy agenda outlined in this report does not downplay the important traditional goals of progressive taxation, public goods, and social insurance. It supplements them in several key ways: First, it seeks to increase productivity and growth by reducing rent-seeking enterprises, which would allow for more resources to be put toward activities that promote broader prosperity. Second, our agenda would adjust the pre-tax-and-transfer distribution of the economy, which is easier than trying to balance the distribution of income using taxes and transfers. Third, this agenda is less focused on raising revenues and spending projects. The agenda includes virtually no new spending, and where it does, such as funding regulators, the amounts are small compared to the overall budget. Though we discuss taxes, and those taxes would raise revenues, their purpose is regulatory as much as budgetary. Finally, with more broadly shared prosperity, more public services would become politically feasible, as weak wage growth makes people view the economy as far more zero-sum than it necessarily is.

THE STRUCTURE OF THIS REPORT

There are three core focuses of this agenda: corporate structures, the financial sector, and the proper regulatory environment.

We begin by considering policies to address the increased concentration of market power. K. Sabeel Rahman and Lina Khan argue for a dual approach to monopoly regulation: a more robust antitrust or competition policy, but also the use of public utility regulation to tackle the increased power of platforms. The platform economy, in which networks support the market domination of single entities, poses new challenges to fair markets. Through a series of proposals, the authors aim to return the goals of anti-monopoly policy to those of the early 20th century progressive movement: promoting innovation, market dynamism, equal access to essential infrastructure. While the authors do suggest new legislation, they also outline the range of executive or agency actions that a new administration could implement even in the face of an intransigent Congress.

In the tax section, Steven Rosenthal, Kimberly Clausing, and Eric Harris Bernstein outline and propose reforms to three different structural problems in the U.S. tax code: multinational, capital, and passthrough taxation. All three
represent enormous tax breaks for the wealthy and encourage unproductive tax avoidance behavior. With both multinational and passthrough taxation, our recommended policies aim to increase productivity and decrease the advantage of large firms by eliminating the economic return to complex arbitrage. In the case of multinational taxation, we call for a system of formulary apportionment in which corporations are taxed based on their economic activity rather than the location of various international partners and subsidiaries. In the case of passthrough businesses, our proposals aim to increase low effective rates on large and wealthy partnerships by raising the capital gains tax rate and discouraging the formation of opaque widely held partnerships that are difficult or impossible to audit. Finally, we recommend increased taxes on capital gains and dividends as well as caps on tax-free retirement accounts, which are inordinately held by wealthy households.

We conclude our section on corporate power with J.W. Mason’s piece on the challenges that the trade deficit poses to U.S. output and employment and the tools policymakers can use to counter lost demand. To a growing number of Americans, open trade has come to symbolize the imbalance of power between multinational corporations earning global profits and average Americans watching local economic prospects dwindle. Mason argues that the trade deficit does impact U.S. employment, taking on neoclassical economists who argue trade balances are resolved through exchange rates and have limited macroeconomic effects. However, he also argues that efforts to reduce the deficit through trade restrictions or currency manipulation are likely to fail or hurt the U.S. economy, taking on the rising chorus of protectionists. Rather, Mason argues, the U.S. can counter lost demand due to imports with domestic investment financed by cheap credit that the rest of the world is willing to offer.

We then move to the financial section. For too long, the debate has treated Too Big to Fail as a stark binary. Mike Konczal proposes that we instead treat TBTF as a continuum. This is true analytically, but also true in terms of how a failure would play out in practice; Dodd-Frank could “work” in a specific instance but still be seen as a failure generally if the process for winding down a bank becomes too messy and leads to a panic. Konczal concludes that the current state of financial reform is closer to, but not finished, to ending the challenge posed by TBTF. The activities of the shadow banking sector are described in detail by Kathryn Milani. Milani explains that shadow banking is a danger not only because it can cause contagion and panics, but also because it distorts the allocation of credit, diverting resources toward unproductive, even fraudulent, activities. She argues that there needs to be a mix of prudential regulations on firms acting as shadow banks, but also more stringent regulations on the activities themselves.

Next, Mike Konczal and Kathryn Milani look at how the financial sector influences the real and political economy in our section on short-termism. Short-termism refers to the ways in which long-term investment and productive value are downplayed relative to short-term manipulations of stock prices and excessively large dividends and buybacks. The authors examine why this is a problem and begins to discuss ways to build countervailing power to solve it. Finally, Saqib Bhatti and Alan Smith look at how finance interacts with municipal government, the state and local institutions that are often manipulated by overly complex and predatory financial instruments. The authors begin to construct best practices for tackling this problem, including giving municipalities more power to bargain with the financial sector.

In the third and final section, Devin Duffy, Lenore Palladino, Kathryn Milani, and K. Sabeel Rahman discuss best practices for regulators with the responsibility to write and enforce the rules of our economy. They cover the importance of the political appointment process for key economic positions and why appointing agency leaders with the independence to effectively regulate industries is in itself a form of policy. They then discuss specific solutions to make the administrative rulemaking process more effective and inclusive in order to tackle the economic challenges of the 21st century. The authors identify key steps agencies can take to ensure all stakeholders are represented and empowered in the policymaking process and outline specific actions to institutionalize stakeholder representation, strengthen enforcement mechanisms, reform the use of cost–benefit analysis, and ensure that regulatory agencies are funded appropriately to execute their important missions.

The strong response we had to Rewriting the Rules shows that the themes we raised last year have resonated. Intriguing new research has corroborated the importance of our earlier findings, and the 2016 election cycle has shown how important these issues are to all Americans. In this report, we look beneath the surface and explore a number of concrete proposals that could make a real difference to our economic and social future.
Racial Justice and This Agenda

One of the central dilemmas in progressive policy today is how economic reform intersects with race and gender. In particular, there has been robust debate over how an agenda designed to tackle inequality and challenge the power of the 1 percent would affect people and communities of color. This is not a new dilemma; corporate power has been a driver of racial and gender inequities, in addition to economic inequities, throughout American history.

This is even more relevant for an institution such as the Roosevelt Institute, which celebrates the achievements of the New Deal and aims to expand it for the 21st century, but also sees how the original New Deal was limited by built-in structures and rules of exclusion. In an era of global economic and social fear and unrest, the New Deal was, in the words of the Ira Katznelson, caught in “a Southern cage”—which is to say, the Jim Crow South shaped and warped it, preventing it from achieving its full promise of economic security for all.¹ The New Deal was also, in the analysis of Susan Mettler, a project of “dividing citizens” by gender: Programs for men and wage-earners were executed at the federal level and framed as a matter of economic rights; programs for women were executed at the state level and framed around community standards of need, charity, and deservingness.² In a context of Southern “states’ rights” ideologies, women, and especially black women, were deemed as suspect and undeserving.

The 1 percent’s share of income fell dramatically by the end of the New Deal, from around 16 percent in the mid-1930s to 11 percent by the mid-1940s and to 8 percent by the mid-1960s. Contrary to some arguments, this was not driven by the collapse in wealth caused by the Great Depression. Instead, it was the result of parts of the New Deal, including policies for full employment, unionization, regulations, and high marginal taxation.³ The ability of workers to unionize and engage in collective bargaining, granted in 1935 and upheld by the Supreme Court in 1937, spread quickly. And in manufacturing industries where black workers were located, industrial unionism helped close racial income gaps.

However, these changes in the rules were not sufficient to ensure broad-based prosperity. The achievements that followed in the mid-20th century were a critical step forward: Social Security was expanded to all citizens, Jim Crow was overturned, voting rights were protected, and women’s rights and autonomy were advanced. While we have made progress on these fronts, we must still expand many other protections and benefits to achieve the promise of economic freedom. Dismantling structures that perpetuate racial inequality is no less important to our current fight for social and economic progress than it was during the civil rights era.

We believe the economic agenda outlined in this report is necessary for broad-based economic security, but we do not believe it is sufficient. As described in the introduction, we must pair an economic agenda like this with an agenda that involves targeted universal benefits and broader social insurance. It must also be part of a mixed economy that truly works for everyone, with strengthened labor regulations, improved and equitable access to public goods like education and health care, and investments in infrastructure, particularly in communities reeling from a long history of systemic exclusion.

Another recent report from the Roosevelt Institute, Rewriting the Racial Rules, aims to bridge that gap by looking at how our present-day institutions, norms, and market structures reinforce historic racial inequities and illustrating why any efforts to address economic inequality must also address race. These two agendas are part of a broader portfolio of work that sees economic and social equity as two sides of the same coin.⁴
With this in mind, however, there are four ways in which our corporate and financial power-focused agenda would directly benefit communities of color and advance racial equity and justice, and it is worth spelling those out. Some are general, but others more specific. They include:

» Access to services
» Expanded public Investments
» Financial sector access
» Access to good government

**ACCESS TO SERVICES**

Monopoly power is not just about unfair profits; it is also about who will be able to access what kinds of services and under what conditions. The profit side of the question is well understood: Monopolies produce too little of a good and charge too much for it in comparison to a market in which there is extensive competition. This raises the real price of goods and services, which disproportionately affects people of color, who are already disadvantaged by racial gaps in income and wealth. The rise in the cost of fuel and utilities, driven by global demand but also by the relaxation of price caps, has been a major driver in the cost of low-income housing, which has in turn become a major driver of the housing insecurity that hurts low-income communities.⁵

But the calculus of economics does not fully capture the way in which monopoly power works against communities of color. Our report documents how public utility law in the progressive era arose from a commitment to access. As legal scholar K. Sabeel Rahman argues, public utility law grew out of the principle that certain firms had “the duty to provide a service once undertaken, to serve all comers, to demand reasonable prices, and to offer acceptable compensation.”⁶ By contrast, the emerging monopolistic sectors are committed to controlling critical platforms and services to maximize profits in ways that would diminish the power of communities of color.

The net neutrality case is a recent example. As Color of Change argued:

> By protecting the open internet, the FCC will protect the platform that is fueling a new civil rights movement. Net neutrality provides a level playing field for all voices, and it has allowed Black activists, entrepreneurs, and citizens to find their audience online, despite often being left out of traditional media.⁷

The exclusion that would come from internet service providers (ISPs) being able to prioritize traffic would disproportionately disadvantage communities of color.

Or consider other platforms and how they can easily allow discrimination to persist and spread. One recent social media campaign, #AirbnbWhileBlack, raised awareness of how people of color are denied access to the popular hotel accommodation app.⁸ This is entirely about duties to provide a service and to serve all comers. Whether or not these standards are extended to the internet economy will determine access for communities that have been systemically excluded.

**EXPANDED PUBLIC INVESTMENTS**

Concerns about access to services also extend to investments in communities. For example, the digital divide is real, with just 61 percent of black households having access to the internet, compared with 74 percent of households overall.⁹ Part of the challenge to closing this divide is that both the private and public sectors are failing to make the kinds of long-term investments that expand access and spur growth.
A corporate focus on returns to shareholders and short-term gains has skewed all kinds of allocation decisions and reduced incentives for investment in long-term projects like seeding less profitable low-income markets (often communities of color) or training workers. This is why short-termism, or the pressure for companies to pay shareholders with dividends and buybacks rather than focusing on jobs and investments, is relevant. Last year, Verizon spent $5 billion on a buyback designed to boost its stock price. If, using reasonable estimates, it costs $500 to install FiOS broadband in a home, that $5 billion could have been used to expand broadband internet access to 10 million new homes, immediately challenging the digital divide.

Theoretically, the government should make these kinds of investments when we witness market failure in the private sector. However, corporate power often succeeds in preventing not only government regulation but also government investments. Fighting municipal broadband projects, where the state directly invests in community internet access, has been a major priority for cable monopolies.

The expanded role of corporate power also extends to trade. Trade agreements allow corporations to evade accountability, and the trade deficit is a major source of economic instability that is most felt by communities of color. We outline why trying to close the trade deficit may be too difficult and counterproductive, and may even put developing countries at risk. But we also argue that we can channel international capital flows into a full employment agenda by investing in clean energy, an infrastructure bank, and public projects.

The current lack of investment has serious consequences for jobs, which are desperately needed. The black unemployment rate is twice that of white workers across education levels. As of 2011, black households earn just 60 cents for every dollar of white median household income; this number has grown in absolute dollars since 1967. A robust investment agenda would help bring about full employment, boosting the employment and wages of communities of color.

**FINANCIAL SECTOR ACCESS**

There is a clear story about how the financial sector devastated communities of color during the housing bubble and subsequent Great Recession. Black households were disproportionately hit by the six million foreclosures that occurred since 2007. According to Pew Research Center, white households held 13 times the median wealth of black households in 2013, compared with eight times in 2010. The median net worth of black households fell from $19,200 in 2007 to $11,000 in 2013.

We attribute this partly to the rise of so-called “shadow banking,” the vast network of unregulated financial institutions that serve many bank-like functions and can thus spread panics such as the one that followed the bankruptcy of Lehman Brothers in 2008. This tendency toward panic and contagion is a crucial part of the problem, but shadow banking is also about the disintermediation of credit, meaning that the people making loans are far removed from those who will ultimately bear the risks of those loans. With no accountability, it is natural for the communities most at risk to be targeted for the most exploitative loans, which is exactly what happened in the 2000s. This environment is a breeding ground for exploitation and abuse, and tackling this problem is essential to ensuring good credit gets to the communities that most need it.

The housing bubble demonstrated that rules and protections don’t matter if there is no one to enforce them. We saw this when states that tried to stop predatory lending, such as Georgia, were overruled by federal regulators.

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**Dismantling structures that perpetuate racial inequality is no less important to our current fight for social and economic progress than it was during the civil rights era.**
acting on behalf of the financial sector.\textsuperscript{13} This is why our report focuses on enforcement, particularly on why the people who enforce the rules matter and on the importance of diversifying the regulatory system.

**ACCESS TO GOOD GOVERNMENT**

The effects of all this are even clearer at the government level, where two important challenges emerge. The first is that the tax code has been rewritten according to a trickle-down ideology that fails to deliver growth and concentrates wealth in the hands of large corporations and wealthy individuals. Tax benefits, such as credits, deferrals, and deductions, go disproportionately toward those who hold assets rather than those who earn income. The low inheritance tax rate and the loopholes it contains benefit wealth-holders across generations. Given the racial gaps in already-existing wealth, this exacerbates future wealth gaps.

In this report, we describe the many different ways in which the highest earners hide income or receive preferential tax rates. As this income is highly concentrated, this means that the sources of public funding must be less progressive. It also means that society is protecting those at the top in a way divorced from the best policies or economic logic.

The second challenge is that, with less funding, cities must turn to more predatory financing to survive. As a result, a larger portion of city budgets is devoted to payments and fees to the financial sector, which means less for social services. Schools are closed, and services that communities of color depend on are cut. As of 2014, a majority of public K–12 students are Latino, African-American, and Asian.\textsuperscript{14} And communities of color cannot simply move or seek private substitutes to public services in the way more affluent white citizens can. Comparing January 2008 with January 2016, total public employment was down by more than 300,000 jobs, with these losses particularly felt at the state and local level. Considering that public employment should have been growing along with the population, this creates an ever-larger public jobs deficit.\textsuperscript{15} The impact is even worse for communities of color, where public employment has in the past provided a steady jobs base and path to entry to the middle class.

Moreover, the need to make up tax revenues encourages cities to turn to their own exploitative practices, which often means exploitation and abuse of communities of color. This can range from imposing large financial burdens on people facing minor charges to the aggressive seizing of homes, cars, and other items. We saw this in the Justice Department’s Ferguson report, which found that “Ferguson’s law enforcement practices are shaped by the City’s focus on revenue rather than by public safety needs.”\textsuperscript{16} This reactionary revenue-seeking mechanism is the end result of a system in which the taxation of businesses and capital falls short.

**CONCLUSION**

Tackling the untamed power of corporations, finance, and monopolies is essential to fixing our economy. It is also an important and necessary—but not sufficient—part of building economic security and opportunity for communities of color. The power that private firms exert over our lives is even more significantly felt in communities of color, and addressing it gives us the ability to begin building a more secure future for a broader population.
This section outlines a set of private sector reforms that will level the playing field so that the U.S. economy works for all Americans, not just large businesses and CEOs. We outline policies that would limit the power and influence of corporations to write economic rules for their own benefit. Rather than focusing on the symptoms of consolidated corporate interests, the policies we lay out here are designed to address the problem at its root by reducing market power, reshaping private sector incentives, and boosting growth and employment.

In particular, we focus on areas in which we have seen the rules increasingly benefit the powerful and privileged at the expense of average incomes and economic performance. We look at the increased concentration of market power and propose a reinvigorated competition policy. We also propose tax reform that would reduce business incentives to dodge tax liabilities using complex legal arrangements. Finally, we propose a set of domestic policies that would channel the benefits of open trade and capital flows to productive investments in the economy and workers.

By reducing monopoly power, ending unfair tax advantages, and rebalancing trade policy, we aim not just to reduce corporate rent-seeking but also to encourage productive economic behavior. Our aim is not simply to shrink market share, redistribute revenue, or close borders, but to encourage innovation, efficiency, and fair competition and usher in a new era of equitable and sustainable growth.

CORPORATE POWER AND RENT-SEEKING IN THE AMERICAN ECONOMY

As discussed, economists and policymakers have documented the rise of a rent-seeking economy, in which the rewards for shaping and avoiding rules and regulations (rents) are greater than the rewards for real economic activity, innovation, and investment. This system, in which private returns far outweigh social returns, creates a vicious cycle in which rents increase wealth and therefore influence, and increased influence further enables rent-seekers to lobby for and win more rents. The result is rising inequality and sluggish economic performance.

Until the late 1970s and early 1980s, regulators were well aware of these dangers. Early efforts by the original trustbusters to fight rent-seeking and tackle the “robber baron” monopolies of the Gilded Age were centered as much on political inequality as on economic inequality. As industrialization gave rise to super-firms like U.S. Steel and Standard Oil, the antitrust movement was not merely concerned with market share and economic dominance, but also with the impact of excessive political power on democracy.

However, conservative intellectual dominance over the past several decades has led policymakers to eschew their past concerns with market power in favor of a more narrow focus on consumer welfare. These intellectual currents, in turn, produced dramatic policy shifts by the 1980s. The Reagan administration’s deregulatory and low-tax approach ended traditional safeguards and led to a concentration of economic power as well as increased corporate political influence.
Today, business regulations, tax policies, and trade policies favor the interests of multinational corporations and the 1 percent as opposed to the average worker. Antitrust policy has been gutted, corporations and wealthy individuals have identified countless structures to legally avoid paying taxes, and more open borders and the free flows of goods and services have increased the power and prospects of firms that could compete globally. By contrast, the workers left behind by globalization have found no champion.

A NEW POLICY AGENDA

None of the outcomes that we have identified is inevitable. In the following pages, we take up the mantle of the bipartisan progressive reformers from the turn of the 20th century, and we aim to curb concentration, enforce transparent taxation, and offer a reasonable response to trade and globalization. We identify concrete actions to curb corporate influence that are available to the president, regulatory agencies, and Congress.

First, we outline a pro-competition policy for the 21st century. We argue for reinvigorated enforcement of existing antitrust regulation, which has been needlessly narrowed to a primary focus on consumer prices. Much of this agenda demands more robust use of existing regulatory powers; however, we also grapple with “platform power”—the new monopolies that benefit from network effects, such as Google and other digital platforms, and are not as easily regulated. In these cases, we argue that we must expand the public utility regulatory model so that, as with net neutrality, we can ensure fair access to and service from the new economic infrastructure.

Second, we identify key tax levers that can curb corporate tax-dodging and put small businesses and average workers on more even footing with multinationals. We focus on the areas of the tax code where legal maneuvering, corporate obfuscation, and privilege—as opposed to productive economic behavior—currently offer the greatest rewards. We recommend new structures for capital gains taxation, multinational taxation, and taxation of passthroughs.

Finally, we put forward a domestic agenda that will counter lost growth and jobs from trade with increased investment. The goal of this part of our agenda is to spread the benefits from the international flows of goods and capital more broadly. We note that the answer to the challenges of global trade is not simply to close the borders or build high walls; we can rewrite the rules to benefit American workers without inducing economic crises elsewhere.
Restoring Competition in the U.S. Economy

By K. Sabeel Rahman, Brooklyn Law School, New America, Roosevelt Institute and Lina Khan, Yale Law School, New America

Increasing market concentration across the American economy has been a driver of declining economic opportunity and widening inequality in recent decades. In industries ranging from hospitals and airlines to agriculture and cable, markets are now more concentrated and less competitive than at any point since the Gilded Age. This growing concentration threatens economic equality and dynamism and has a range of effects that include raising costs for consumers, lowering wages for workers, stunting investment, retarding innovation, and handing a few corporations and individuals in each sector outsized power over our economy and our democracy.

As an expanding body of research shows, corporate concentration has enabled dominant firms to collect rents and may be contributing to income inequality in the U.S. These studies suggest two key trends: A smaller group of companies now earn a larger share of total profits and uncompetitive factors like firm size and age seem to increasingly drive corporate profits. From transportation and manufacturing to telecom and finance, the top four firms increased their share of revenue by upwards of 30 percent between 1997 and 2012. Analysis of census data found a much broader trend: Market concentration in over 600 sectors increased during that time period.

Concurrently, and at an increasing rate, the nation’s largest corporations are earning profits well beyond what competitive markets would predict. In 2014, the rate of returns for corporations in the top 10th percentile was five times that of median firms; in 1990, the ratio was two to one. In theory, innovation or improved productivity could be the cause—but the companies capturing greater profits tend to be older, suggesting that the culprit may be a monopoly advantage. This rise in profits among older firms has coincided with a decline in market dynamism: The rate of new business creation, a key driver of job creation, has fallen dramatically over recent decades.

There is also reason to believe that inequality among corporations contributes to inequality among workers. As Peter Orszag and Jason Furman argue in a recent paper, wage inequality between workers in the largest, most profitable firms and the smallest, least profitable firms increasingly accounts for diverging incomes in the U.S.

Most troublingly, the problem looks set to get worse. Total merger activity in the U.S. surpassed $2 trillion last year, breaking records. The trend continues this year, as a major boom in corporate mergers is sweeping sectors across the board—including cable providers, airlines, and pharmaceutical companies, to name a few. Perhaps most alarming is the tech sector, where a combination of network effects, outdated laws, and permissive regulation has enabled a handful of companies to consolidate vast control over key internet services.

None of these outcomes—large firms extracting large rents, rising inequality, softening labor markets, stagnating business creation—are inevitable. Instead, they are the product of distinct political and policy choices that the next administration should revamp to make markets more open, fair, and competitive. While the Obama administration has taken some steps towards addressing these concerns, much more can and needs to be done.

» Revise the merger guidelines.
» Reinvigorate agency action.
» Pass a new anti-trust law.
» Reduce platform power and data consolidation with antitrust enforcement.
» Employ public utility regulation.

THE RISE AND FALL OF MARKET COMPETITION AS A PROGRESSIVE VALUE

Markets and market outcomes are products of legal and policy regimes. Understanding market structure as a way to promote competition, dynamism, and opportunity has been a long-standing pillar of the progressive economic vision. For progressive reformers

i For examples, see the April Executive Order calling for agencies to identify anticompetitive practices and refer cases to the FTC and DOJ, and in its modest increase in antitrust criminal enforcements.
of the late 19th and early 20th century—the era of “robber barons” and monopolies in rail, oil, finance, and other sectors arising from the newly industrializing economy—the goal of market reform was not just to lower prices, but also to protect economic and political liberty. Reformers recognized that allowing dominant firms to capture control over markets led to a host of harms—enabling these companies to undermine market innovation and dynamism, restrict access to essential goods and services, and leverage their economic power to influence and corrupt the political process, skewing regulations to favor the interests of corporate leaders and investors.\textsuperscript{10}

This core concern with concentrated private power animated a variety of policy responses. Most famously, reformers during this period battled to create antitrust laws and regulations, facing stiff opposition from business interests and legal and political elites. In 1890, Congress passed the Sherman Act, a landmark statute declaring combinations, trusts, and monopolies that restrained trade to be illegal, and empowering the Department of Justice (DOJ) to bring enforcement actions. The law was controversial, and within a few years the Supreme Court had dramatically undermined it, holding that it forbade only “unreasonable” restraints of trade, defined narrowly. It took Woodrow Wilson’s administration to give the law and its enforcement real teeth. Wilson expanded the scope of antitrust laws through the Clayton Act of 1914, which prohibited price discrimination, mergers and acquisitions that substantially reduce competition, and forms of exclusive dealing. Wilson also created the Federal Trade Commission (FTC) to regulate competition and enforce these laws.\textsuperscript{11}

Notably, reformers didn’t seek to use antitrust categorically. In some instances they responded to dominant companies not by breaking them up but by accepting their economies of scale and regulating them instead. Thus this period of antitrust innovation was paralleled by the rise of public utility regulation. In cases where private corporations had established control over a key infrastructural good or service—such as transportation, electricity, water, or even basic necessities like milk and ice—federal, state, and local governments increasingly imposed public obligations such as fair pricing, nondiscrimination and common carriage requirements. These rules left in place the economies of scale that stem from concentration while ensuring that private control of these public necessities did not lead to extractive or exploitative business practices. In particular, the rules mandated equal access to these networks and necessities, preventing discrimination. By ensuring that the power to pick winners and losers did not lie with a handful of executives, these policies also opened the economy up to a wider range of individuals, businesses, and communities.\textsuperscript{12}

But starting in the 1970s, a group of legal and economic scholars began to lay the intellectual groundwork for the dismantling of New Deal and progressive economic regulations. These scholars argued that regulators were likely to be “captured” by special interests, that unregulated markets would self-correct, and that deferring to shareholder interests would generate a more efficient economy. The effects of this new thinking were dramatic. Led by conservative intellectuals-turned-policymakers like Robert Bork, the Reagan administration overturned antitrust policy, abandoning the traditional focus on open market structure, innovation, and system stability for a narrow focus on economic efficiency. The DOJ and FTC enacted this new approach by weakening their merger guidelines and halting enforcement of key provisions. At the same time, state and local governments privatized many public utilities and, in industries like airlines and electricity, shifted from regulated rates to market-set prices.\textsuperscript{13}
These policies helped generate today’s political economy, characterized by highly concentrated markets and extreme inequality. As the consequences of this concentration come into full view, both policymakers and the public are recognizing that it threatens economic dynamism and political democracy.

We need to revive an open markets agenda for the 21st century. While this need not mean reverting to an old economic model, it should involve restoring traditional democratic principles—such as the idea that unfettered private power threatens the public good—and applying them to our new economy.

**POLICIES TO REVAMP ANTITRUST REGULATION**

**Revise the Merger Guidelines**

*Stronger guidelines would assess market structure, scrutinize vertical deals, adopt “per se” standards, and seek to promote the public interest in merger analysis.*

First issued by the DOJ in 1968, merger guidelines identify the factors that antitrust agencies will consider when reviewing mergers. Indeed, the merger guidelines served as one of the primary levers the Reagan administration used to significantly weaken enforcement. Under the 1968 guidelines, the agencies looked primarily to market structure to assess effects on competition. The 1982 guidelines, by contrast, established that short-term effects on price and output were the primary metrics agencies would use to gauge competitiveness—a shift that ushered in an era of highly permissive merger review. Strikingly, this drastic reorientation in antitrust policy was achieved entirely by the executive branch, absent input from Congress or the public, or judicial review.¹⁴

To help revive competition, the next president could similarly revise the merger guidelines. Stronger merger guidelines would reassert the centrality of market structure to competition analysis—namely, the idea that how a market is structured directly implicates its competitiveness. A mainstay of antitrust thinking for much of the last century, this foundational idea has since fallen into disuse. Because merger guidelines are issued as agency guidance, agencies possess full authority to revise them whenever and however they see fit. The change would require no new law, nor would it require agencies to go through the rule-making process. Moreover, courts generally defer to agencies on this guidance, minimizing the likelihood that private parties would succeed by challenging the guidelines in courts.

Second, the DOJ should scrutinize vertical mergers. Current analysis of vertical deals is extremely rudimentary and neglects to consider how these tie-ups can create anti-competitive conflicts of interest and market structures conducive to exclusionary conduct. Some of the largest deals ushered in by recent administrations have been vertical (e.g., Comcast and NBC or Ticketmaster and LiveNation).

Third, we should establish a policy in favor of simple rules and presumptions over “rule-of-reason” analyses. The “rule of reason” standard involves open-ended tests that require plaintiffs to define the relevant market, establish that defendants possessed market or monopoly power, and show anticompetitive effects. This approach contrasts with the “per se” standard, under which certain practices are presumed to be illegal, without requiring plaintiffs to make significant showings. This would involve blocking problematic deals rather than seeking to mitigate harms through conduct remedies or divestitures. A host of research shows the “rule of reason” approach has widely failed to preserve competition—a lesson that agencies have largely neglected to heed or incorporate into their enforcement approach.¹⁵

Finally, we must reorient the merger guidelines to promote a “public interest” or “citizen interest” standard. A more comprehensive approach to competition policy would acknowledge the full range of consolidation’s effects—including its effects on the quality of products and the availability of services, the ability of potential competitors to enter the market,
monopsony power over both workers and producers, innovation, and the stability of global supply chains and the financial system. One of the primary failures of current policy is that it reduces “competitive harm” to near-term price hikes, blinding enforcers to the myriad other hazards that extreme concentration can pose.

Critics will likely argue this approach would render antitrust policy subjective and unstable, creating uncertainty for businesses. This line of argument echoes Chicago School critiques from the 1960s and ’70s, which helped open the door for the initial change. A few responses follow. First, regulators and enforcers are routinely tasked with balancing a variety of goals and priorities. An approach that considers the multi-dimensional aspects and effects of a policy should be embraced as more rather than less sophisticated, as it will more accurately reflect and capture the range of ways in which market concentration affects us. Second, to the extent that strengthening antitrust in this fashion will lead to stricter enforcement, it is true that businesses will need to revise their expectations. However, this potential uncertainty is no reason to maintain the status quo. While the business community is quick to decry the costs of uncertainty, the current, highly permissive approach also imposes enormous economic costs, many of which economists are only now beginning to quantify. Moreover, one of the main potential benefits of stronger enforcement will be greater business opportunity for entrepreneurs and independent ventures—a boon for economic growth and job creation.

Reinvigorate Agency Action

Executive branch leadership can spur agency personnel to pursue aggressive competition policy through existing powers.

Executive agencies like the DOJ and FTC have significant latitude to shape both antitrust policy and enforcement. It is true that a conservative federal
judiciary has adopted defendant-friendly standards that make it more difficult for plaintiffs—including the government—to overcome court challenges. But the antitrust agencies have responded by dramatically scaling back enforcement, taking a highly diminished view of their expansive powers, and leaving entire areas of law untouched.

We should prioritize reinvigorating the antitrust agencies and appointing leaders keen to use the full range of their expansive powers. This is especially important to enable these agencies to pursue the kind of vigorous enforcement suggested above.

First, and perhaps most significantly, the next administration must fill agencies with leaders and staff who have a proven commitment to investigating and litigating anti-competitive behavior. Presently, too many enforcers have been trained primarily in defense-side work, which results in weak approaches and a highly circumscribed view of the law. Potential candidates should include state-level enforcers, plaintiff-side lawyers, and academics whose scholarship identifies the failures of the current regime. Similarly, these agencies need expanded resources, staff, and expertise to enable them to keep up with the waves of merger activity, technological change, and anti-competitive practices in the economy.

In addition, the executive branch should restore the FTC’s Section 5 authority, which would expand its enforcement powers. It is widely acknowledged that through Section 5 of the FTC Act, which prohibits “unfair methods of competition,” Congress intended to equip the agency with powers that went beyond what current Clayton and Sherman Act jurisprudence permits, the next administration should restore Section 5 to the full breadth of what Congress intended.

In this same vein, antitrust agencies should target monopolization and abuse of monopoly power. Section 2 of the Sherman Act was written to guard against the kind of monopolistic abuse we see today. Enforcement of laws that target abuse of monopoly and oligopoly power is paramount, yet antitrust agencies have largely abandoned enforcement of Section 2. 19 Although court precedent has narrowed the likelihood of success on certain claims, other areas of the Section 2 jurisprudence remain largely untested. Important Section 2 wins by private plaintiffs—whose investigative powers and resources are limited—suggest that actions by the antitrust agencies, who have broad subpoena powers and large budgets, could go far. 20 Agencies should litigate to test the boundaries of the law and to alert monopolist firms that certain conduct (i.e., tying/bundling practices, predatory pricing, exclusive dealing) will be closely scrutinized. We should prioritize litigating Section 2 cases, as even defeats in court will provide an important service to Congress and the public by identifying what areas of the law have been defanged and must be restored, potentially through statutory fixes.

Finally, the president should direct agencies to introduce programs and mechanisms to regularly collect data on market concentration. Presently, there are few public databases that document the extent of consolidation across sectors. The Census Bureau’s Economic Survey contains some information on concentration, but its measures do not capture fine market definitions and its data is revised too infrequently to be of regular use. The FTC’s “Line of Business Survey,” carried out in the 1970s, may offer a useful model on which to base new collection efforts. 21

Antitrust agencies possess the authority to enact these changes, which would be steered by internal decisions rather than rule-making. In some instances it is possible that business interests would challenge these policies in court (e.g., FTC’s guidance on its expansive Section 5 powers). While regulatory agencies are accorded judicial deference in their interpretation of their legal authority, at times the degree of deference courts grant to agencies on this front—as well as how they read the

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ii The guidance pegged “unfair competition” to the consumer welfare paradigm and the “rule of reason” balancing test.
mandate of antitrust laws—will depend to a nontrivial degree on who is staffing the federal judiciary. If progressives are successful in appointing judges with a less hostile approach to antitrust, it is likely that agency efforts on the above-mentioned fronts will be successful. And even if certain efforts are struck down, short-term losses may make the case for statutory fixes that serve the long-term interests of competition policy.

Pass a New Antitrust Law

A new statute should adopt a “public interest” standard to guide and advance competition policy.

As suggested earlier, the primary limitation on this kind of expanded antitrust enforcement is that both agencies and courts orient antitrust enforcement around the narrow goal of promoting consumer welfare and efficiency. This standard has in practice worked to narrow and weaken antitrust enforcement—a limitation that, in turn, has stemmed from the combination of vaguely drafted Sherman and Clayton Acts and the decades-long practice of agencies lacking the will or capacity to pursue vigorous enforcement. A revised and clarified statutory mandate would both direct and bolster antitrust agencies in their enforcement efforts.

Specifically, a new statute could define a “citizen interest” or “public interest” standard requiring agencies to consider not just narrow price effects but also issues such as market openness, competition, and innovation. Similarly, a new statute could explicitly change the “unreasonable restraint” standard to an “abuse of dominance” standard akin to what prevails in European antitrust law, allowing for greater scrutiny of the business practices of market-dominant firms.

Third, a new statute could require greater business justification for mergers in concentrated markets. For example, we might adopt a presumption that horizontal mergers are illegal if they produce a firm with a market share greater than 20 percent, unless the companies can show business justifications for the merger and rebut presumptions of anti-competitive results. This was the approach articulated by the Supreme Court in United States v. Philadelphia National Bank—a case that is still good law, though rarely followed. Critically, this approach would look not simply at national market shares but also at the specific effects within regions. Even a firm that holds only 10 percent of the national market may control 90 percent of a local market, a level of concentration that should be treated as unacceptable. Adopting this new standard would simplify merger review, shorten review times, and limit current reliance on speculation about future market developments.

GRAPPLE WITH “PLATFORM POWER”

A reinvigorated competition policy must also adapt to the distinctive challenge of the 21st century economy: platform power. From Amazon to Google to Uber, there is a new form of economic power on display, distinct from conventional monopolies and oligopolies. These firms leverage data, algorithms, and internet-based technologies to create and operate “platforms” upon which many other businesses, workers, and consumers engage. They link, for example, content providers to searchers, drivers to riders, and buyers to sellers. While these firms on the surface expand consumer choice and lower prices—features that would suggest they are not violating antitrust principles—they nevertheless have acquired outsized influence over their markets. By operating the platforms, these firms can influence who can buy and sell and what information is transmitted, all in ways that could operate invisibly and anti-competitively.

The problem of platform power poses a major policy challenge for competition policy in the coming years. Future administrations will have to innovate novel responses to these new challenges.

Reduce Platform Power and Prevent Discrimination and Dominance Arising from Data Consolidation

Adapt antitrust and public utility regulations to address new forms of data monopolies.

Antitrust agencies should consider the control and consolidation of data by platform monopolies when evaluating threats to competition. While the FTC has begun to address how these firms might threaten consumer privacy, they have yet to address how
concentrated control over data deeply affects market competition.24

By collecting an extensive and rich dataset on user activity and habits, dominant platform operators have created a high barrier to entry. This trove of data can tilt the marketplace entirely in the direction of a single dominant player and positions these firms to enter into adjacent markets with an anti-competitive advantage. Concentrated control over data threatens competition especially in cases where firms are vertically integrated—Google and Amazon, for example—as these businesses can use data insights generated in one line of business (advertising or third-party marketplace sales) to privilege other businesses (search results or direct retail). Amazon is already using its consumer database to develop Amazon-branded retail goods that undercut well-performing products;25 Google’s simultaneous control over search results and entry into other sectors positions it to discriminate against firms in industries as wide-ranging as ratings and insurance.26

Concentrated control over data also enables dominant firms to implement price discrimination, where users are charged different prices for the same goods or services. While forms of price discrimination are already widely practiced in certain areas (e.g., discounts for senior citizens; need-based college tuition), widespread and highly detailed data collection empowers firms to implement first-degree price discrimination at an unprecedented level. If allowed to persist, this practice threatens to create deep asymmetries of information between users and dominant firms. Moreover, it threatens to create regressive wealth transfers. While research on the extent and effects of first-degree price discrimination is limited, initial studies have found that low-income consumers are prime targets of exploitative schemes.27 Given that many economists promote price discrimination, arguing that it effects a progressive wealth transfer, this research is important, as it shows that the primary effects of price discrimination may instead be highly regressive.28 Price discrimination may also enable implicit forms of racial discrimination by steering some users away from minority buyers or businesses.

As suggested above, antitrust agencies (or a new antitrust statute) should be attuned to these anti-competitive implications by:

- Considering data consolidation issues when reviewing mergers
- Limiting vertical integration by platform monopolies
- Limiting the cross-market use of data
- Restoring traditional prohibitions on discrimination in pricing and service

Employ Public Utility Regulation

Public utility regulation of key infrastructure platforms can be retooled to regulate digital “platforms”.

The Federal Communications Commission (FCC) and FTC can employ public utility regulation to ensure that platforms that effectively serve as foundational economic infrastructure remain open and accessible to all. While there are benefits to network effects of singular platforms, the platform operators can, through their control of the underlying infrastructure and algorithms, come to favor unfairly some sellers and providers over others, or to restrict access.29 In the Progressive Era, reformers sought to counteract this problem of access and fairness in foundational goods and services by imposing public utility regulations, requiring these firms to charge fair and reasonable prices and to serve all comers equally and without discrimination. These duties in turn stemmed from a historical tradition of “common carrier” regulations required by common law on innkeepers and transportation services. Public utility regulations were most famously developed in the context of railroads and early telecom regulations, but they now offer an avenue for addressing platform power in the 21st century.

The recent net neutrality debate offers a good example. The core issue in net neutrality is the concern that internet service providers (ISPs) can, in exchange for
extractive fees and rents, agree to “prioritize” and speed up the traffic of “preferred” internet content providers, like Netflix, to the detriment of other competing businesses. The central concern in the net neutrality debate was that ISPs like Comcast would engage in “paid prioritization,” converting the internet from an open marketplace and arena for free expression and innovation into a domain dominated by established players who can pay to entrench their privileged positions. The response to this problem took the form of FCC regulations that prevent ISPs from discriminating against unaffiliated or otherwise disfavored market actors, ensuring equal access to the basic internet infrastructure. The legal foundation for these regulations stemmed from the Communications Act originally passed in 1934 (though amended in 1996)—an act that, when originally passed, sought to ensure exactly these same norms of nondiscrimination and equal access in telecom industries by codifying the old progressive idea of public utility.

A similar policy strategy can be valuable in ensuring that information platforms like Google (and, increasingly, Facebook) do not influence in hidden ways the transmission of information, news, and advertising so as to enable self-dealing or to prioritize some market actors over others in exchange for payouts. In the case of information platforms such as Google or Facebook, the FCC or FTC might require that these platforms act as “common carriers,” with a commitment to nondiscrimination, equal access, and disclosure of which posts (if any) are being promoted due to paid agreements. Indeed, the FTC’s 2011 investigation into possible anticompetitive bias in Google’s search engine resulted in a settlement that took a step in this direction by requiring some policy changes on Google’s part. However, internal FTC documents mistakenly released in 2015 indicate that some FTC officials believed an even more aggressive policy response might be warranted over how Google absorbed product and service ranking data from competing search and ranking sites like Yelp or Tripadvisor. In the case of urban infrastructure platforms such as Uber in transit and Airbnb in housing, city and state regulators might require similar obligations to prevent implicit forms of racial and price discrimination and to ensure that all constituencies have equal access to the services.

Another policy approach might be to require data platforms to be open access, enabling other apps, goods, and services to interface with the dominant data platforms. This could be achieved by providing an open access API or some equivalent. Here too there is an old-economy analogy: As the FCC adapted common carrier and public utility regulations to the telecom industry following the breakup of AT&T’s monopoly, one of the key requirements was “interconnection,” enabling new rival phone networks to connect to the existing AT&T infrastructure so that people could place phone calls to one another without being on the same phone provider.

Critics of such public utility regulations might cast them as restricting innovation, but this gets the story backwards: this form of oversight is vital to ensure that platforms generate socially beneficial innovation rather than rent-seeking. Comcast and Verizon decried the effects on innovation in their opposition to the FCC’s net neutrality orders, but, as the FCC noted, net neutrality doesn’t stifle innovation but enhances it: By ensuring that all content is transmitted equally across the network, net neutrality encourages content providers to innovate and create new material on the web. If, by contrast, they were to continue engaging in paid prioritization, Comcast and Verizon would not be “innovating”; rather, they would be extracting greater profits in a way that discouraged new content providers who lacked the resources to pay for higher transmission rates. In much the same way, requiring fairness and equal transmission on information platforms such as Google or Facebook would protect beneficial forms of content innovation rather than sacrificing content producers to the potentially extractive and self-dealing manipulation of information feeds and search results.

**CONCLUSION**

An administration eager to reduce concentration of corporate power and corporate profits could employ an array of policy tools. Even without legislative cooperation, the executive branch could issue new merger guidelines and reinvigorate policing of anticompetitive conduct and structures. Further, the White House and the relevant agencies could begin the critical process of conceptualizing and crafting a competition policy for the 21st century that benefits from platform innovation but preserves the spirit of open markets.

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Restructuring the Tax Code for Fairness and Efficiency

Rethinking Capital’s Privileged Place in the Tax Code by Steven M. Rosenthal
Long-Term Strategies to Address Multinational Taxation by Kimberly Clausing, Reed College
Problems with Passthrough Taxation by Eric Harris Bernstein, Roosevelt Institute

It is no secret that the American tax code is deeply flawed. The system rewards short-term profits over productivity, privileges wealth over work, and cedes a systemic advantage to large, complex firms over simple businesses. The current tax code grants a preferential rate to capital income and allows passthrough businesses and multinational firms to engage in large-scale tax avoidance.¹ Estimates vary year by year, but the combined annual estimate of the revenue lost to these three areas exceeds $300 billion per year, accruing disproportionately to the top 1 percent.² But the problem is not just a matter of fairness; it is also a matter of skewed incentives and lost efficiency.

Beyond making the rich richer, top-heavy loopholes and rate cuts create the expectation that taxes can be avoided. This encourages wealthy individuals and firms to seek outsized profits (rents, in economic terms) through tax gamesmanship rather than pursuing productive activity that grows businesses and creates jobs. Lobbying from hedge funds and private equity firms, for example, has increased enormously in recent years as the carried-interest loophole has become a key source of profitability.³

Reforming the tax system to close these loopholes would increase fairness and efficiency by raising tax rates for the wealthy and discouraging rent-seeking. ³ To accomplish this, we recommend the following policy solutions:

» Equalize capital and personal income tax rates.
» Limit the size of tax-free retirement accounts.
» End the stepped-up basis at death.
» Mark derivatives to market for tax purposes.
» Explore a system of formulary apportionment.
» Raise rates on financial passthroughs.
» Institute a nuisance tax on inter-partnership dividends.
» Increase funding for the Internal Revenue Service (IRS).

ECONOMIC CONSEQUENCES OF THE CURRENT TAX CODE

Many of the regressive and inefficient components of the U.S. tax code that garner widespread attention, such as corporate inversion or the “carried interest” loophole, are really just symptoms of larger tax problems at work. In this section we outline and propose reforms to the three most problematic areas of the U.S. tax code: capital, multinational, and passthrough taxation. The policies recommended are aimed not merely at raising rates on the wealthy and on large, profitable firms—although they would do that—but at maximizing efficiency by rewarding productivity and discouraging wasteful rent-seeking.

CORPORATE INVERSION occurs when a US company combines with a foreign company for the purpose of locating its residence in a foreign jurisdiction with a low corporate tax rate and a favorable set of tax rules and treaties. Corporate inversions are often undertaken to facilitate profit-shifting and reduce tax payments.

Despite bipartisan acknowledgment of problems in these areas, proposed reforms have failed to offer the transformative, progressive solutions that are required and discussed here. In fact, while the ineffectiveness of trickle-down tax policies has become increasingly clear to many on the left, anti-tax rhetoric on the right has only intensified. Some in Washington have gone so far as to question the basic necessity of taxes on corporate income and dividends, and numerous 2016 Republican presidential candidates offered tax plans that aggressively undercut the very foundation of progressive taxation.⁴

¹ Congressional Budget Office (CBO) (2013) estimates the tax expenditure on preferential capital gains rates at $161 billion a year, 68 percent of which goes to the top 1 percent. Cooper et al. (2015) estimate that passthrough tax avoidance cost the government more than $300 billion per year, 69 percent accruing to the top 1 percent. Clausing (2016a) estimates that multinational tax avoidance cost between $77 billion and $111 billion of revenue in 2012, and while it is unclear exactly how much was captured by the top 1 percent, Cooper et al. (2015) show the top 1 percent capture 45 percent of all corporate income, including multinationals. Complex behavioral responses and varying statistical methods mean that these estimates are not necessarily equivalent to what revenue the government would generate with reform, but they provide a useful illustration of the magnitude of the revenue loss currently being experienced.
In this tax-phobic political climate, it is important to remember that these taxes play an essential role in the broader U.S. tax system, and that many tax policies are interconnected. Capital income, a growing share of GDP in recent decades, is far more concentrated among the wealthy than labor income. A progressive tax system must account for this disparity and recent economic research refutes many of the conventional arguments against taxing capital. Corporate income taxes act as a key tool for taxing wealth accumulating within corporations as well as an important “backstop” for the personal income tax, since corporations could otherwise act as tax shelters.

It is time for those with the best interests of the American people and the American economy in mind to reframe the conversation on taxation with these points in mind.

RETHINKING CAPITAL’S PRIVILEGED PLACE IN THE TAX CODE

No part of the tax code contributes as much to wealth inequality or tax avoidance as our complicated and inefficient system of taxing capital. By taxing capital gains—the profit from the sale of property such as stock or real estate—and capital income—dividends and interest payments—at a lower rate than income from work, today’s tax code grants a major break to the wealthy, who own the overwhelming majority of capital in the United States. In 2013, the top 1 percent owned 42 percent of all wealth and taxpayers with incomes over $1 million claimed three-quarters of the benefit of the lower rate on long-term capital gains. As we will show, this preferential rate is foundational to a number of inequities and inefficiencies in the tax code; eliminating it would restore fairness, raise revenue, and reduce wasteful arbitrage activities.

In theory, capital income is taxed at a top rate of 20 percent plus a 3.8 percent tax on net investment income. This is roughly half of the total statutory rate on labor income, which is taxed at a top federal income tax rate of 39.6 percent plus an additional 0.9 percent Medicare surtax on amounts above $200,000. To make matters worse, a number of other tax policies, as well as the relentless pursuit of lower rates by wealthy firms and individuals, have combined to drive rates down even further.

For example, taxes on appreciated property (capital gains) are deferred until the property is sold, and are eliminated altogether if the property is held until death or given to charity. This means that wealthy families can build fortunes across generations without ever paying a dime in capital gains tax. Additionally, tax-deferred retirement accounts, though important for many planning retirement, are increasingly exploited as legal tax shelters for the very wealthy. As contribution limits have increased in recent years, so too has the amount of wealth held in these accounts: 45,000 Americans now have IRAs worth more than $3 million. Finally, the preferential rate on capital income has enabled firms to engage in complex tax planning in order to get wage income labeled as preferentially treated capital income. For example, private equity firms are able to report their income as “carried interest” and thus greatly reduce their tax liability.

These low rates on capital income were sold to the American public as an investment booster that would create new jobs, but decades of evidence roundly refute the notion that low capital taxes are good for the economy. Recent studies have suggested that low rates on capital have been responsible for increased inequality and have had no discernible positive impact on economic performance. The chart below illustrates the point that tax rates appear to play little role in determining growth.

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\[\text{\textcopyright} 2011, \text{Hungerford (2011).}\]

\[\text{\textcopyright} 2011, \text{All taxpayers, without income limitation, can convert their traditional IRAs to Roth IRAs.} \]

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Another common refrain is that lower tax rates for capital gains and dividends offset the taxes that have already been paid at the corporate level. Here again, we observe that lowering taxes on all capital gains is an improper tool for this policy goal, as the lower rate disproportionately favors investment in real estate, carried interest, and numerous assets other than stock. If the double tax were a substantial issue—and there is little reason to believe it is—policymakers could permit corporations to deduct dividends paid to taxable shareholders, which would more effectively address the issue.

Some politicians have suggested piecemeal solutions to the various symptoms of the capital preference, but the IRS’s struggles to catch up with existing schemes suggest that only a simple, comprehensive reform can end systemically low effective rates and widespread complexity in capital taxation.\(^7\)

**Tax Planning, Complexity, and Efficiency**

It is important to understand that low rates on capital lower tax bills that result enrich the wealthy but provide no wider benefit to workers, consumers, or society; not only are these resources wasted from an efficiency standpoint, but their effectiveness—and the porous system they reveal—only encourages more of this unproductive tax avoidance behavior.

Private equity managers, for example, categorize much of their income as carried interest that is taxed at the 20 percent capital gains rate, which is much lower than the rate faced by ordinary workers who pay full income tax rates as well as Social Security and Medicare taxes. Some schemes, like the abuse of options, forwards, swaps, and other financial derivatives, are even more complicated, but all have the same ultimate impact: The reduced rate makes these firms more profitable and potentially more desirable to wealthy investors, employees, and capitalists, even though their profitability is based on arbitrary tax treatment rather than genuine economic value.\(^8\)

Tax preferences for investment earnings can be seen as one contributing factor to the well-documented disproportionate growth of America’s financial sector. With a level playing field, less productive capital and fewer human resources would be drawn to finance, shifting these resources to more productive sectors of the economy.\(^9\)

**POLICIES TO IMPROVE FAIRNESS AND EFFICIENCY IN CAPITAL MARKETS**

**Equalize Capital and Personal Income Tax Rates**

*Taxing capital income at the personal income rate will end the benefit of mischaracterizing income and raise effective rates on wealthy capital owners.*

\(^x\) Two years ago, the U.S. Senate Permanent Subcommittee on Investigations (2014) exposed the use of “basket options” by hedge funds to convert short-term trading profits (previously taxed at 35 percent) into long-term capital gains (previously taxed at 15 percent).
No part of the tax code contributes as much to wealth inequality or tax avoidance as our complicated and inefficient system of taxing capital. Defining the assets or activities that deserve favorable tax treatment is tricky; rather than try, we should eliminate capital preferences altogether. This was done to good effect by the Tax Reform Act of 1986, but the rate of 28 percent and other provisions proved too much of a cut. As income tax rates on ordinary income rose to meet budget needs and capital rates fell further, the gap between rates returned, and with it came opportunities for arbitrage by mischaracterization and other wealth-favoring avoidance schemes.

End the Stepped-Up Basis at Death

Ending the stepped-up basis at death, which allows capital gains to escape taxation when investments are passed down, would raise overall rates on capital and end concerns over the lock-in effect.

One stated goal of the low capital gains rate was to reduce “lock-in,” whereby taxpayers would hold assets indefinitely, despite the presence of more desirable and therefore more economically efficient investments, in order to avoid paying taxes on their gains. But these arguments do not hold up when one considers the current system, in which capital assets pass from one generation to the next without being taxed, as a result of the “stepped-up basis at death.” So long as this provision creates a light at the end of the tunnel for asset holders, taxpayers will have a strong incentive to avoid realization indefinitely.

Instead of creating an enormous tax break for the wealthy by cutting or lowering the capital gains tax, Congress could simply end the benefit of step-up or tax capital gains at death, thus guaranteeing their eventual taxation and reducing the incentive to keep assets indefinitely. These policies would raise in excess of $30 billion per year, which could fund productive investment, deficit reductions, or lower tax rates.

Limit the Size of Tax-Free Retirement Accounts

Limiting the amount of money that can be held in tax-free retirement accounts or capping the income level of eligible contributors will end the use of these accounts as tax havens for the rich. Although raising the capital gains rate would do much to eliminate tax avoidance, a good concurrent step would be to limit the extent to which tax-preferred retirement accounts can be used as tax havens for wealthy individuals. This could be done either by capping the total amount that one person can contribute to tax-preferred accounts, or by restoring income limits for contributors. Either policy would be in line with the belief that Congress should enhance retirement savings for the middle class and not shelters for the rich.

Mark Derivatives to Market for Tax Purposes

Taxing derivatives as they incur gains or losses will increase compliance in financial markets.

Finally, derivatives should be marked to market for tax purposes. This would require investors to pay tax on any gains (or recognize losses), regardless of whether or not they sell the security. Although some experts have proposed marking all securities to market, we recommend marking just derivatives to market, as derivatives are far more amenable to tax gaming than other classes of financial assets. Practically speaking, accountants have already been doing this for financial reporting purposes for more than 17 years, so extending the practice to taxation would be simple. This would greatly reduce the amount of time and energy that firms and the IRS devote to the taxation of derivatives, which has been increasing in recent years.

LONG-TERM STRATEGIES TO ADDRESS MULTINATIONAL TAXATION

By all accounts, the U.S. system of taxing multinational firms is badly in need of repair. Despite strong corporate profits and a high statutory rate, the system generates less tax revenue as a share of GDP than tax regimes in comparable countries. It is also exceedingly complex, which raises the cost of compliance and administration. More generally, the U.S. multinational tax system is ill-suited to a global economy in which operations are integrated across national borders and the source of economic value is frequently intangible. As a result, multinational companies have become adept at booking income in low-tax jurisdictions. Estimates suggest that tax avoidance by multinational firms is currently costing the U.S. government around $100 billion per year, and that cost has increased more than five-fold since 2000.

xi Senator Ron Wyden recommended this step in 2016 and former Chairman of the Ways and Means Committee David Camp similarly recommended this step in 2013. For further reading: Rosenthal (2013) and Rosenthal (2016).

xii Clausing (2016a) documents these trends in detail. Estimates for 2012 indicate a revenue loss of between $77 billion and $111 billion. Extrapolating to 2016 based on 5 percent foreign profit growth indicates a current revenue
Problems in multinational taxation have been exacerbated by a changing global economy with which policy has failed to keep pace. As an increasing share of corporate profits are generated by ideas that cannot be pinned to a fixed location, and as production processes are increasingly global, determining the source of corporate income for tax purposes has become difficult. Rather than reforming this system, policymakers have often defended the status quo, as revenue losses from profit-shifting continue to increase.

FORMULARY APPORTIONMENT is a tax system that assigns a firm’s total income to each tax jurisdiction based on factors such as the location of its sales, employment, and assets. Formulary apportionment is distinct from the present system of separate accounting, under which firms book income in each jurisdiction separately. Under separate accounting, profit-shifting techniques often separate the location of profits from the location of economic activity for tax avoidance purposes.

Like our trading partners, the U.S. relies on “separate accounting” to tax multinational corporations, so that multinational firms report income and expenses separately in each jurisdiction in which they operate. Indeed, multinational firms are adept at utilizing transfer price manipulation to exaggerate both costs in high-tax jurisdictions and revenues in low-tax jurisdictions. Unlike most trading partners, the U.S. system purports to tax the worldwide income of multinational companies at the statutory rate of 35 percent, granting a tax credit for taxes paid to other countries. Yet, because U.S. taxation is not triggered unless income is repatriated, multinationals can avoid residual tax by indefinitely holding income abroad.

In addition to the aforementioned complications, credits can be used to offset tax due on royalty income, and tax base protections are weak, and check the box rules facilitate the creation of “stateless income” that does not fall under any taxing jurisdiction. As a result, the U.S. “worldwide” system of taxation is substantially more generous to foreign income than many alternative systems of taxation, and U.S. multinational firms routinely pay low effective tax rates, often in the single digits. This mismatch between how we label our tax system and the reality of how it functions undermines its integrity.

Explore a System of Formulary Apportionment
Congress should take steps to modernize the U.S. corporate tax code to make it more suited to the global economy. One option worth considering is a system of formulary apportionment—already employed to divide tax obligations between states—in which a company’s tax base is determined by the location of its operations and sales rather than by its strategic financial arrangements. This system would make profit-shifting out of the United States through financial accounting impossible and would end the incentive for corporate inversions. There could also be economic gains from reduced compliance and administration costs, which were part of the impetus behind proposals to consolidate corporate taxation in the European Union. Overall, a tax system using formulary apportionment would be far more suited to the modern, intellectual-property-centered economy.

The system could be designed in several ways, including a “single-sales” formula based on the destination of customers or a two- or three-factor formula that would also consider payroll or assets. It is important to note that a formulary approach is not equivalent to a tax on the factors in the formula (sales, employment, etc.), but uses these factors to approximate where profits are earned. The tax itself is proportionate to a corporation’s worldwide profits, net of deductible expenses. This means that if a corporation does not earn profits, it will not incur tax liability, no matter how large its sales or employment.

The Organisation for Economic Cooperation and Development (OECD) recently conducted a massive project to suggest methods for curbing profit-shifting under the current regime of separate accounting. In October 2015, it issued nearly 2,000 pages of proposed guidelines, which, despite their length and complexity, were widely recognized as far from comprehensive. The

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xv While domestic firms have far fewer options for lowering their effective tax rate, many multinational firms, including Pfizer, have achieved single-digit tax rates prior to their planned inversion. See Americans for Tax Fairness (2010) and sources within. Many other companies have achieved comparably low rates, Helman (2010). For a broader discussion of stateless income, see Kleinbard (2011a, 2011b). For a discussion of the mismatch between the worldwide “label” of the U.S. tax system and its underlying effects, see Clausing (2015).  

xvi The OECD’s model corporate tax system, for example, proposes a two-factor formula based on sales and payroll, whereas the OECD (2015) report recommends a “single-sales” formula based on the destination of sales. These options are但在 impossibility and would end the incentive for corporate inversions. There could also be economic gains from reduced compliance and administration costs, which were part of the impetus behind proposals to consolidate corporate taxation in the European Union. Overall, a tax system using formulary apportionment would be far more suited to the modern, intellectual-property-centered economy.

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complexity of these recommendations illustrates just how difficult it is to determine the source of income under separate accounting.

In addition to providing a solution to the problems of separate accounting, formulary apportionment would greatly reduce “competitiveness” concerns associated with corporate tax policy differences between nations. Any firm—U.S.- or foreign-based—operating in the United States would be taxed based on the economic activities occurring here; therefore, there would be no tax advantage associated with being a foreign-headquartered firm and no incentive to undertake corporate inversions in order to change tax treatment. Formulary apportionment would also level the playing field between multinational firms, which can avail themselves of profit-shifting strategies under the current system, and smaller, domestic firms, that have no such opportunities.

Tax competition would not disappear under this system, but it would be greatly attenuated. For example, Bermuda’s corporate tax rate of 0 percent would still be more attractive than positive tax rates, but instead of shifting profits to Bermuda on paper, the only way to move profits would be to sell, relocate, and/or operate in Bermuda. Critics may argue that this system would encourage corporations to move to lower-tax jurisdictions, but evidence suggests that, while U.S. multinational firms are extremely sensitive to tax rates when booking profits, they are far less interested in relocating their actual economic activities such as sales, jobs, and investments. xvii

In U.S. states, there is no evidence that firms operating in multiple states under formulary apportionment respond to tax differences by moving real economic activities from one state to another. xviii On the multinational scene, while over 50 percent of U.S. multinational foreign income is booked in just seven important tax havens, these countries account for less than 5 percent of employment among foreign affiliates of U.S. multinationals. Notably, none of the top 10 employment locations for U.S. multinational firms are tax havens. xix

The essential advantage of formulary apportionment is that it is a transparent way to determine the source of multinational income in a global economy. Still, if formulary apportionment is not politically feasible in the short run, there are other useful steps that can shore up our international tax system, including taxing multinational firms on a worldwide consolidated basis. Worldwide consolidation would end deferral and substantially eliminate income-shifting incentives. Though it would give U.S. multinational firms a larger incentive to change their residence for tax purposes, anti-inversion provisions could combat this incentive. Also, tough base erosion protections could be adopted within the current system, including steps to reduce earnings stripping, minimum taxes for income earned in low-tax countries, and steps to combat corporate inversions, such as an exit tax.

PROBLEMS WITH PASSTHROUGH TAXATION

The growth of the passthrough sector has given rise to a tax avoidance problem on par with capital and multinational taxation. But passthroughs have garnered far less notoriety, despite the fact that they could be costing American taxpayers around $100 billion a year. xi Reforming how we tax these entities would

untamed how to check corporate, financial, and monopoly power
mean ending a major tax break for the wealthy, ending the incentive for wasteful tax arbitrage activities, and redirecting resources toward more socially productive avenues.

Passthroughs are a category of business structure, including partnerships, S-corporations, LLCs, and sole proprietors, in which profits are taxed as the personal income of the owners as opposed to the earnings of the legal entities themselves. Unlike corporations, passthroughs avoid the first layer of taxes, which corporations pay on profits, and are instead taxed only at the individual level when profits are distributed to owners. Beyond avoiding entity-level taxes, the flexibility of passthrough structures enables a number of other strategies that can further decrease tax liability, including the mischaracterization of income as capital gain. Although there are legitimate societal benefits to the flexibility and lower administrative burdens that these entities offer, recent evidence suggests that the rise of partnerships and S-corporations is problematic in the current economic climate.

Contrary to the claims of those who defend the passthrough tax system, the majority of these entities are not just small businesses but wealthy firms in industries such as finance and real estate. xx Legal maneuvers and clever accounting practices lower the tax rates of these firms, generating rents that accrue overwhelmingly to the wealthy. A landmark 2015 study by a group of economists revealed that in 2011 the top 1 percent received nearly 70 percent of S-corp and partnership income, which was taxed at just 25 and 15.9 percent, respectively, compared to 31.6 percent for traditional C-corporations.17

As a result of key policy decisions that increased the tax benefit of passthrough organization, including the rate reductions of Reagan’s “trickle-down” economics, this sector has more than doubled since 1980.18 The exploitation of these business structures and the failure of regulators to keep pace has not only exacerbated inequality but generated inefficiency by rewarding, and thus incentivizing, clever accounting and opacity over productive industry. The growth in complexity can most clearly be seen through the growth in complex tiered partnerships, widely considered the most problematic of all passthrough entities.

From 2002 to 2011, the number of partnerships with more than 100 partners and $100 million in assets more than tripled from 720 to 2,226.19 Entities like this can have hundreds of direct shareholders, any of which can themselves be a partnership (“tiers”) with shareholders also numbering in the hundreds or thousands.20 According to analysts, the sheer number of individuals involved in an audit of a complex partnership so greatly reduces the IRS’s ability to audit that many partnerships now operate with assumed impunity, free from fear that misconduct could be redressed.21 Unsurprisingly, these complex entities pay a startlingly low rate of just 8.8 percent, scarcely half the already-low overall partnership rate of 15.9 percent.22

These business structures are like mazes, serving no economic purpose but to shield money from taxation, with each dividend from one partner to another acting as a wall in the path of auditors.23 The complexity is such that these mazes are not only impervious to audit but may enable even more nefarious activities, such as money laundering. Recent legislation has moved in a positive direction, but without improved enforcement and reforms that cut at the structural underpinnings of this convoluted system, most problems with partnership tax avoidance—and the massive waste of economic resources it represents—will remain.24

Moreover, the power and wealth of these firms poses serious problems for democracy; financial sector passthrough businesses like hedge funds and private equity firms form a powerful lobbying block. In 2014, the top two campaign donors were hedge funds, which benefit from the tax advantages of partnership structure.25 So long as these businesses are successful in lobbying for preferential treatment and shielding profits from taxation, they will continue to direct resources toward the wasteful pursuit of rents. Only comprehensive reforms structural reforms can reverse the trend.

POLICIES TO IMPROVE PASSTHROUGH COMPLIANCE

Raising Rates on Financial Passthroughs

Raising the tax rate on capital gains would eliminate much of the tax advantage held by wealthy partnerships such as hedge funds and private equity firms.

Perhaps the most significant passthrough tax reform possible is one that we have already discussed: In 2011, over 40 percent of all passthrough income was categorized as capital gains or dividends, so treating the capital income as labor income would eliminate a significant portion of the passthrough tax advantage, with most of the hike affecting the wealthiest passthrough owners. This policy would neutralize the carried interest loophole and also reduce the broader tax advantage of the finance and real estate industries, which recorded 60 percent of their income as either dividends or capital gains in 2011.26

Exactly how much these groups save by claiming income as capital gains...
is unclear, but estimates of the size of the capital gains tax expenditure and of the size of the finance and real estate passthrough sectors suggest the number would be significant.\textsuperscript{xix}

From a broader economic perspective, we argue that the current capital tax preference misguided rewards wealth over work, giving a large advantage to those who are already rich. All of this is doubly true within the passthrough sector, in which much of what should be taxed as regular income is categorized as dividends or capital gains.

But while this policy would greatly increase the tax rate among wealthy passthrough owners, it would not disincentivize or prevent profit-shifting and other avoidance and evasion maneuvers. Meaningful reform must not only raise the overall passthrough tax rate but must also address rampant complexity and avoidance among partnerships.

**Institute a Nuisance Tax on Inter-Partnership Dividends**

An inter-partnership dividend tax would strongly discourage the creation of opaque partnerships and greatly increase compliance.

As long as complex partnerships remain too complicated for even devoted tax experts to fully understand, efforts to increase compliance will fall short. Simply capping the size or wealth of individual partnerships sounds straightforward, but such a policy could easily create a greater incentive to divide profits among tiers of subsidiary partnerships.\textsuperscript{27} Returning to the maze analogy, limiting the size of mazes could prove ineffective because just as much money can be hidden in a larger number of smaller mazes. Simply making a maze more expensive to build and operate, however, would largely defeat the purpose of building one in the first place. Simplifying corporate structures through a disincentive would naturally increase transparency, making auditing easier and raising compliance.

One option would be a small tax incurred on disbursements made from a partnership to its non-individual owners—the “walls” in our maze analogy. This could be seen simply as a tax on complexity, and it is not unprecedented; a similar approach was employed in the corporate sector during the New Deal. By instating a tax on intercorporate dividends, FDR disincentivized the creation of pyramidal holding companies that received payments from large numbers of subsidiaries. The intercorporate dividend tax was successful in reducing corporate complexity, combating consolidated power, and increasing compliance.\textsuperscript{28} Like the corporate dividend tax, the partnership dividend tax would be a small nuisance tax, designed to become a burden only if incurred multiple times through numerous transfers within a complex entity.\textsuperscript{29}

**Increase Funding for the IRS**

*Increasing funding to the IRS and instructing it to direct resources to understanding the passthrough sector would greatly increase compliance and help to end avoidance incentives.*

Other reforms do not aim to change how passthroughs are organized but strive to improve compliance through changes in reporting and auditing procedures. One recent change included in the 2015 Bipartisan Budget Agreement holds the potential to greatly ease the burden of auditing complex partnerships.

Under new rules currently being drafted by the IRS, partnerships will be responsible for making up unpaid taxes as a group, freeing the IRS from tracking down individual owners and greatly reducing the burden of auditing. This is a step in the right direction, but much depends on the drafting and implementation of IRS guidelines. Some in Washington have speculated that the positive impact will be small because the IRS lacks the resources and in-house partnership expertise to adequately write and enforce new rules.\textsuperscript{30}

One policy reform that is guaranteed to raise revenue and compliance is increased funding of the IRS, which has seen its budget cut by 17 percent since 2010.\textsuperscript{31} Each additional dollar of funding has been found to generate an average of four dollars in revenue, with much higher returns on money spent on compliance within particular parts of the tax code.\textsuperscript{32} The IRS could invest a portion of this increased funding in personnel who would train to better understand and audit complex partnerships. A better-funded IRS would end the implicit safe harbor under which many large partnerships appear to operate today and would have broad carry over benefits to revenue and compliance overall.

**CONCLUSION**

America’s robust middle class rests on a foundation of progressive taxation. In recent decades we have seen this foundation erode in the face of rising tax avoidance and rate preferences for privileged sources of income. It is time for policymakers to address these structural problems in our tax code with comprehensive reforms that will cut at the root causes of our tax code’s most inefficient and regressive components.

Dealing with the Trade Deficit

By J.W. Mason, John Jay College-CUNY, Roosevelt Institute

The current domestic trade debate focuses on two related but distinct problems. One is the degree to which the U.S. trade deficit affects output and employment; this is the topic we address below. A second set of arguments centers around international trade agreements, in particular the Trans-Pacific Partnership being fast-tracked in the U.S. Senate. This debate is less relevant to U.S. employment and more germane to regulatory independence and the power of corporations to override a democratic process; we address this topic at length in a series of briefs by Joseph E. Stiglitz.¹

Regarding the U.S. trade deficit, currently equal to about 3 percent of GDP, there is growing concern that it is a drag on growth and kills jobs in America. Should U.S. policymakers seek a more favorable trade balance?²

Economic orthodoxy says that trade is irrelevant to GDP and employment. The textbook view is that exchange rates will automatically adjust to allow balanced trade without any effects on growth or employment. When we do see trade imbalances, in this view, they are the result of different countries making different choices about present versus future spending. Full employment will be maintained regardless of trade deficits or surpluses, either through automatic market adjustments or with the routine tools of monetary policy. In the textbook view, trade is an important microeconomic concern, in that it contributes to the efficient use of scarce resources. But at a macroeconomic level, the trade balance simply reflects underlying economic conditions; it does not play any independent role.

Whether or not this view was ever reasonable, it is clearly inapplicable today. In the U.S. and much of the rest of the world, neither market forces nor conventional economic policy are reliably maintaining full employment. Under these conditions, the trade balance has important macroeconomic effects. If there is no guarantee that the economy is operating close to potential, then we should expect a trade deficit to reduce demand and employment.

It is natural, then, to look to measures to improve the trade balance as a way to raise demand and boost output and employment—especially if fiscal policy is ruled out for practical or political reasons. The trade balance might be improved through a weaker dollar, making exports cheaper and imports more expensive, or through tariffs or other direct limits on imports. While the U.S. has done little to boost net exports in recent decades, there is increasing public discussion of such measures today. Republican presidential candidate Donald Trump has lately become the most visible advocate for tariffs, but support for a weaker dollar and other measures to improve the U.S. trade balance can be found across the political spectrum.

We argue that while the orthodox view is wrong about trade being macroeconomically neutral, measures to improve the U.S. trade balance would nonetheless be a mistake. All else equal, a more favorable trade balance will raise demand and boost employment. But all else is not equal, thanks to the special role of the U.S. in the world economy. The global economy today operates on what is effectively a dollar standard: The U.S. dollar serves as the international currency, the way gold did under the gold standard. In part for this reason, and in part because of the depth and security of U.S. financial markets and the disproportionate weight of the U.S. in the global economy, the U.S. can finance trade deficits indefinitely while most other countries cannot. Higher net exports for the U.S. imply lower net exports somewhere else, but for many of our trade partners, any reduction of net exports would imply unsustainable trade deficits. So policies intended to improve the U.S. trade balance are likely to lead to lower growth elsewhere, imposing large costs on the rest of the world with little or no benefits here.

We do not deny that the trade deficit has negative effects on demand and employment in the U.S., but we argue this is only a reason to redouble efforts to boost domestic demand. The solution to the contractionary effects of the trade deficit is not a costly, and probably futile, effort to move toward a trade surplus, but rather measures to boost productive investment in both the public and private sector.


² The trade balance means total exports less total imports—a trade surplus if positive, a deficit if negative. Net exports is a synonym for the trade balance. The current account balance is a broader category that includes income payments and transfers as well as trade.
There is a second link between trade and investment policy. One challenge in increasing public and private investment is the need for financing. Increasing investment requires new debt, which someone must hold. Here, we argue, the role of the dollar in the international financial system is an advantage. Because of the role of the dollar as the international currency, there is enormous demand in the rest of the world, especially but not only from central banks, for safe, liquid dollar assets to hold as foreign exchange reserves. This means that the demand for U.S. assets is much greater than demand for the assets of some other country offering a comparable return. This in turn means that the U.S. can borrow at much more favorable interest rates, and in greater volume, than other countries, and is not vulnerable to a “sudden stop” of financial inflows in the way that other countries are.

In the decade before 2008, this “exorbitant privilege” was used to support the expansion of housing lending. In effect, securitized mortgages were falsely sold as able to provide the safe, liquid dollar assets the rest of the world desired. Reserves must be held mainly in dollars for the simple reason that dollars are used in the great majority of international transactions: 87 percent of foreign exchange transactions involve the dollar and some other currency; only 13 percent of foreign-exchange contracts involve two non-dollar currencies. There is no sign of any movement away from the dollar as the world currency. Both the fraction of reserves held in dollar and the fraction of international transactions using dollars are just as high today as they were 25 years ago, despite the creation of the euro in the interim.

In the short run, at least, the U.S. should not seek a more favorable trade balance, but should instead use its privileged position in the global economy as an opportunity to boost socially useful investment. In the long run, there are undoubtedly better ways to organize the global economy than a de facto dollar standard with liquidity supplied by U.S. trade deficits. These would involve some mix of international provision of liquidity and long-term finance (through a reformed International Monetary Fund (IMF) and World Bank or through new institutions) and greater space for countries to manage their trade and financial flows, so that foreign exchange reserves are less needed. Until such long-term solutions are in place, however, it would be irresponsible, costly, and probably futile for the U.S. to seek a more favorable trade balance. Fortunately, better solutions exist. Our proposals include:

- Increase federal borrowing.
- Shift from monetary policy to credit policy.
- Increase borrowing by state and local government.
- Provide loan guarantees for qualified private borrowers.
- Establish a national infrastructure bank.
- Focus on public and private “green” investment.
- Build toward a new Bretton Woods.

**SHOULD THE U.S. PURSUE A MORE FAVORABLE TRADE BALANCE?**

**The International Role of the Dollar**

Discussions of U.S. trade policy cannot focus on the trade deficit in isolation; they must take into account the special role of the U.S. in the international monetary system. As noted, under the current regime, in which the dollar serves as the world’s reserve currency and the U.S. serves as the consumer of last resort, global macro-stability to some degree requires the U.S. to run trade deficits. Dollars make up 64 percent of foreign exchange reserves, according to the most recent survey by the IMF. Over the past decade, foreign central banks have increased their dollar reserves by $4.8 trillion. This is almost equal to total U.S. current account deficits over the same period ($5.25 trillion). In other words, the U.S. is not so much borrowing to pay for imports as supplying a vital financial resource in exchange for them. Reserves must be held mainly in dollar for the simple reason that dollars are used in the great majority of international transactions: 87 percent of foreign exchange transactions involve the dollar and some other currency; only 13 percent of foreign-exchange contracts involve two non-dollar currencies. There is no sign of any movement away from the dollar as the world currency. Both the fraction of reserves held in dollar and the fraction of international transactions using dollars are just as high today as they were 25 years ago, despite the creation of the euro in the interim.

The dollar has played this international role for decades, but the trend toward deregulation of capital flows and recurring foreign exchange crises have increased the demand for foreign exchange reserves, especially among developing countries. Jörg Bibow has described the increase in reserve holdings by developing and middle-income countries as a form of “self-insurance,” the need for which has been clear since the 1997 crises. So the demand for dollar reserves, and the concomitant need to run trade surpluses, is in large part a consequence of the pressure that the U.S. put on developing countries to open up their financial markets during the 1980s and 1990s.
As mentioned above, efforts by the U.S. to shift its trade balance toward surplus, if successful, would mean that other countries would have to shift toward deficits, which many would be unable to do. Instead, they would have to impose higher interest rates and fiscal austerity, thus reducing GDP. In effect, we would be subjecting other countries to more frequent balance of payments crises, or, more likely, the ultimate result would be slower growth in our trade partners and little improvement in the U.S. trade balance. There are a few other countries that might help play the U.S.’s role—mainly Germany and Japan—but they have failed to do so, leaving the burden on the U.S.

In short, the “exorbitant privilege” of being unconstrained by the balance of payments comes with an “exorbitant duty” to provide the rest of the world the insurance it needs against unexpected shifts in trade and financial flows.

The flip side to trade deficits are financial inflows. As payments flow from the U.S. to the rest of the world for goods and services, payments flow back to the world to pay for U.S. assets such as government bonds. The international role of the dollar means that the U.S. pays considerably less on its foreign liabilities than it receives from its foreign assets, a privilege that has remained intact over nearly 40 years of trade deficits. This means that for the U.S., unlike most other countries, trade deficits do not lead to an unsustainable snowballing of foreign obligations. In recent decades, the return on U.S. assets abroad has been more than three points higher than the return on foreign investment here, a difference that shows no sign of diminishing over time.

Because of both the special international role of the dollar and the size, depth, and security of U.S. financial markets, the U.S. is the favored outlet for the “global savings glut” famously described by former Fed chair Ben Bernanke. As Bernanke noted, anticipating today’s “secular stagnation” debates, the global savings glut implies persistently low interest rates, especially in the U.S. This creates a great opportunity for anyone who is able to supply safe, liquid, dollar-denominated assets at the scale the rest of the world demands. Instead of using the exorbitant privilege of the dollar to finance an unsustainable real estate boom, as it did in the 2000s, we could put that privilege to use for better ends, both through the guaranteed global market for U.S. bonds and by channeling cheap, abundant credit to private borrowers.

Are U.S. Trade Deficits Sustainable?
Some suggest the special status of the dollar could be endangered by continued deficits, i.e., that foreign investors might flee from the dollar in a crisis. There is strong evidence, however, that these worries are misplaced.

First, in most countries that run sustained deficits, the danger is that interest payments on the accumulated foreign debt eventually become unsustainable. But the U.S., despite 30 years of trade deficits, still receives much more income from its assets in the rest of the world than it pays to its foreign creditors. In 2015, U.S. net investment income was over $200 billion, and this positive income is growing over time. So the trade deficit is not creating any financial burden, and is sustainable in a way that it would not be for other countries.

Second, if foreign investors were worried about excessive U.S. borrowing, that should show up in market prices as either rising interest rates or a declining value of the dollar. But the reality has been just the opposite. During the crisis of 2008–2009, there was a flight to the dollar, which increased in value by 20 percent despite the fact that the crisis was centered in the U.S. This was the opposite of what had been predicted by those worried about “unsustainable” U.S. borrowing. And even if investors wanted to move away from the dollar as the international currency, there is no plausible alternative; the euro, which was once the most plausible candidate, faces an ongoing crisis and may not even exist 10 years from now.

A third problem with the “sudden stop” scenario is that these crises have occurred historically in countries with a great deal of public and/or private debt denominated in foreign currencies. But the great bulk of U.S. liabilities to the rest of the world are denominated in dollars. This means that as soon as any outflow produces a depreciation of the dollar, the U.S. financial position automatically improves. As long as this is the case, it is not possible for the U.S. to face an external constraint, since any reduction in the willingness of the rest of the
world to lend to us just results in a reduction in the value of our existing liabilities. And, of course, the fact that U.S. external liabilities are denominated in dollars means that there is no possibility of default—which means there is no reason for runs.

The bottom line: Because the dollar functions as the world reserve currency, the U.S. can run a large trade deficit indefinitely without increasing interest rates or other financial consequences. The U.S. can offset the negative demand from a trade deficit with increased domestic demand; most other countries cannot.

POLICIES TO BOOST DEMAND AND EMPLOYMENT: USING CAPITAL INFLOWS

The facts that the trade deficit can be offset by increased domestic demand, and that foreign demand for dollar assets can be channeled into productive investment, does not guarantee it will actually happen. On this point, the anti-trade critics are right, and the establishment view is too complacent. The solution, however, need not be policies to reduce the trade deficit. Instead, it can be policies to channel foreign lending into uses that both boost demand and employment and serve broader public interests. The most straightforward way to do this is for the federal government to replace the financial system as the link between foreign lenders and the U.S. economy, borrowing directly in order to increase public investment. For various reasons, however, it may be preferable to support private spending instead.

Increase Federal Borrowing

*The federal government can use cheap credit to fund public works.*

The most straightforward way to finance socially valuable investment is for the government to carry it out directly. While the federal budget process is not always straightforward, in principle public investment allows choices about spending priorities to be made in a transparent, democratically accountable way. If, as a number of economists have suggested, the world suffers from a safe asset shortage, why shouldn’t the U.S. federal government, as the biggest producer of safe assets, step in to fill the void? Bibow has observed that the natural route to sustaining aggregate demand would be to “boost public spending with a focus on infrastructure investment,” noting that “private debt-financed consumer spending as the counterpart to the U.S.’s external deficit, is dead and cannot easily be revived, but a [new] regime may come to take its place, featuring continued U.S. current account deficits, this time driven by public spending and public debt.” But while increased federal borrowing is the most natural solution, it may also be desirable to improve financing for private investment. This is especially important insofar as the size of the U.S. government debt is seen, rightly or wrongly, as a constraint on policy.

**Shift from Monetary Policy to Credit Policy**

*The Federal Reserve can target credit to productive institutions such as municipalities.*

The Federal Reserve could expand the monetary policy tool box to boost demand through direct lending to socially useful entities rather than relying on the financial markets as intermediaries. Specific steps here would include: selectively purchasing the liabilities of economic units engaged in socially useful investment and facing significant credit constraints, such as municipal bonds; pushing banks to increase lending to the same set of units, for instance by taxing excess reserves; the Fed directly lending to a wider range of borrowers, as it did briefly in the commercial paper market during the fall of 2008; setting targets for a wider range of interest rates; and setting targets for credit growth both in the aggregate and for specific sectors. This sort of “credit policy” has been practiced by many central banks historically, including central banks in both developing and advanced countries. One particularly successful example of directed credit by the central bank is Japan during its postwar boom. A number of economists have described the advantages of a broader credit policy over conventional monetary policy.

Such policies could also include supporting municipal borrowers. In particular, the Federal Reserve should study and make recommendations on its ability to aggressively use its existing authority to purchase short-term municipal debt, and the effectiveness of supporting municipal debt markets using that approach. It is hard to understand why a lack of financing should lead to catastrophic cuts in local services when the country as a whole enjoys abundant liquidity.

This discussion is largely motivated by concerns that conventional monetary policy has proved ineffective in stabilizing aggregate demand, and that low interest rates lead to asset bubbles and other distortions. Connected with this is an increasing recognition that monetary policy inevitably affects relative prices and the direction as well as level of economic activity, including the distribution of income. While not explicitly addressed to the trade balance, these new ideas about monetary policy dovetail nicely with the idea that the international role of the dollar implies...
persistent U.S. trade deficits but also great demand for U.S. assets. This implies a shift in the focus of monetary policy toward the quantity and direction of credit rather than its price.

Increase Borrowing by State and Local Government
*Provide state and local governments with cheap credit to invest in long-term projects.*

One specific piece of a shift from monetary policy to credit policy would be support for increased borrowing by state and local governments. In the U.S., the majority of infrastructure and education spending happens at the state and local level, so any program to channel financial flows into productive investment needs to include increased municipal borrowing. State and local governments themselves should also reevaluate their current fiscal positions and explore ways to use the low-interest environment to expand investment in physical and human capital.

Today, most state governments are constitutionally prohibited from running operating deficits but committed to funding a certain set of programs and services. State and local governments also hold large asset positions outside of pension funds; most state governments are substantial net creditors, as is the sector as a whole. State governments generally shifted toward net asset positions during the 1980s, and at a time in which interest rates were well above growth rates, this commitment to avoiding debt and to prefunding had a clear logic to it. But in the current environment, it is counterproductive. Municipal governments would be better off with more borrowing and less prefunding; when risk-adjusted returns fall below growth rates, it is cheaper to fund pensions on a pay-as-you-go basis, especially given the high fees state and local governments have historically paid to the managers of their pension funds. (See our section on municipal finance for more.) In a low-interest environment, more debt and less prefunding is fiscally sensible, and, importantly for present purposes, it will help support aggregate demand.

**Provide Loan Guarantees for Qualified Private Borrowers**
*To seed desirable private projects, the federal government can offer a cushion against losses.*

Loan guarantees are a commitment to absorb some fraction—typically 50 to 90 percent—of the losses from defaulted loans to designated borrowers. They are a natural tool to allow the federal government to use its status as a privileged borrower to support credit flows to private businesses. The value of loan guarantees comes from the existence of pervasive information problems in private credit markets. In a world of perfect information, a loan guarantee would simply be a subsidy. But because of information problems in credit markets, there are a number of loans that are not made even though they would offer positive private returns. By offsetting the risks created by information asymmetries, a loan guarantee program can support increased lending with private and social returns much greater than the required outlay of public funds. One recent study of loan guarantee programs suggests that it is reasonable to expect an annual default rate of 10 percent and a recovery rate of 50 percent. Given these assumptions, a program covering 80 percent of default losses could support $20 billion in increased loans with an outlay of $590 million per year. The program would therefore cost the federal government 2.9 cents for every dollar of private loans extended.14

Establish a National Infrastructure Bank
*Funnel international capital flows into transformative public investment.*

An infrastructure bank is a natural channel to direct credit to socially useful private borrowing.

One specific mechanism to improve financing for state and local investment is a national infrastructure bank. Such a bank would make long-term loans to state and local governments, public–private partnerships, and perhaps private businesses to finance infrastructure investment. The federal government would provide initial capital, and the bank would be publicly owned, but going forward it would finance itself by issuing its own bonds. An infrastructure bank would encourage public investment by offering more favorable terms than private lenders, especially for smaller and financially weaker borrowers. It would be a hub for national planning around infrastructure investment. Just as important for present purposes, the bonds issued by the bank would help satisfy the world’s demand for safe, liquid dollar assets.15

Focus on Public and Private “Green” Investment
*Funnel international capital flows into low-carbon public investment, such as building retrofits.*

Both public and private investment should be focused in “green” sectors—development of non-carbon energy and increased energy efficiency. One particularly promising area is building retrofits. Most energy consumption is associated with buildings, and there are straightforward modifications that can greatly reduce energy use, especially for older buildings. For an average-sized single-family home in the United
States, an investment of as little as $2,500 in energy-efficiency retrofits can reduce energy consumption by 30 percent. These kinds of investments also tend to support more employment than many other forms of expenditure. Building retrofits have been estimated to produce seven direct jobs and five indirect jobs for each $1 million in spending. Because these retrofit projects combine upfront costs with savings over a long future period, they are natural candidates for debt financing. But the dispersed building owners, the information problems, and, in the case of commercial structures, the transaction costs often created by the separation of ownership from liability for utility bills means that there is a natural role for a public agency in channeling loans into retrofits.

Build Toward a New Bretton Woods
Replacing the dollar standard with a genuine international currency would reduce foreign dependence on exports to the U.S.

To the extent that we do want a more favorable trade balance, the focus needs to be on reducing the rest of the world’s need for dollar reserves rather than boosting U.S. competitiveness. In the long run, this could mean the creation of a new international financial architecture, along the lines of the Bretton Woods agreements 70 years ago. This is not a solution in the short run, and raises difficult questions about the goals as well as the mechanics of a new system. But in the long run, the only way to wean the world off its dependence on exports to the U.S. is to replace the de facto dollar standard with a genuine international currency.

In the absence of such global reforms, the U.S. government could take steps now to reduce the need for reserve accumulation abroad. It could reverse its opposition to capital controls (restrictions on cross-border financial flows), as its current commitment to a universal regime of free financial mobility does not serve any obvious public interest. That commitment leads to a greater need for foreign exchange reserves, mainly dollars, by increasing our trading partners’ vulnerability to changing sentiments in financial markets. In effect, by discouraging countries from taking steps to protect their foreign exchange, the U.S. has put them in a situation where they have a strong national interest in accumulating dollars via trade surpluses. The IMF has recently expressed some limited support for capital controls. The U.S. should encourage the IMF to carry this rethinking further and abandon its support for capital account liberalization.

Neither extending swap lines nor supporting capital controls would have an immediate effect on the U.S. trade balance, but over time, these measures would remove some of the structural factors that make the trade deficit so resistant to conventional measures to boost net exports.

CONCLUSION

The trade balance in itself is not a problem for the U.S. If trade deficits reduce demand and employment, that is only because we lack the the necessary institutions to channel the corresponding financial inflows into productive investment. Developing these institutions is the best response to understandable pressures for protectionism.

More broadly, trade policy poses a fundamental challenge. Domestic goals like full employment must be the responsibility of our elected government. But at the same time, the U.S. cannot ignore its role in the international monetary system. This tension between democratic legitimacy, which remains national, and the reality of a global economy does not have any straightforward solution. A balance must be struck in each particular case. For the U.S. today, in our view, an appropriate balance requires foregoing policies to improve the U.S. trade balance; instead, we must develop policies that jointly address the U.S.’s need for strong demand and full employment and the rest of the world’s need for dollars by channeling foreign capital into productive, job-creating domestic investment.
II. Tame the Financial Sector

While a well-functioning financial sector plays a critical role in driving productive economic growth, the U.S. financial industry has increasingly shifted away from its essential function, focusing instead on the pursuit of profits through unproductive or even predatory activities. As a result of widespread changes to regulatory and economic rules, private rewards for risk-taking have increased, driving up incomes for the top 1 percent. At the same time, productive activity and corporate investment have stagnated, which has weakened macroeconomic growth and made average Americans less financially stable.

Beginning in the 1970s, regulators, operating under the assumptions that growth required unfettered markets and that Wall Street would regulate itself, eschewed traditional concerns and deregulated financial markets. Dangerous conditions, such as a preponderance of asymmetric information that allowed sophisticated investors to take advantage of trading partners, were ignored. New products, from money-market funds to sub-prime mortgages, fueled bottom lines and kept the party going. The size and profitability of the financial sector increased along with the complexity of its products, and policymakers failed to adapt regulations for a financial landscape transformed by globalization and technology. Despite the crisis that eventually resulted from this regulatory neglect, the finance sector remains large and profitable relative to the rest of the economy. Financial services peaked at 7.6 percent of GDP before the crisis, dipped below 7 percent during the Great Recession, then promptly returned to 7.1 percent in 2015.

As the financial sector increased in size, it also increased in power. And in finance as in other monopolistic industries, an increased concentration of market power over the last few decades has gone hand in hand with increased profits from rents and increased lobbying efforts aimed at preserving the industry’s growing power and privilege. The 2014 defeat of the Dodd-Frank Lincoln amendment, which would have prevented FDIC-backed banks from purchasing some of the riskiest derivatives, provides a prime example of the finance sector’s power to rewrite rules to its own benefit. The final language of the repeal was nearly identical to that proposed by Citibank.

The misalignment of private rewards and public costs in the financial sector is particularly damaging because of the way in which finance influences every aspect of the economy. A well-regulated banking system takes healthy risks while preserving macro-stability, but excessive risk-taking threatens that stability. The government’s mandate to act in a crisis thus becomes a subsidy for reckless financial activity. While non-bank financial services can improve stability through insurance or asset management, poorly regulated “shadow banking” can devolve into a black box of regulatory arbitrage and predatory activities with grave consequences for global capital markets. And while capital markets can channel funds into productive firms for investment, their short-term management tricks can just as easily act as a financial drain. Finally, while finance is critical to fueling public investment in big-ticket items such as new schools or improved infrastructure, lenders can benefit from asymmetric information to extract excess funds from public services and institutions.

In the following section, we lay out an agenda to curb rent-seeking in the financial sector and incentivize productive lending and investment. The financial sector’s impact on our economy can be
thought of like waves emanating out in concentric circles from a rock dropped in a pond. With each circle, the impact of the financial sector’s weight becomes less apparent on the surface, but it remains extremely important overall.

In the first circle, we find the most obvious elements of the problem, which are systemically important financial institutions (SIFIs) and the banking sector at large. Much of the debate since the Great Recession has focused on these gargantuan institutions and whether they remain “Too Big to Fail” (TBTF), and thus capable of once again wreaking havoc on the global economy. Our agenda in this first circle of impact looks beyond TBTF as a stark binary in which the largest financial institutions either pose no risk or are deemed a systemic threat. We propose, instead, that TBTF is a continuum along which large financial institutions move as their balance sheets change. While we believe Dodd-Frank has reduced both the risks of bank failure and the subsidy the largest banks received from implicit government backing, there is still work to do. Primarily, we must raise and restructure leverage requirements in order to reduce risk and rents in the banking system.

In the next circle—rather prominent to an observer—is a broader swath of financial sector activities known as “shadow banking,” which, despite its anonymity relative to SIFIs, has had profound economic effects in recent years. Mimicking traditional banking in many ways, but without any of the standard banking regulations, the shadow banking sector was a key source of risk and contagion during the financial crisis. Furthermore, shadow banking networks can distort the allocation of credit, diverting resources to unproductive and even fraudulent activities. In this section we outline an agenda to better regulate the shadow banking sector, starting with the somewhat obvious assumption that institutions that perform bank-like activities should be regulated like banks.

Moving out to the third circle, we examine an impact of the financial sector that is far less apparent to many but still extremely significant: the rise of short-termism and the corresponding growth of the finance sector’s influence over mainstream corporate America. Short-termism can be defined as the rising preference for short-term stock price manipulation and the excessive use of dividends and buybacks over long-term investment and real productivity or growth. We explore why this is a problem and identify a number of interventions that would build countervailing power to solve it.

In the outermost circle, we look at a symptom of the finance sector’s growth that is perhaps even more difficult to identify, but no less impactful: how finance interacts with the political economy. From campaign finance reform to international capital flows, the financial sector interacts with governments in many ways. We begin by examining municipal, state, and local institutions and showing how these government entities are often entangled in overly complex and predatory financial instruments. We then construct a set of best practices for tackling this problem, understanding it both as necessary in itself and as a building block to best practices for finance as a whole.

The challenges outlined above are much bigger than the policy solutions proposed in this report. Yet these discussions and solutions form a solid basis from which policymakers can build and continue to do more.
Financial institutions play a critical role in the economy, allocating credit to productive enterprises while mitigating financial risks for both individuals and businesses. However, the role of banks as mediators between savers and borrowers and in the transformation of short-term deposits into long-term investments also poses inherent risks to both individuals and the overall economy. Because of these inherent risks and benefits of banking, governments have historically subjected banks to unique regulation and protection. In light of the financial crisis, the majority of Americans, and a significant number of policymakers and economists, have come to believe that the U.S. errs too much on the side of protecting banks and not enough on the side of regulation.

This imbalance was epitomized by the bailouts that saved financial institutions deemed “Too Big to Fail” even as those firms’ risky bets dragged down the economy and individual incomes. However, the potential consequences of TBTF expand beyond the perception of unfairness. Financial firms had engaged in widespread bad practices and were not accountable to the rules and laws of our economy. Over the previous 30 years, regulations had been rewritten to allow the industry to police itself; in practice, financial firms wound up taking home the gains from risk and making everyone else cover their losses. While progress has been made in shifting banks away from risky bets subsidized by taxpayers, still more progress is necessary and possible.

Below, we outline key steps that would build on the Dodd-Frank Act to address these concerns. We examine how to regulate firms’ entire balance sheets by increasing leverage requirements and risk-weighted capital and reducing reliance on short-term debt. To reduce the likelihood of failure, and also reduce the consequences of bank failure, we recommend a series of policies:

» Preserve Dodd-Frank.
» Regulate the whole balance sheet.
» Continue to push for credible living wills.
» Coordinate international derivatives.

We will examine two main ways in which perceived TBTF banks impose costs on the economy and on average Americans. First, a TBTF firm can pose excessive macro-risk to the economy even if the institution itself is bailed out. The second cost is a potential subsidy that TBTF institutions receive when the market assumes they will be bailed out regardless of their risky activities.

The Costs of Failure
The risks associated are not simply about the potential impact of a single bank failure on creditors, but also on the potential for a bank failure to spread uncertainty throughout the financial system. Panics could make otherwise healthy banks and financial firms fail as a result of the failure of others. This process is referred to as contagion. There are three drivers of contagion:

» Balance sheets: Firms borrow short-term and lend long-term, and this maturity mismatch is a source of instability. It is often difficult to assess the value of their assets in the middle of a panic. As such, short-term lenders can panic at uncertainty.
» Exposure: There is a complex network of exposures among banks through payments systems, derivatives, interbank credit lending, and so forth. These all act as transmission mechanisms to spread panics.
» Uncertainty: The value of financial contracts is often based on expectations of the future, and there is an asymmetry between what the firms and lenders know about those values. This uncertainty can reinforce the dynamics of a run. Moreover, fire sales can drive down the price of assets, creating stress on other parts of the financial system and reducing the value of collateral.

These potential failures not only create panic but also result in redistribution of public money to private firms via bailouts. There are specific reasons the public finds bailouts unfair: Bailouts are ex post facto and ad hoc, meaning they are a response to a failure that has already occurred and are granted arbitrarily. They also put public dollars at risk to absorb the losses of private
actors. This is different from more formal ways of assigning losses. Bankruptcy, for instance, is a type of planned failure in which certain claims are prioritized, often in an inconsistent manner, by a government official. Yet few think of bankruptcy as a type of bailout. It is the spontaneous and arbitrary function of such a move, as well as the redistribution of private money to public taxpayers, that generally upsets people and reflects unequal economic and political power.

Some suggest we have dealt sufficiently with these macroeconomic risks of TBTF, particularly in light of progress on the FDIC’s powers to liquidate a large bank. However, TBTF is not a switch that can be flipped on or off. There is no identifiable moment at which a bank is TBTF, and then suddenly it isn’t. TBTF is a continuum on which, at one end, the failure of a large, systemically important financial institution causes cascading failures and panics across the financial sector, and at the other end, a bank can fail in a way that causes minimal disruption. While we have made progress, we have not moved far enough along the continuum. Future failures could still trigger panics, which would lead to terrible macroeconomic effects, prolonged recessions, and a basic sense of unfairness.

The Nature and Decline of the Too Big to Fall Subsidy

A TBTF firm can be seen by the capital markets as so risky and likely to be bailed out by the government that it receives a subsidy. In case of a failure, creditors believe that they will get paid back by the government, or that the government will intercede to ensure that the firm doesn’t fail in the first place, and as such the creditors are willing to lend at a lower rate than they otherwise would based upon the firm’s risk profile.

The TBTF subsidy has declined dramatically from its peak in 2011, which shows, contrary to critics, that Dodd-Frank is not a permanent bailout, nor has it strengthened TBTF. This result has been found using straightforward statistical models on interest rates. But it also has been found using more complex financial modeling, as with credit default swaps. These two techniques are the opposite of each other, with each trading off in terms of theory and data sophistication, so it is encouraging that they have the same conclusion: The TBTF subsidy is much lower, and perhaps not distinguishable from zero.

Note that the goal of financial reform, however, is not to simply ensure that a TBTF subsidy is zero in statistical models. Financial reform needs to go further than that. All the subsidy does is tell us whether markets believe there will be a bailout; it absolutely does not tell us that a failure would not cause cascading consequences for the rest of the financial sector and the economy as a whole.

The failure of a TBTF bank could impose large externalities on the economy as a whole due to contagion, panics, financial instability, and so forth, just as we saw in the 2008 crisis. Not forcing a firm to absorb these external costs is a form of subsidy, as it allows the firm to have more debt and be larger than it would be otherwise. This would not be the case if the government were expected to let firms fail. Thus, there is good reason to believe that the TBTF “subsidy” should be negative, even strongly so, in a proper regulatory environment.

A TBTF firm could also impose serious macroeconomic risk through its creation and allocation of credit, independent of the effects of a sudden failure. Imagine if Lehman Brothers failed but there were no financial crisis: There would still be a Great Recession due to deleveraging, millions of foreclosures, plunder of black wealth in housing, and so forth. This is another negative externality that should lead to a negative subsidy, but it is based on the activities of the TBTF firms, not their failure. We discuss how to tackle this problem in the shadow banking section of this report.

The Promise, and Pitfalls, of Resolution Authority

Title II of Dodd-Frank attempted to create a cleaner process by which a TBTF institution could, in fact, fail. There has indeed been progress, as acknowledged below, thanks to the FDIC’s plan to take over and liquidate large, systemically risky firms. However, the solution is dependent on a number of variables that could go wrong. We briefly take stock of the FDIC’s success and then urge policymakers to go further to prevent failures before they occur.

According to the FDIC plan, which is called “single point of entry,” regulators would fail just the holding companies, using their assets to shore up any of their subsidiaries’ capital shortfalls. The very existence of this proposal has been deemed sufficient to solve the problems of TBTF; in reality, however, even a “successful” resolution could cause significant problems.

Consider what it would mean for a Title II resolution to go well: Bankruptcy court would be a realistic option. It would be clear to what extent a firm was suffering
from a liquidity crunch versus being actually insolvent. There would be no need for the FDIC to take over a firm; if it did, there would be sufficient loss-absorbing capacity to ensure a swift process, and if it didn’t, there would be little public funding necessary, and perhaps even private capital would be available. The firm itself would repay public funding. Liquidity would be easily accessible. Living wills would provide a practical guide for resolution. International coordination, particularly around foreign derivative contracts, would be set up well in advance. The process would be quick, easy, and put minimal stress on the economy as a whole.

On the other hand, one of the biggest problems Dodd-Frank faces is that a resolution could be “successful” in a general sense but widely seen as a failure in practice. In this scenario, there would be no sense of how insolvent the firm was in advance. Bankruptcy would not be a realistic option. There would not be anywhere near sufficient long-term capital to survive the losses. Large amounts of public funding would be necessary, and it would need to be repaid as an assessment on the financial industry as a whole, which would cause political controversy and cause other firms to cry foul. Living wills would turn out to have no predictive power, and liquidity would dry up, requiring more extensive Federal Reserve support. A lack of international coordination and a run by foreign derivative parties would make the panic worse, and this would not be isolated to a single firm.

Such a failure would have two immediate consequences: The first is that it would be unlikely to quell a panic and less likely to isolate the damage to one firm; the second is that if it looked like it was going poorly, Congress might move to stop the process as it was ongoing, adding significant political uncertainty. Indeed, given the difficult political threshold necessary to invoke it in the first place, the political uncertainty over whether and how such a process could be used should not be underestimated.
As a result, it is essential to prepare in advance for this kind of failure. There should be more efforts to risk-proof the financial sector in advance of a crisis.

**Policies to Tackle Risk in TBTF Banks**

**Preserve Dodd-Frank**

*Because Dodd-Frank as a whole is more than the sum of its parts, policymakers should resist efforts to repeal entire sections of the law.*

At a high level, all the component parts of Dodd-Frank are important and all of them reinforce one another. There will be efforts to trade off major sections of the Act in order to bolster others, which may sometimes extend to removing parts—for example, removing the Volcker Rule in exchange for higher capital requirements. Such efforts should be resisted, as they are based on a fundamental misreading of how Dodd-Frank works.11

This is not to say there are no good tradeoffs to consider, or different ways to prioritize the different parts of the law. But reformers should be very skeptical of removing an entire section of Dodd-Frank. Skeptics will say that it is better to focus on capital requirements, which can do the work of the other parts, yet is impossible to imagine a successful resolution if derivatives, for instance, are unregulated. Indeed, in order to end TBTF, it is essential to ensure that no institution has an outsized position in the derivatives market. They go together, as do other parts of the law. The current move to slim down and remove business lines at SIFIs tells us that this is the right approach.

**Regulate the Whole Balance Sheet**

*Require higher leverage requirements, higher risk-weighted capital, and more long-term debt.*

This chart depicts the balance sheet of a large, systemically risky financial firm. As with any firm, there are assets and liabilities. The mismatch between them helps lead to runs in financial markets, which is why it is important to extend prudential regulations to both. As a general principle, the liabilities side should be pulled toward the long term, with higher equity relative to debt and more long-term debt relative to short-term debt. More specifically, this reform would require the following:

**Regulate Equity: Higher Leverage Requirement**

Regulators should mandate a higher leverage ratio as a statutory requirement. A leverage requirement of 10 percent for SIFI firms over $500 billion in size, graduated above that to some extent, is a good first approximation, though the important point is to shift leverage requirements up one important level. If regulators do not move to do this, Congress should pass a requirement to this effect. Directed statutory authority written by Congress is not necessarily the best way to implement such a rule, but it is clear that regulators are behind the curve. Studies have consistently shown that leverage requirements are the best defense in case of failure.

Many will cry foul, saying that a higher leverage requirement is both unnecessary and dangerous. There are indeed small costs to higher leverage requirements,
but they are notably small due to the fact that they involve replacing one set of funding with another. There are also major benefits to the firm, to the financial markets, and to the economy as a whole. The best available evidence has the costs of marginally higher leverage requirements as much lower than the potential benefit from preventing a financial crisis.

**Regulate Assets: Higher Risk-Weighted Requirements**

Leverage requirements are important to regulating equity, and risk-weighted capital requirements are important to regulating both equity and assets. Currently, these requirements are balanced against each other, so Congress should maintain that balance by instructing regulators to pass a higher risk-weighted capital requirement in proportion to higher leverage requirements. If regulators increase leverage requirements on their own, they should likewise adjust risk-weighted requirements to retain their proportionate level.

Opponents say that risk-weighted capital requirements are unnecessary at best and a problem at worse. They argue that such requirements are endlessly gamed and subject to abuse and confusion by ratings agencies and internal models. To these opponents, leverage requirements are sufficient because they avoid these conflicts and should be prioritized.

However, risk-weighted requirements are essential complements to leverage requirements. Without risk-weighted requirements, banks can make excessively risky loans given a level of capital, subverting much of the purpose of capital requirements. Firms’ efforts to reduce risk in order to avoid the strictest surcharges show that the risk-weighted requirements have a binding effect, but they are not enough by themselves. Crucially, if an entire asset class is downgraded, as in the aftermath of a bubble or during a crash, the leverage requirement provides the binding requirement necessary for sudden, swift changes in asset classes.¹

**Regulate Debt: Making Debt More Long-Term**

Once a firm has the correct amount of equity, regulators should turn to the debt component of the balance sheet. The overall goal is to shift away from short-term debt, which is prone to runs and panics, and toward long-term debt. This is preferable for three reasons, all of which have been incorporated into Dodd-Frank: The first is to provide sufficient liquidity in the short term to survive a crisis; the second is to provide enough long-term debt to ensure that regulators have options in case of failure; and the third is to ensure that there is enough overall loss-absorbing capital to survive a crisis.

As a first step, reformers should defend the liquidity coverage ratio, which is the mechanism by which firms prove they have enough liquidity to survive a short-term decline. This has come under tremendous attack by the financial industry.

The second step is to develop a clear and expansive long-term debt strategy. The Federal Reserve should start by revealing more publicly how it determined thresholds for total loss-absorbing capacity (TLAC) and long-term debt. If it looks at the Great Recession, how does it balance this requirement against the extensive state support of financial markets that was required to prevent further collapse? It is quite possible the current estimates form the weakest level, one that requires extensive assumptions.

With that in mind, the Federal Reserve should tighten what qualifies as instruments for TLAC to ensure only high-quality instruments are used. There will be significant pressure to weaken this requirement.

**Continue to Push for Credible Living Wills**

*Ensure a clear liquidation process for when banks do fail.*

Assuming failure cannot be prevented in some cases, it is crucial that SIFI firms are able to move through bankruptcy with minimal disturbance to the overall financial sector. Dodd-Frank’s alternative process for winding down a failed bank, known as orderly liquidation authority (OLA), requires political sign-off that the FDIC may not be able to obtain. It requires the Treasury Secretary, after consulting with the president, to approve. It also requires the recommendations of two-thirds of the Federal Reserve Board of Governors and two-thirds of the FDIC (or other relevant regulators). If any of these “three keys” refuse to turn, which would be a strong possibility in the politically contentious and polarized environment that would come with a bank failure, bankruptcy will be the only option left.

OLA also puts significant public resources at risk—resources that regulators are bound to protect by binding SIFIs to the safest program in advance of a failure. Instead of prefunding resolution, Dodd-Frank uses assessments on financial firms in order to recoup potential losses. Those assessments will also be politically contentious. As an added benefit, every step taken to prepare for bankruptcy will also prepare a firm for OLA should regulators opt for it, because preparing for failure gives either judges or regulators more information and options to use.

In April 2016, the Federal Reserve and FDIC failed the living wills of several SIFIs. The living wills are the blueprint for how a large financial institution can survive bankruptcy, and for many of the largest SIFIs it is clear that serious problems remain.

Subsidiaries should not be allowed to presume a parent company will contribute resources toward capital or liquidity as part of a bankruptcy procedure. Full requirements for a safe resolution should be monitored and clear at both levels of the firm. This is likely to be legally challengeable under bankruptcy law. It is encouraging that the Federal Reserve recognizes such possibilities and is telling SIFI firms to engage in legal analysis, but it is very likely a conclusion will not be reached in advance of such a failure. If there is no immediate progress on this front, the Federal Reserve and FDIC should enact stricter remedies, such as higher prudential standards and divestiture of business lines.

**Coordinate International Derivatives**

*To reduce the risk of contagion, require that banks deal only in backstopped derivatives.*

Currently 18 major banks and the International Swaps and Derivatives Association (ISDA) are in agreement that they would contractually apply temporary stays to qualified financial contracts (QFCs) in case of failure, helping to prevent derivatives and other types of short-term contracts from forcing runs and panics in the case of an emergency. This is essential for foreign derivatives in the case of the failure of a firm. It is also essential that private markets standardize derivatives for automatic stays across the financial sector. Regulators should make this a priority; if they fail, international organizations should see what options are available to push this regulation further.

Regulators should pass their proposed rule that large financial firms may only use QFCs that allow for a temporary automatic stay in the event of a failure. This is essential for giving regulators the ability to handle these instruments in case of an OLA action.

**CONCLUSION**

Too Big to Fail is a challenge, but it can be managed. The most important thing, though, is to understand it as a problem to be managed consistently, not as a switch that we can simply flip off. A more robust means of bringing accountability and safety to all parts of the balance sheets of largest, systemically risky firms is the first, but not final, step toward bringing accountability to the financial sector as a whole.
The “shadow banking” system is largely responsible for the enormous economic and social costs associated with the financial crisis. Before the Great Recession, it was widely believed that these loosely regulated activities and entities were not subject to the same risks and vulnerabilities as traditional banks and were therefore unlikely to spread risk to the average consumer or the rest of the economy. However, the unprecedented bailout of the financial system revealed this assumption to be false. It was revealed that like banks, shadow banks could be subject to runs, transmit contagion, and benefit from structures of asymmetric information. Even now, policymakers and regulators find it difficult to address the vulnerabilities of shadow banking in part because the label applies to a wide range of different types of entities and activities.

While financial reform largely focused on regulating U.S. banks or systemically important financial institutions, the vulnerabilities in the shadow banking system has drawn the attention of regulators, elected officials and the public as one of the remaining components to achieve comprehensive financial reform. This system of unregulated activities and entities is not only a danger because it can cause contagion and panics among the institutions themselves, but they also distort the allocation of credit, which can result in sending resources towards unproductive, even fraudulent, activities. Shadow banking has been one of the drivers of economic inequality and economic instability over the last decades. As witnessed in the fraudulent mortgage lending practices that contributed to the 2007–2008 housing crisis, these activities affect the real economy and average Americans. Since these activities and entities are “constantly changing and largely unrelated,” it is imperative that policymakers put in place regulatory mechanisms to monitor and oversee how emerging innovations in the financial system may create new economic risks and predatory practices.

In considering how best to rewrite the rules to address the systemic risks caused by shadow banking, we start by relying on the same principles that guide current banking regulation:

- Bank-like activities subject to bank-like runs (e.g., money-market mutual funds) should be regulated like banks.
- Non-bank institutions and activities linked to the regulated banking sector (e.g., select investment banks and hedge funds) can lead to contagion and should be regulated to reduce macroeconomic risk.
- New rules should unrig a system in which certain stakeholders obtain rents due to regulatory arbitrage or information asymmetries.
- Although individuals and firms should be allowed to speculate with their own funds, average savers and the overall economy should be protected.

Academics, regulators, and market participants define shadow banking in different ways. As U.S. Federal Reserve Board Governor Daniel Tarullo stated, “shadow banking is not a single, identifiable ‘system,’ but a constantly changing and largely unrelated set of intermediation activities pursued by very different types of financial market actors.” Here we refer to shadow banking as any unregulated financial activity that facilitates the creation of credit by funding long-term, illiquid, and sometimes risky assets with short-term, liquid debt. While there are many different entities and functions involved in the credit creation process, we focus on the activities that:

- Share similar characteristics with traditional deposit-taking institutions (i.e., they take funds from savers and investors and lend out those funds, primarily to other financial institutions or corporations, through a range of products).
- Played a direct role in the financial crisis.

The primary distinction between traditional banking and shadow banking is that shadow banking activities and institutions do not have explicit access to deposit insurance or emergency lending from the Federal Reserve, except in unusual and exigent circumstances. These entities remain loosely regulated despite continued risk to the safety and soundness of the financial system.
In the following sections we attempt to demystify some of the complexities surrounding the shadow banking system and outline policies to reduce its economic and social costs. Through a series of policy solutions, we argue for a mix of prudential regulations on specific activities and more transparency and oversight on the activities themselves. Our recommendations are as follows:

» Prudentially regulate money-market mutual funds.
» Regulate leverage and realign incentives.
» Overhaul the bankruptcy regime.
» Enhance transparency and access to information across the chain of transactions.

MMMFs, one of the first shadow banking innovations, benefited from regulatory arbitrage in a lax regulatory environment. High inflation in the 1970s eroded the interest rates offered by bank deposits, which were capped under Regulation Q, and bank customers flocked to MMMFs because they promised higher interest rates for relatively safe, liquid investments. This was followed by an explosion of shadow banking functions that enabled firms to get around accounting rules, securities laws, and bank regulations. As noted, it was widely believed these activities were not exposed to same risk of bank runs as traditional, deposit-taking banks. However, that was not the case. The financial crisis clearly illustrated how new activities and innovations in the largely unregulated shadow banking system widely spread the costs of bad financial bets to individual savers and the real economy.

Economist and former PIMCO managing director Paul McCulley first introduced the term “shadow banking” in 2007 at the annual conference of central bankers in Jackson Hole; from there, it became a critical unit of analysis to understand the modern financial system and the 2007–2008 global financial crisis. A useful way to grasp the role of the shadow banking system in the financial crisis is to revisit the factors that brought one of the largest shadow banks, Lehman Brothers, to bankruptcy in 2008.
Unregulated Firms: From Mortgage Lenders to Investment Banks

Lehman Brothers, an investment bank, played a direct role in the mortgage lending market. During the U.S. housing boom in the 2000s, Lehman acquired five mortgage lenders, including the subprime lender BNC Mortgage, which lent to homeowners with poor credit, and Aurora Loan Services, which specialized in a type of home loan (known as Alt-A) that did not require full documentation. These subsidiaries issued consumer loans secured by mortgages. These mortgages were then turned into mortgage-backed securities through the securitization process, and ultimately bought, sold, and traded by investment banks, such as Lehman Brothers.

Due to pervasive fraud and predatory lending activities in the 2000s, the Consumer Financial Protection Bureau (CFPB) now regulates retail mortgage lenders, such as Lehman's subsidiaries. But prior to the crisis, they were largely unregulated. At the time, the Securities and Exchange Commission (SEC) was charged with regulating global investment banks, such as Lehman Brothers, under the Consolidated Supervised Entities (CSE) program. However, industry participation in this program was voluntary, and the mandate lacked the necessary teeth. Former SEC Chair Mary Schapiro testified, “the program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate.” As a result, investment banking firms remained loosely regulated as their activities extended well beyond the types of products and business lines typically found in registered investment banks.

Securitizations

Lehman was a major player in the mortgage market, specifically through its role in underwriting and securitizing these financial assets—which is to say, repackaging assets such as mortgages into products for investors. In 2007, Lehman issued, and had on its balance sheet, more mortgage-backed securities than any other firm. As housing prices fell, the value of the securities backed by failing mortgages eroded. With these depreciated securities on Lehman’s books—along with other assets that fell in tandem with mortgage-backed securities—the firm’s value quickly plummeted, making it insolvent. Similar to any banking panic, the shock in mortgage-backed securities spread to other asset classes, such as securities backed by corporate debt.

Run on Short-Term Debt Markets

Many financial institutions, such as Lehman, relied heavily on short-term debt instruments, primarily repurchase agreements, to fund their day-to-day operations. Lehman was leveraged 31-to-1, meaning the investment bank had $31 of debt on its books for every dollar of equity from shareholders. This meant that a 3 or 4 percent decline in the value of its assets meant the firm would be insolvent. As confidence in securitized debt crumbled, which was used as collateral in the repo agreements, firms like Lehman were unable to refinance, or roll over, their short-term debt. Lehman was the most infamous example of a highly leveraged firm being unable to withstand the crisis.

Money-Market Mutual Funds

Immediately following Lehman’s bankruptcy filing, a money-market mutual fund called the Reserve Primary
Fund, which was considered a safe place to deposit cash, realized losses of approximately $785 million from Lehman’s debt. When MMMFs could not maintain $1 net asset value (NAV) per share, commonly referred to as “breaking the buck,” this sparked further panic throughout the financial system. There was a flight to quality as investors moved assets out of MMMFs that were invested in private-sector debt and into MMMFs that primarily invested in U.S. Treasury debt.

Experts thought shadow banking activities would distribute risk, but instead they concentrated risk and transmitted it throughout the banking system. Exposure across the financial sector to a relative handful of risky mortgages was amplified and widely distributed throughout the system via leverage and the risky reuse of collateral. Former Federal Reserve Chairman Ben Bernanke famously declared the subprime mortgage crisis contained before he was aware of how amplified the risk was. As part of a response to prevent a systemic meltdown, the government responded by providing liquidity to non-banks during the financial crisis and guaranteeing certain account balances through an alphabet soup of programs such as the Term Asset-Backed Securities Loan Facility (TALF), Term Securities Lending Facility (TSLF), and Temporary Liquidity Guarantee Program (TLGP).

**Policies to Rein in Shadow Banking**

Even since the crisis, this network of loosely regulated activities continues to grow. The global shadow banking market was valued at $36 trillion in 2014, with 40 percent of its assets in the U.S. The value of these activities has increased on average $1.3 trillion a year since 2011. However, many of these activities are designed for the purpose of regulatory arbitrage, which can put the safety and soundness of the financial system at risk. While proposed and implemented policies tweak around the edges, we argue that regulators should pursue structural changes and question the fundamental existence and social benefit these complex activities that continue to operate outside the macro-prudential regulatory framework.

The financial crisis exposed shadow banking’s vulnerability to classic banking panics and information asymmetries, which threatened financial stability and added fuel to the fire of the crisis. The Dodd-Frank Act contains several explicit provisions to address shadow banking, which include the following:

- Hedge funds must now register with the SEC.
- Many derivatives transactions are to be moved to public exchanges and clearinghouses.
- Institutions identified as systemically important financial institutions, including bank and non-bank entities, are regulated by the Federal Reserve.
- The Financial Stability Oversight Council (FSOC) was created to identify and manage system-wide risks and fill the gaps in prudential regulation by designating firms or activities as systemically significant.
- Retail lenders that interface with average consumers are now subject to consistent federal regulation through the newly created CFPB housed within the Federal Reserve.

Beyond Dodd-Frank, regulators have successfully pushed reforms in MMMFs with the recent floating NAV rule, which allows the daily share prices of these funds to fluctuate in step with the value of the fund’s assets. The Federal Reserve Board of New York also put forth structural reforms to short-term debt market, specifically targeting the tri-party repo market “to reduce reliance on intraday credit, make risk management practices more robust to a broad range of events, and take steps to reduce the risk that a dealer’s default could prompt destabilizing fire sales of its collateral by its lenders.”

These are important reforms; nevertheless, policy must go further. Financial entities and activities change and adapt in response to the regulatory (or deregulatory) frameworks put in place, and any new regulatory regime “requires a balancing of the resulting increase in socially beneficial credit, capital, or savings options against any associated increase in risks to the safety and stability of the financial system.”
Our proposals aim to preserve the social and economic benefits of these banking activities while discouraging activities that are not.

**Prudentially Regulate Money-Market Mutual Funds**

Extend prudential regulations, such as deposit insurance, to money-market mutual funds to prevent bank-like panics.

Regulators should explicitly extend the prudential regulatory framework—the regulatory approach used to regulate and oversee the traditional banking system to mitigate systemic risks—to a subset of shadow banking activities in order to prevent bank-like runs. MMMFs are one of those activities.

Leading experts and regulatory agencies from the Financial Stability Board to the Group of Thirty argue for effectively establishing a form of deposit insurance for these transactions. This specific component of the shadow banking web has similar characteristics to traditional bank deposits: MMMF shares are effectively treated as safe, “cash-like,” demandable deposits, which are prone to banking runs.

The U.S. long ago took clear steps to prevent runs on traditional banks. The Federal Reserve was created in 1913 to address panics by providing liquidity to banks that were hit by a run. After the Great Depression, society made a decision to “panic-proof” the banking system by establishing deposit insurance managed by the Federal Deposit Insurance Corporation. The FDIC’s deposit guarantee reassured depositors that their deposits were safe, which prevented mass withdrawals during banking panics. These institutions continue to provide these benefits to the financial industry, and the rest of the economy, with unarguable success.

We should rethink the scope of these “panic-proof” protections and broaden them to include the shadow banking system. During the financial crisis, there was a classic bank-like panic in MMMF as depositors simultaneously sold their shares (demanded their “deposits”) because of fear that their investments would not be able to maintain value. As a result, MMMFs were forced to sell assets at lower, fire-sale prices to return the deposits to shareholders. The federal government wisely guaranteed certain MMMFs to prevent the crisis from spreading. Congress should explicitly extend this guarantee going forward by passing legislation to bring MMMFs under prudential bank regulations.

Extending deposit insurance to MMMFs would require a government entity to establish explicit legal guidelines and licensing to determine eligibility for a government guarantee, including collateral requirement guidelines in order to receive licensing (or a charter). Critics of this solution argue that deposit insurance could increase systemic risks and moral hazard and shift incentives for prudent risk management away from fund advisers, who may be better positioned to monitor risks, toward public or private insurers. However, MMMF shares are already considered to have an implicit government backing, thus moral hazard issues arguably already exist. It would be better to formalize this backstop and pair it with strong prudential...
regulations to prevent failures of the type we saw during the crisis.

Current MMMF regulation primarily focuses on transparency and reporting, but this does not go far enough. Prudential regulation and deposit insurance are the most effective ways to prevent bank runs, as we have seen in the traditional banking system. We have not experienced a run since the establishment of this regime in the 1930s. Extending it to MMMFs is a small price to pay to prevent another bank-like panic in the shadow banking sector.

**Regulate Leverage and Realign Incentives**

*Entities funding their activities with short-term debt instruments, such as repurchase agreements, over-the-counter derivatives, and securities lending, should be regulated to prevent excess leverage.*

Shadow banking institutions, such as brokerage firms that buy and sell securities on their own account and to customers, investment banks, and hedge funds, depend on short-term funding, primarily through repurchase agreements, derivatives, and securities lending, for their day-to-day operations. This makes them highly leveraged and vulnerable in times of economic panics. Leverage among broker-dealers, such as Lehman Brothers, reached 40-to-1 in 2007 before falling to 22-to-1 in 2012, according to a 2014 FSOC report. According to the FSOC, leverage among broker-dealers remains “significantly higher” than among commercial banks. High leverage was pervasive among shadow banking institutions, which exacerbated their vulnerability to the crisis.

Regulators should increase leverage requirements for institutions engaged in short-term debt instruments. The SEC has considered new rules to limit leverage for investment banks, similar to the requirements put in place by the Federal Reserve and other regulators for banks. The SEC reportedly discussed imposing a 6.66 percent leverage ratio on investment banks (or non-bank broker-dealers) in a series of private meetings with market participants and industry bodies. Critics of this policy warn it could have a damaging impact on market liquidity and could cause these entities to retreat from the market. However, excessive leverage was one of the key drivers of the crisis, and we should regulate this critical component of finance. Leverage ratio requirements are an important policy that the SEC should actively pursue and implement since these activities are riskier and more systemically pervasive than previously imagined.

Another mechanism to regulate leverage is the establishment of so-called “minimum haircuts.” Regulators such as Federal Reserve Board Governor Tarullo support this type of policy solution, which would effectively constrain leverage in certain shadow banking transactions. A system of “minimum haircuts” for securities financing transactions (SFT), such as repos, reverse repos, securities lending and borrowing, and securities margin lending, “would require any entity that wants to borrow against a security to post a minimum amount of extra margin to its lender.” The minimum amount would vary on the type of collateral used in the transaction. This policy, as Tarullo notes, “could also mitigate the risk to financial stability posed by pro-cyclical margin calls during times of financial stress, since putting a regulatory floor under SFT haircuts during good times would reduce the amount by which they would increase during periods of stress.”

This could effectively result in less panic and fewer runs by providing investors with a greater cushion against credit losses, and thus more confidence.

Regulators have already taken some steps to regulate leverage. For example, the SEC proposed a rule to limit the use of derivatives to increase leverage ratios by

<table>
<thead>
<tr>
<th>Company</th>
<th>Leverage Ratio (Assets to Equity), 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bear Stearns</td>
<td>34:1</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>33:1</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>32:1</td>
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<tr>
<td>Lehman Brothers</td>
<td>31:1</td>
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To incentivize market participants to implement the minimum haircut provision outlined above, academics and regulators have pushed to change the bankruptcy protections for repurchase agreements. Currently, bankruptcy law provides a “safe harbor rule,” which carves out repurchase agreements from the Chapter 11 bankruptcy process. Under the safe harbor rule, these transactions are not subject to the “automatic stay” that ordinarily prevents creditors and counterparties of bankrupt companies from taking legal action to collect their debts. This means that the repurchase agreement counterparties can immediately liquidate the collateral they are holding to raise the cash owed to them under the terms of the agreement in the event of a borrower default. Academics such as Gordon and Metrick argue that “that the bankruptcy safe harbor for repos has been crucial to the growth of shadow banking, and that regulators can use access to this safe harbor as the lever to enforce minimum repo haircuts and control leverage.” The Federal Reserve, in conjunction with the SEC and the Treasury, should establish a requirement for minimum haircuts, and Congress should amend the bankruptcy regime to realign incentives around these risky activities.

Enhance Transparency and Access to Information
Strengthen the Financial Stability Oversight Council’s authority to evaluate and monitor the financial sector for

Shadow banking institutions, such as brokerage firms that buy and sell securities on their own account and to customers, investment banks, and hedge funds, depend on short-term funding, primarily through repurchase agreements, derivatives, and securities lending, for their day-to-day operations.

Overhaul the Bankruptcy Regime
Revoking the repurchase agreement safe harbor rule in order to incentivize implementation of the minimum haircut provision.
emerging risks, and establish a central clearinghouse for short-term debt activities.

The final component to tackling shadow banking is addressing the vast information asymmetries in the sector, i.e., lack of public information and transparency needed for regulators and market participants to effectively identify and price risk in the market. Currently, there is no comprehensive data on the short-term debt market. The New York Federal Reserve started to track data on tri-party repo transactions in 2010, but there are other types of short-term debt transactions that remain in the dark. It is critical to enhance public disclosure for all short-term debt activities, specifically securitizations and repurchase agreements.

One way to enhance transparency and information in the market is to establish a central clearinghouse for these activities. Regulatory authorities such as the Financial Stability Board have recommended exploring the central clearing house structure as a potential approach to bringing greater transparency to the market. The clearinghouses could become vulnerable market participants to systemic risk and taxpayer bailout, just as the mega-banks were in 2008. However, clearinghouses are regulated entities and have yet to pose that problem. As such, authorities should assess the costs and benefits of central clearing in securities lending and repo markets.

This FSOC is the regulatory body that is best positioned to monitor and assess the systemic impact of these evolving and emerging activities. It was created by Dodd-Frank in response to the weaknesses in the U.S. financial regulation system that were revealed during the financial crisis. Many of these weaknesses were the result of fragmentation and lack of coordination across the different regulatory entities, which no longer reflected the reality of the modern, interconnected financial system. The FSOC, with its voting members drawn from the different regulatory agencies, was given the authority to designate large non-banks, such as insurance companies, hedge funds, and systemically important industrial firms like GE, for heightened prudential oversight by the Federal Reserve. The FSOC has specifically identified asset managers, mutual funds, and hedge funds as areas for further research and assessment. Since the FSOC is the only regulatory mechanism to identify emerging systemic risks, we should ensure its authority is maintained and enhanced and identify ways to expand this coordinated oversight.

There should be no controversy around the role of the FSOC and the Office of Financial Research (OFR), the FSOC’s research arm, in evaluating and monitoring the financial sector across interconnected business lines for emerging risks. The designation procedure is a lengthy process that includes multiple procedural safeguards and opportunities for appeal. However, there are ways to increase transparency. A 2012 General Accounting Office (GAO) study identified potential improvements such as mandating the release of transcripts of FSOC closed meetings after a suitable time period. This is a good policy that should be implemented.

Conclusion

Reining in shadow banking is one of the most critical components of financial reform that has not yet been addressed effectively, even as regulators, advocates, and elected officials have continued to sound the alarm that more needs to be done. While there are many policy solutions that can chip away at the edges of specific risky activities, it is imperative to note that these activities are constantly changing and responding to new rules put in the place. As such, it is equally important to have bold regulators with the expertise and leadership to make sure rules adapt to emerging trends in the shadow banking system, and that these rules are implemented, defended, and enforced.

ii The nine independent financial regulators whose chairs are voting members of the FSOC are the Department of the Treasury, the Commodity Futures Trading Commission (CFTC), the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Commission (FDIC), the Federal Housing Finance Agency (FHFA), the Federal Reserve, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the SEC.
Curbing Short-Termism
By Mike Konczal and Kathryn Milani, Roosevelt Institute

In spite of the declared end of the Great Recession, the U.S. economy continues to function well below potential. One factor contributing to sluggish economic growth is short-termism, a corporate philosophy that prioritizes immediate increases in share price and payouts at the expense of long-term business investment and growth. Abetted by a series of policy changes that increased the power of shareholders and the financial sector over the past 30 years, corporate managers have shifted their focus from stable long-term returns to short-term profits. The result has been not only a marked increase in inequality, but a decline in productive investment as these payouts consume resources once devoted to growth.¹

Short-termism is the inevitable result of the growing power of finance over the real economy. However, policy choices can push back against this excess of corporate power and curb the incentives that currently shape corporate myopia. This section documents the evolution of the problem and proposes two broad approaches: limiting the known drivers of short-termism and increasing the power of long-term stakeholders. Within these categories, we recommend the following policy changes:

- Limit share repurchases.
- Investigate pension obligations.
- Reform private equity.
- Reform CEO pay.
- Establish proxy access.
- Allow alternative share approaches.
- Affirm board power.

CONSEQUENCES OF THE SHAREHOLDER REVOLUTION

Before the 1970s, American corporations consistently paid around 50 percent of their profits to shareholders and retained the rest for investment in long-term productivity drivers like research and development (R&D), equipment, or training for employees. During this time, an additional dollar of earnings or borrowing was associated with about a 40-cent increase in investment.² Beginning in the late 1970s, however, changes in corporate finance theory, management...
practices, changing regulations, as well as the general rise of Wall Street precipitated the “shareholder revolution,” in which owners of corporate stock came to expect larger payouts. As a result, since the 1980s, less than 10 cents of each borrowed dollar is invested back into a company. Over the same period, shareholder payouts have averaged 90 percent of reported profits.

In short, the relationship between the flow of profits and borrowing for corporate investment has weakened as that between borrowing and shareholder payouts has skyrocketed.

Share repurchases, also known as buybacks, have become one of the main outlets through which cash leaves firms—and thus one of the primary building blocks of short-termism—with corporations spending roughly 100 percent of their profits to buy back stocks or pay out dividends. Between 2003 and 2012, publicly listed companies in the S&P 500 used 54 percent of their earnings—$2.4 trillion—to repurchase stocks. Combined with dividends, payouts to shareholders surpassed 100 percent of earnings.

From 2009 to the end of 2013, corporate investment increased by $400 billion. Meanwhile, shareholder payouts increased by $740 billion and corporate borrowing by almost $900 billion. It turns out that the businesses that have been borrowing the most since the end of the recession have not been those with the highest levels of investment but rather those with the highest dividend payments and share repurchases. In other words, the financial system is no longer an instrument for getting money into productive businesses, but has instead become an instrument for getting money out of them. The sector overall is now predicated largely on seeking rents through payouts rather than increasing profits through growth.

Recent research shows the broader consequences of this shift. A comparison of similarly situated public and private firms shows that public firms invest substantially less and are also less responsive to changes in investment opportunities. Public firms are responsible for roughly two-thirds of all non-government R&D expenditures in the United States; however, research suggests almost half of managers would reject a profitable investment if it meant missing an earnings forecast.

From a social standpoint, short-termism exacerbates inequality. Most Americans own little or no stock and therefore do not benefit from higher share prices or larger payouts. The bottom 50 percent of households own just 9 percent of shares. Stock ownership is significantly concentrated, with just 4 percent of households owning a majority of all shares. Rather than having a democratizing effect, the concentration of income from capital is one of the primary drivers of inequality.

Many argue short-termism is not a real problem because cashing out profits to shareholders results in a net positive benefit for the overall economy and increased buybacks and dividends are funding a wave of high-tech and innovative firms. But this isn’t the case. Robust evidence shows that short-termism is increasing inequality and disrupting the link between borrowing and investment: Share of investment and employment from young firms has lowered since 2000 along with the share of investment from tech companies. At the same time, technology firms have increased dividends and buybacks even faster than publicly traded firms as a whole. Estimates show that all of finance, including IPOs and venture capital, invested just $200 billion in the real economy during 2014 and payouts reached $1.2 trillion. The short-termism system overall is a significant drag on investment, which leads to weakened productivity, growth, and innovation.

POLICIES TO COMBAT SHORT-TERMISM

The rise of short-termism has gone hand in hand with developments in law, regulations, and the structure of financial markets. Combating short-termism and reversing these trends will require a comprehensive approach; we will need to rewrite a series of rules and policies put in place over the last three decades. There are three key approaches to achieving this. The first is limiting the known drivers and incentives for short-
termism, the second is increasing the power of long-term stakeholders, and the third is expanding the role of the state. We will concentrate on the first two here.

**Limit Share Repurchases**  
*The SEC should revoke or limit the 10b-18 Rule and require more extensive reporting of share repurchases.*

Share repurchases, in the form of buybacks, have become one of the main drivers of cash leaving firms. When the Securities and Exchange Commission adopted regulation 10b-18 in 1982, known as the “safe harbor rule,” the practice of share repurchases became more common. This rule protects companies that repurchase shares against charges of insider trading as long as repurchases on any given day is less than 25 percent of the stock’s average daily trading volume over the previous four weeks.\(^{13}\) The SEC should revoke or limit the 10b-18 Rule and require more extensive reporting of share repurchases. Limiting these activities could take a number of different forms. Rule 10b-18 could be revoked, eliminating the safe harbor rule. Alternatively, the SEC could lower the daily trading volume limit. The SEC should also begin tracking share repurchases on a regular schedule to allow for enforcement of this rule.

Critics argue that shareholder payouts are a way to move capital from established corporations to newer, faster-growing ones.\(^{14}\) Yet the share of investment coming from new and small companies is actually declining over time instead of increasing.\(^{15}\)

The share of investment spending accounted for by publicly traded corporations has tended to rise in booms and fall in downturns. Not surprisingly, such investment was particularly high during the tech boom period around 2000. But there is no long-term upward trend; on the contrary, during the past decade the investment share of younger corporations has been near record lows. As for the share of investment going to small firms, it has steadily declined since the 1950s apart from, again, a temporary spike during the tech boom. Like the investment share of newer firms, the investment share of small firms is now near its lowest level ever.\(^{16}\)

Others defend payouts on the grounds that these profits will fund increased investment in new businesses, but the evidence suggests otherwise.\(^{17}\) In 2014, payouts topped $1.2 trillion, but new investment, such as IPOs and venture capital, was less than $200 billion. This means that in the best case, for every dollar yielded from investments that went to stimulate new business, $6 simply went to shareholders’ pockets.\(^{18}\) The primary effect is not to raise funding for companies but to bid up share prices.

**Investigate Pension Obligations**  
*The Pension Benefit Guaranty Corporation (PBGC) should use its existing resources and authority to directly limit share repurchases unless the corporation’s pension liabilities are properly funded.*

Combating short-termism will require creative solutions, especially when public stakeholders are directly at risk. Share repurchases can have harmful effects on companies with unfunded pension liabilities. The PBGC is mandated, under the Employee Retirement Income Security Act (ERISA), to regulate and insure private sector retirement plans. This agency should use its existing resources and authority to directly limit share repurchases unless the corporation’s pension liabilities are 100 percent funded, as required by the Pension Protection Act of 2006.\(^{19}\) We do not have comprehensive data on the extent of this problem, but more robust oversight of the relationship between pension funds liabilities and buybacks from the PBGC will provide broader protection to consumers and more accurate information to the market.

Ideally, the PBGC would use its existing monitoring and enforcement authorities to ensure companies do not repurchase their shares unless their pension fund is fully or almost fully funded. An additional tool the PBGC has to discourage buybacks, which it can use independently or in tandem with other rules, are the premiums it collects to oversee pension funds. Single-employer plans get charged both a fixed-rate premium and a variable-rate premium. The variable rate is correlated with how underfunded the plan is; i.e., the more likely the plan is to fail, the higher the premium becomes.\(^{20}\) The PBGC states that one of the early warning signs it looks for to identify underfunded pension funds is excessive dividend payments.\(^{21}\) The PBGC should charge companies a higher variable rate if they engage in buybacks because buybacks can be interpreted as weakening a company’s financial position.

Furthermore, companies with unfunded pension liabilities that conduct repurchases should not be granted “hardship waivers,” which allow struggling companies to forgo late payment penalties. Currently, multiemployer plans that are in critical condition receive assistance in the form of emergency loans from
the PBGC. Recent legislation allows the PBGC to lower participant benefits if a plan is critically underfunded. According to the PBGC website, “the agency projections show continued and significant growth in the amount of projected financial assistance as plans near insolvency run out of money over the next few years.” The PBGC should not grant such financial assistance to companies engaged in buybacks.

Lastly, Congress should update ERISA to enhance PBGC’s enforcement mechanisms and ensure the agency has the resources and funding necessary to execute this mission. Congressional approval is necessary to charge multiemployer plans engaged in buybacks a higher rate. PBGC’s current powers allow it to take liens on a company’s assets if the company is not making adequate contributions to its pension fund. Updating ERISA should allow the agency to use this enforcement mechanism to limit buybacks. If a company’s pension fund is only 90 percent funded and the company is engaged in buybacks, the PBGC should be able to place a lien on the company’s assets to make up the funding gap.

Any criticism of the agency’s effectiveness is largely due to funding: The PBGC is teetering on insolvency. Implementing higher premiums for buybacks and requiring 100 percent funding before allowing companies to engage in buybacks would strengthen their balance sheets in two ways: The PBGC would have more revenue and less chance of taking on failed pension plans.

Reform Private Equity
To ensure the impact of private equity (PE) is more beneficial than harmful, Congress should limit leverage in PE and forbid new debt to pay dividends to shareholders.

Short-termism is not limited to public companies. PE is a growing, lightly regulated industry that represents the most extreme case of shareholder power because the shareholders manage the privately held company. PE firms borrow money to take public companies private with the stated intention of conducting value-increasing changes and selling the companies at a higher price three to five years later. The rationale behind PE firms is that they target distressed companies and manage them back to health, but research shows this is not always the case. PE firms overwhelmingly target healthy companies and boost their balance sheets in the short term by cutting the kinds of costs that build long-term value.

To ensure PE’s impact is more beneficial than harmful, Congress should limit leverage in PE and forbid new debt to pay dividends to shareholders. A good benchmark for how much leverage should be allowed would be the amount of leverage utilized by middle market PE firms—a debt-to-income equity ratio closer to 1-to-1. Congress should also limit moral hazard by requiring matching partner equity and demand more transparency and public disclosure of fees.

Tax reform is also crucial to addressing these issues. Currently, taking on more debt is rewarded through discounted tax bills. The more debt a business has to service, the less tax it incurs. Studies suggest that large debt can increase a company’s value by 10–20 percent because of the interest deductibility it receives. Interest deductibility should be eliminated as part of a larger tax reform agenda.

Congress can address this moral hazard and force investors to have more to lose if a portfolio company fails, especially in cases where risky management decisions were made. It could demand that PE firms put more skin in the game by matching limited partner equity in the fund. It could also eliminate the carried interest loophole, which currently allows carried interest on an investment to be taxed as capital gains, not as ordinary income. Congress could also mandate that if a company goes into bankruptcy due to sale of assets or dividend recapitalizations, the investors must be liable for severance pay for workers and are not eligible to pass off pension liabilities to the PBGC. If long-term investors are indeed long-term, they should not need a short-term exit.
The growth of equity-based CEO compensation is largely responsible for incentivizing managers to engage in short-termism.

Reform CEO Pay
Congress should cut the performance pay loophole, ending the tax break for multimillion-dollar performance-based compensation packages.

The growth of equity-based CEO compensation is largely responsible for incentivizing managers to engage in short-termism. In an attempt to align executive interest with their own, shareholders have demanded that a greater percentage of CEO compensation be based on stock performance. This means that, rather than focus on actual performance and long-term growth, self-interested CEOs look to drive up share price using short-term strategies such as buybacks. As such, performance pay can be seen not only as one of the major drivers of the rise of CEO pay, which has more than quintupled for large public companies since the early 1980s, but of short-termism as well.25

One way Congress can address this issue is by updating Section 162(m) of the tax code to remove the performance pay loophole, a primary motivation for using stock options and other “incentive-based” pay as compensation. In 1993, in an attempt to limit executive pay, Congress created Section 162(m), which ended tax deductibility of executive pay over $1 million but made a misguided exception for performance pay. To discourage performance-based pay and the myriad related problems described above, Congress should close this loophole and require that the deductibility limit of $1 million apply to all types of executive pay. Beyond executives, the rule should apply to all employees earning more than $1 million.26

In addition, Dodd-Frank included a handful of rules designed to better regulate executive compensation, and these have represented a move in a positive direction. Last year, the SEC finally approved 953(b), the Dodd-Frank provision that requires companies to disclose the ratio between their CEO and median worker pay. This not only raises public awareness, it also creates an enormous opportunity to link these ratios to helpful policy reforms. For example, in 2015, a Rhode Island state senate bill was introduced that would give favorable treatment when awarding government contracts to companies that have pay ratios of 25-to-1.27

Establish Proxy Access
The SEC should rerelease its proxy access ruling, authorized through the Dodd-Frank Act, and make the rule stronger by reducing the ownership requirement and lengthening the holder time requirement to target long-term institutional investors.

In order to reorient firms toward long-term value, long-term stakeholders should have greater participation in board nominations. Corporate boards are responsible for supervising executives and making important company decisions. Board members are usually nominated by independent committee and are placed on a company ballot for shareholder vote. Shareholders who wish to place their own nominees on the ballot for election are required to spend their own resources to mobilize other shareholders behind their desired candidate, which is costly. The proxy access rule would remove this barrier.

The Dodd-Frank Act affirmed that the SEC has the authority to develop a proxy access rule, and in 2010, the SEC passed Rule 14a-11, which stated that if a shareholder holds at least 3 percent of a company’s shares for at least three years, that shareholder could nominate either 25 percent of a board or one member, whichever is greater. This rule was struck down by the D.C. Circuit Court of Appeals, largely due to lobbyists claiming that the economic impact of the rule was not fully considered.28 The SEC should appeal this ruling and make the rule stronger by reducing the ownership requirement and lengthening the holder time requirement to target long-term institutional investors.

Allow Alternative Share Approaches
Listing requirements on stock exchanges should be changed to allow more innovative experimentation with these and other approaches.

Firms need the ability to innovate new approaches to shares. Loyalty shares are one innovation that would link more votes to longer-held shares. Dual-class shares empower long-term management by granting them more votes per share. Listing requirements on stock exchanges should be changed to allow more innovative
experimentation with these and other approaches. Research shows that efforts to expand alternative, innovative ways of structuring shares can help orient a firm toward long-term value. Though this does not require legislative effort, it does show that regulators should incentivize market-based alternatives. Small efforts from regulators and institutions can bolster this.

As the regulator of the exchanges, the SEC could support these efforts by changing listing rules to be more inclusive of time-varying shares. The SEC could directly try to give long-term shareholders more power by requiring investors to hold company stock for longer periods in order to obtain certain voting rights. In the past, the SEC has “proposed a one-year holding requirement for each nominating shareholder or member of a nominating shareholder group.” Congress could also pass legislation similar to France’s Florange Act, which states that, unless shareholders vote against it, any shares held for two years will receive twice the voting rights.

Labor is particularly disadvantaged by current corporate governance structures, but strengthening labor is in the best interest of companies. “Co-determination,” or involving workers in company decision-making, has the potential to greatly increase the productivity and representation of the labor force by adding necessary long-term stakeholders. Congress should investigate adopting the German model, with the long-term goal of mandating employee representation on company boards to supplement more traditional forms of labor organizing.

**Affirm Board Power**

*Regulators such as the SEC should publicly reaffirm the business judgment rule and clarify that shareholders are not owners or residual claimants of the firm.*

The relevant governing bodies, particularly the SEC, should reaffirm the business judgment rule, which empowers boards with the benefit of the doubt concerning their decisions. The SEC should also clarify that shareholders are not owners or residual claimants. Additionally, management and regulators should continue to allow the practice of board staggering. Reaffirming these principles would help set the standard for the proper relationship between the many key stakeholders in a firm.

The first step is reaffirming the business judgment rule, which protects directors from personal civil liability for the decisions they make on behalf of a corporation. Some may hesitate to give managers more power and protection, but there are two reasons to consider this approach. First, this action should be carried out in tandem with the other policy proposals in this agenda. A holistic approach is the most effective way to address short-termism, and that includes seeking to end short-termist trends but also empowering good management.

The second step, as noted, is for agencies and law associations to state publicly that shareholders are not the owners or residual claimants of the firm. The claim that they are is often repeated but incorrect. Corporations are a nexus of contracts and obligations, and shareholders are just one of many agents who have claims on a firm. Shareholders own stock but do not have traditional ownership rights to a firm because they cannot “freely access the company’s place of business, exclude others, or decide what happens on a day-to-day basis.” UCLA Law Professor Stephen Bainbridge uses the case of *W. Clay Jackson Enterprises, Inc. v. Greyhound Leasing and Financial Corp* to illustrate the fact shareholders are not owners. In this case, it was stated, “even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation’s property.” In other words, shareholders do not have the right of use or possession of corporate property.

**CONCLUSION**

These policies represent a diversified set of approaches to combat short-termism. It is important that policymakers address this growing trend and put mechanisms in place to address its economic effects. As long as corporations are simply conceived of as machines for increasing share value, they will be unable to fully utilize America’s collective productive capacities or develop those capacities for the future.
The financialization of the United States economy has distorted our social, economic, and political priorities. Previously in this report, we discussed how changes to the rules shaping financial markets have increased macroeconomic risk and reduced private investment and innovation. But in addition to affecting the real economy, financialization has changed the political economy. The increasing political power of the financial sector at both the local and national level is a broad phenomenon with an impact on everything from campaign finance to the provisioning of public goods.

This section covers the changing nature of public finance, particularly at the state and city level. As financial tools have increased in complexity and opacity, we have seen a surge in information asymmetry between private lenders and public borrowers. As a result, cities and states across the country have signed financing deals that are often characterized by high costs and high risks and designed in such a way that their failure can be predicted.

Many of these municipal loans resemble the subprime mortgages that banks sold when plain vanilla mortgage deals would have offered more affordable and sustainable terms to borrowers. Similar to the complex and costly deals made during the housing boom, revenue-strapped state and local governments sign deals with exorbitant fees, which are paid for with taxpayer dollars at the expense of public services. There are many reasons why local and state governments enter into these deals; however, one of the primary explanations is that these deals often promise short-term cost-savings, and public officials who are facing budget deficits are more willing to overlook long-term risk if it helps them solve their short-term budget crisis. Every dollar that cities and states send to Wall Street as part of these costly deals is a dollar that is not invested in essential community services; the resulting funding shortfalls have a significant impact on already underserved communities and reduce the kinds of public investments that fuel economic growth.

Across the country, states and municipalities are cutting public services and taking austerity measures that have a disparate impact on working-class communities, especially communities of color. Complex financial deals are among the biggest culprits. This may prompt one to wonder why municipal governments would be drawn to such deals in the first place, but the temptation is clear on both sides: State and municipal finances have deteriorated in recent decades for a number of reasons, chief among them, depressed tax revenues. In order to close the resulting budget shortfalls, many cities and states borrow money or resort to financial gimmicks. Wall Street firms had the resources to lend and, in the culture of financialization, the power to set the terms that would be most favorable to themselves.

To repay bad loans, taxpayers provide trillions of dollars of business to Wall Street every year. Just three cities—New York, Los Angeles, and Chicago—and their related agencies and pension funds conduct nearly $600 billion worth of business with financial institutions each year. We need to renegotiate the relationship between state and local governments and the financial sector in order to return government to its primary mission: providing people with critical services and infrastructure, not providing the financial services industry with profits. We can do this by implementing common-sense reforms to safeguard our public dollars, make our public finance system more efficient, and ensure that taxpayer money is used to provide fully funded services to our communities.

In this section, we identify how the current rules of our economy can be restructured to make municipal finance deals work for the benefit of the public and local economic growth. We do this by recommending a range...
of solutions to help protect and empower municipal borrowers given the opacity and fragmentation in the municipal lending market. These include:

» Create a Municipal Financial Protection Bureau.
» Explore Federal Reserve lending to municipalities.
» Require disclosure of pension fund fees.
» End guilt-free and tax-free fines and settlements.
» Fix the fiduciary loophole for municipal advisors.

THE GROWING COMPLEXITY OF PUBLIC FINANCE

The ability to borrow is vital to public finance. State and municipal borrowing for long-term public infrastructure projects, such as building roads, maintaining aging infrastructure, and investing in public transportation, has been a standard public finance practice. However, as the rules shaping financial markets changed over the last few decades, public finance shifted away from traditional, simple debt instruments used to finance long-term infrastructure projects and toward more complex debt products, like interest rate swaps, used to finance day-to-day operations and fill revenue shortfalls. A 2009 report from the Municipal Securities Rulemaking Board (MSRB) found that “the municipal securities marketplace has evolved from one in which states and municipalities offered plain-vanilla, fixed rate bonds to finance specific projects into a market that involves the use of complex derivative products and intricate investment strategies.”

The increase of corporate and financial power shaped public finance deals by allowing banks to exploit asymmetric power dynamics to sell bad loans. As a result of this new dynamic, the financial sector began selling municipal borrowers more complex deals that generate more fee revenue, turning a plain vanilla corner of banking into a complicated goldmine for bankers. For example, banks started marketing risky variable-rate debt to public officials, which typically required those officials to purchase additional financial products like interest rate swaps and letters of credit to protect against rising interest rates and mitigate the increased risk of default. This enriched the financial sector at the expense of public services and gave private financial firms more power over how our public resources are deployed.

The complexity of these products has posed challenges for public officials making critical financial decisions. These challenges include a lack of transparency and lack of information on the terms of the products and their long-term impact on a government’s financial obligations. Information asymmetries are a pervasive problem in finance and equally pervasive in municipal finance.

Examples of these bad deals abound. Between 2010 and 2012, school districts in Minnesota had to borrow nearly $2 billion when the legislature indefinitely delayed state education funding to fill a budget hole, which forced the districts to cut staff in order to pay firms more than $6 million in fees on top of high interest rates. Chicago’s school district is slashing special education programs to close a $480 million budget shortfall while paying $502 million to banks for interest rate swaps. Cities like Los Angeles are spending twice as much on publicly disclosed banking fees as they are on their entire street services budget, and schools such as the University of California have Wall Street executives as board members who vote to raise students’ tuition to pay for expensive debt financing schemes that benefit their own banks. These are only a few examples of how the financialization of our political economy has distorted our state and local government priorities.

Since the financial sector has increasingly played a prominent role in the state and local political economy, it is critical to explore policy options to protect municipal borrowers, ensure transparency in this opaque market, and shed light on information asymmetries to ensure that state and municipal borrowers have the information they need to make sensible financial decisions and investments.
Policies to Promote Fairness in Public Finance

There are a number of policies that Congress and regulators can adopt that would strengthen the fairness of municipal finance transactions. This includes creating a Municipal Financial Protection Bureau, letting the Federal Reserve lend directly to municipal borrowers, requiring public pension funds to disclose fees and gross returns, ending guilt-free and tax-free fines and settlements, and closing the municipal advisor loophole.

Create a Municipal Financial Protection Bureau
Like the Consumer Financial Protection Bureau, the agency’s primary function would be to protect the interests of municipal borrowers.

Congress should create a federal agency similar to the CFPB whose primary function is to protect the interests of municipal borrowers. Researchers have explored how decentralized local policymakers lack the resources and expertise to exercise autonomy or protect public interests over wealthy and organized interests. Like the CFPB, a dedicated federal agency to oversee and advocate for state and municipal borrowers would help counter this problem. The CFPB has been extremely effective as an advocate for consumers and regulator of consumer financial products such as home mortgages, auto loans, credit card products, and student loans. As Senator Elizabeth Warren stated, “the consumer bureau’s statutory obligations are grounded in the goal of making markets for consumer financial products and services work in a fair, transparent, and competitive manner.” A municipal finance agency would be grounded in the same principles.

This agency should be responsible for determining which products are suitable for banks to sell to municipal borrowers and which are inappropriate. It should be charged with curbing the use of abusive practices such as accelerated payment clauses, which can force borrowers to pay back the entire outstanding principal on a 30-year bond right away; prepayment penalties that can cause interest costs to grow exponentially; discriminatory credit ratings that penalize municipal borrowers with lower ratings than corporations with similar credit profiles; unnecessary refinancing, which can cause the overall cost of debt to balloon; and clauses that obstruct full public disclosure of financial fees. It should also cap interest rates, regulate fees, and establish rules of conduct for all financial service providers. Finally, it should be an advocate for cities and states as they try to get the best deals possible from the financial industry.

Detractors may argue that the SEC and the Municipal Securities Rulemaking Board are already charged with protecting municipal borrowers, and that a new agency would be unnecessary, redundant, or overly bureaucratic. However, the SEC and MSRB have been ineffective at safeguarding taxpayer interests. The MSRB is hamstrung by its lack of authority to enforce its own rules, which means it can make rules against bank misconduct but cannot take corrective action when banks break them. Furthermore, the MSRB is run by officials from the municipal finance industry and skirts Dodd-Frank’s requirement that a majority of board members be independent from the industry by defining independence to include anyone who has not worked in the industry for at least two years. That means someone who worked for 30 years as a municipal advisor but retired two years ago can qualify as independent. Moreover, both the MSRB and the SEC are typically more concerned with protecting bondholders and investors than they are with municipal borrowers. Even though the SEC has enforcement authority over the MSRB’s rules, it rarely uses that authority against banks that defraud taxpayers. Neither agency makes it a priority to protect taxpayer interests.

Reforming the MSRB would require a total overhaul; Congress should instead abolish it and create a new agency modeled on the CFPB whose only purpose is to protect the interests of municipal borrowers. Congress should also take steps to safeguard against regulatory capture so that the new agency does not suffer the same fate as the MSRB. Care should be taken to replicate the CFPB’s prohibitions on “preemption” of state laws so that this overhauled iteration of the MSRB cannot be used to weaken or overrule tougher state standards. The creation of a new agency is a logical solution since
the current regulatory institutions that govern the municipal finance market are deeply ineffective and incapable of acting as a check on predatory municipal finance practices.

The creation of a new regulatory agency is a proposal that may seem out of reach given the current congressional environment. Until such an agency is established, the CFPB should interpret its mandate broadly and act to protect municipal borrowers as consumers of financial products. The CFPB’s track record suggests that it is likely to be more effective at protecting municipal borrowers than the MSRB or SEC.

Explore Federal Reserve Lending to Municipal Borrowers

To remove the incentive to gouge taxpayers through public finance, the Federal Reserve should explore a mechanism to lend directly to municipalities at discounted interest rates.

The Federal Reserve could play a critical role in the municipal finance market and should explore making low-interest, long-term loans directly to cities, states, school districts, and other public agencies to allow them to avoid predatory Wall Street fees. Currently, banks borrow money at near-zero interest rates from the Fed while public entities pay billions in fees and interest each year. Even as the Fed increases rates, banks will continue to enjoy far lower interest rates than municipal borrowers. The Fed should consider giving cities and states access to the same low interest rates it offers banks. Fiscal crises are typically caused by revenue shortfalls. Distressed cities often find themselves unable to access the credit markets without paying a steep premium, which further exacerbates their long-term fiscal health. A loan from the Federal Reserve can allow municipal borrowers to address their budget crises.

Detractors will argue that it would be imprudent to use federal taxpayer dollars to make loans to distressed cities and states that might be unable to pay them back. However, the reality is that municipal borrowers in the United States have extremely low rates of default because their debt is ultimately backed by tax revenues. According to Moody’s, one of the three major credit rating agencies in the country, the default rate for municipal issuers that it rates was 0.012 percent between 1970 and 2012. Even though there has been a slight uptick following the financial crisis, the likelihood of municipal default is still virtually nonexistent.

If a municipality defaults on a loan, it is because elected officials made a political decision to default rather than raise taxes. In the case of Detroit, state elected officials in Michigan made that decision by cutting revenue-sharing with the city and prohibiting it from raising additional taxes. The Fed could take proactive steps to address this political problem. For example, it could attach a provision requiring elected officials to raise taxes on large corporations and high-income earners to avoid defaulting on loans from the Fed. There are provisions in power and water utility bonds that require utilities to raise rates as necessary to ensure they will be repaid. A provision to raise taxes is conceptually the same. The Fed could also dictate that the borrower raise taxes to avoid default. The borrower might need to get the legislature or voter approval before issuing such a bond, but it could be done and is worth further exploration as a solution.

The Fed already has the power to purchase municipal bonds that mature within six months. This means the Fed can effectively lend directly to cities and states for up to six months by buying their bonds or notes. Theoretically, the Fed could agree to roll over these bonds automatically every six months to turn them into longer-term debt; however, without a systematic approach, having to rely on the Fed’s word that it would continue to extend the debt would create uncertainty for the borrowers. If Congress were to pass a law allowing the Fed to make long-term loans directly to cities and states, we could unlock the full potential of our central bank to support the long-term financial and economic health of our cities and states. This would allow us to cut Wall Street out of the middle and ensure that our taxpayer dollars are going toward improving our communities instead of padding bankers’ bonuses.

Require Pension Funds to Disclose Fees and Gross Returns

Pensions should disclose the financial performance of their fund managers and the fees paid to these managers in order to ensure excessive costs don’t strain city resources.

The Government Accounting Standards Board (GASB) should require all pension funds to fully and publicly disclose all fees they pay to investment managers—including hedge funds and private equity firms—and the gross returns that each investment manager produces. This will help improve pension fund performance and reduce pension shortfalls that can strain city and state budgets.
Pension funds are among the largest pools of capital in the United States and, as they provide retirement security to workers, their assets must be rigorously protected. However, because fee structures for alternative investments like hedge fund and private equity firm investments are opaque, it can be impossible to determine whether pension funds are getting a good deal. In many cases, even pension fund trustees do not have access to gross investment returns before fees are taken off the top. As a result, many trustees do not know how much they are paying in fees.

A November 2015 study by researchers at the Roosevelt Institute, ReFund America Project, and the American Federation of Teachers that looked at 11 public pension funds from around the country found that hedge funds charge significantly higher fees than most other asset classes and produce significantly lower returns. The report estimated that the pension funds had lost $15 billion through their hedge fund investments; it also found that the pension funds paid an average of 57 cents in management fees for every dollar of net returns from hedge fund investments, compared with 5 cents in management fees per dollar of net returns for the pension funds as a whole.

End Guilt-Free and Tax-Free Fines and Settlements

Ensure lenders convicted for misconduct against municipal borrowers pay real, non-deductible fees.

When federal regulators or DOJ officials reach settlements with financial institutions for misconduct against municipal borrowers, they should require the banks to admit guilt and should explicitly stipulate that any fines or settlements that the banks have to pay are not tax-deductible.

Regulatory agencies like the SEC often prefer to settle because this allows them to avoid costly trials against big banks with deep pockets and deeper political connections, which could exhaust the agency’s own financial resources and political capital. However, by letting banks settle for paltry fines and not requiring them to admit guilt, these regulators effectively incentivize illegal behavior. Banks are able to avoid the bad press and embarrassing discovery process that a trial would entail, dodge the business consequences of a criminal conviction, and often keep most of the money they made illegally. This turns these fines and settlements into just another cost of doing business.

Furthermore, the SEC has a history of granting banks waivers to exempt them from laws designed to punish fraud. The New York Times reported in 2012:

By granting exemptions to laws and regulations that act as a deterrent to securities fraud, the S.E.C. has let financial giants like JPMorganChase [sic], Goldman Sachs and Bank of America continue to have advantages reserved for the most dependable companies, making it easier for them to raise money from investors, for example, and to avoid liability from lawsuits if their financial forecasts turn out to be wrong.

An analysis by The New York Times of S.E.C. investigations over the last decade found nearly 350 instances where the agency has given big Wall Street institutions and other financial companies a pass on those or other sanctions... JPMorganChase [sic], for example, has settled six fraud cases in the last 13 years, including one with a $228 million settlement last summer, but it has obtained at least 22 waivers, in part by arguing that it has “a strong record of compliance with securities laws.” Bank of America and Merrill Lynch, which merged in 2009, have settled 15 fraud cases and received at least 39 waivers.

Republican Senator Charles Grassley decried this
practice, saying, “It makes weak punishment even weaker by waiving the regulations that impose significant consequences on the companies that settle fraud charges. No wonder recidivism is such a problem.”

Furthermore allowing financial institutions to claim tax deductions on the fines they have to pay effectively forces taxpayers to foot part of the bill for bank misconduct. This is always egregious, but it is particularly perverse when the initial fraud was against taxpayers in the first place.

In one example, Bank of America paid a then-record $16.65 billion fine to settle allegations that it knowingly participated in financial fraud in the financial crisis of 2008. However, $11.63 billion of that fine was tax-deductible, which means that taxpayers had to pay about $4.07 billion of that $16.65 billion settlement. According to a 2005 Government Accountability Office study of 34 companies’ settlements worth more than $1 billion, 20 companies deducted some or all of their payments. Given the tax deductibility of these fines, there is a strong argument to be made that fines should be larger. Fines are supposed to punish and deter illegal and predatory financial activities; furthermore, fines are a mechanism to recuperate losses to the victims. Paltry fines are not an effective deterrent, and undermine justice for the economic losses absorbed by the public.

Regulators like the SEC should follow the example of the Environmental Protection Agency, which explicitly defines the tax consequences of the fines it levies to ensure that they are not tax-deductible. To help cut down on this practice, Congress should pass The Truth in Settlements Act. This bill, introduced by Senator Elizabeth Warren in 2015, would require agencies to report the expected after-tax value of settlements and whether they are tax-deductible. This would increase transparency and make it hard for regulators to use tax deductions to make fines appear higher than they are.

However, by letting banks settle for paltry fines and not requiring them to admit guilt, these regulators effectively incentivize illegal behavior.

Close the Municipal Advisor Loophole
Ensure all financial advisors to municipalities assume fiduciary duty, which means they must put the financial interests of the municipality first.

The Dodd-Frank Act required financial firms that provide advice to municipal borrowers to assume a fiduciary duty to put the interests of their municipal clients ahead of their own interests. The MSRB created a significant loophole in the rulemaking process by waiving the fiduciary requirement if the advice is “incidental to or ancillary to a broker-dealer’s execution of securities transactions.”

This is problematic because most of the advice that public officials receive is actually from representatives of financial institutions whose primary job is to sell them products, not to give them advice. In other words, most advice that municipal borrowers receive from bankers is incidental to some other transaction.

This may seem counterintuitive, but an example will illustrate the point. When most people go to an auto mechanic, they are aware that part of the mechanic’s job is to sell them on additional repairs, but because they are not experts on their cars, they rely on the mechanic’s advice anyway and hope for the best. Dodd-Frank instituted this requirement so that municipal borrowers would not have to hope for the best, but could rest assured that they were getting good advice that would protect taxpayer dollars. Toward that end, in the absence of a newly created Municipal Financial Protection Bureau, the MSRB, in its current form, should close the municipal advisor loophole.

CONCLUSION

Instead of paying their fair share in taxes, bankers and billionaires now lend cities and states that money and force them to pay it back with interest. As the United States economy has become increasingly financialized, state and local governments have fallen prey to Wall Street’s predatory lending practices. This drains money out of public budgets that are already broke and forces public officials to slash public services. This, in turn, has a disproportionate impact on working-class communities of color, who have also been targeted by predatory lenders for subprime mortgages and payday loans. None of this is a coincidence. Federal policymakers can take several steps to protect taxpayer interests and ensure that taxpayer dollars are used to fund public need, not complex and costly financial products that enrich Wall Street and the 1 percent.
III. Fixing the Regulatory State

Despite continued legislative gridlock, the next administration must take steps to rewrite key economic rules and further aspects of the inclusive agenda outlined in the previous pages. The economic rules are determined by individuals in the position to write them. We believe who writes the rules, and the system by which the rules are written, is a critical component to our economic agenda. The next president will set the policy goals and regulatory parameters for a range of policymaking institutions, from the SEC to the FTC to the Environmental Protection Agency (EPA). These agencies are critical to turning policy into reality because they are responsible for drafting and implementing rules to ensure markets function and enforcing these rules on everything from financial regulation to labor and environmental standards.¹

Like Congress, regulators can make decisions that curb corporate power, promote growth, and level the playing field. In recent years, regulatory agencies have been the drivers behind several major initiatives to combat inequality and promote the public good, from the Department of Labor’s new rule expanding overtime pay to millions more workers, to the EPA’s push on regulating greenhouse gas emissions and power plants. But agencies can also at times be “captured” by industry lobbyists, which can lead to rules that favor the powerful and the privileged.² Lobbying groups can influence the writing and enforcement of regulatory statutes through direct political pressure, but also through subtler methods. For example, regulators and lobbyists often share similar socioeconomic backgrounds, experiences, and even similar resumes. Too often agency appointees have worked in the industries they are tasked with regulating, and in many cases their former private sector employers offer them bonuses for accepting regulatory positions.³ On the other hand, regulators often leave government for more lucrative industry jobs—a trend referred to as the revolving door. Furthermore, policymakers and regulators often rely on expertise or data from the resource-rich firms and industries they are meant to be regulating, which only heightens their dependence on and receptiveness to a concentrated subset of stakeholders.⁴

These subtle methods of industry “capture” help to ensure that the rules of our economy fit the worldview of those with resources and power and structure markets in ways that preserve entrenched business interests and exacerbate economic imbalances. This ultimately marginalizes the voices of underserved and underrepresented communities. As frequently reported, the financial industry has been extremely successful in using the regulatory process and the court system to slow and water down the implementation of Dodd-Frank financial reform.⁵ The same is true of labor regulation, environmental regulation, and other areas of rulemaking.

The next administration will have an opportunity to ensure the rules of the game work for average Americans. A critical first step will be appointing agency leaders with the independence to effectively regulate industries. It is the responsibility of regulators to appropriately balance competing interest groups, including the industries they regulate; however, a successful regulator who avoids capture will not give undue weight to the perspectives of industry relative to the public interest. A second step toward leveling the playing field is instituting a more inclusive regulatory process within agencies. In this section we consider the importance of political appointments and outline the critical role played by personnel. We then identify key steps agencies can take to ensure all stakeholders are represented and empowered in the policymaking process and outlines specific action to:

» Institutionalize stakeholder representation.
» Strengthen enforcement mechanisms.
» Reform the use of cost–benefit analysis (CBA).
» Fund regulators appropriately.

[REGULATORY CAPTURE refers to situations in which regulatory agencies tasked with protecting the public interest instead act in ways that serve the political or financial interests of the industries they regulate. Nobel-winning economist George Stigler introduced the concept of capture in his 1971 article “The Theory of Economic Regulation,” in which he argued that regulation was often sought or influenced by industry interests seeking policies that would prevent new market competitors.¹ Stigler’s argument inspired decades of conservative attacks on economic regulation as inherently prone to capture. Recent studies of capture suggest a more complex picture: regulatory agencies are necessary to make effective public policy, but they remain potentially vulnerable to more subtle kinds of special interest influence. These other forms of capture might manifest in the lack of prosecution or enforcement actions, or in the drafting of regulations that favor more established business interests.]
PERSONNEL IS POLICY

Presidential elections are about far more than putting one individual in the White House. The next administration will appoint the top staff in federal agencies—the hundreds of handpicked regulators, economists, and cabinet members who control the topline priorities and agendas of their agencies and direct tens of thousands of career government service workers. Personnel appointments are among the most effective methods of influencing the creation and implementation of policy.

Nominations for the Treasury Department, EPA, the Office of Management and Budget (OMB), and many other executive and judicial bodies flow through the White House. Between 1,200 and 1,400 presidentially appointed positions in the executive branch require Senate approval, and there are additional appointments that the president can make without the confirmation of the Senate. These appointees will shape the personnel makeup of their departments by hiring thousands of staffers to execute their agencies’ mandates.

Broadly, regulatory personnel have three categories of responsibility: to interpret and execute passed legislation, to enforce rules against wrongdoers, and to act as the public faces of their agencies.

Interpreting and Implementing Legislation

While Congress writes the laws, the interpretation and implementation of any law ultimately depends on federal agencies. As a result, federal agencies have the power to shape the rules of the market. The degree to which market structures favor private power or public welfare is often the result of regulatory interpretation. Telecommunications policy, financial policy, environmental policy, and many other parts of the law are molded by regulatory personnel carrying out congressional orders, often in coordination with key White House staff. Furthermore, statutory authorizations, once granted, tend to remain a reservoir of regulatory authority that does not require congressional reauthorization. Once an agency is delegated the authority to make regulations on a particular issue—such as defining workplace safety standards or financial disclosure standards—the agency can update, revise, and create new policies under that authority. Many of the Obama administration’s most prominent and important policies to combat inequality have originated in and been executed by regulatory agencies acting under preexisting statutory authorizations, including the fiduciary rule, the myRA pension plan, the overtime pay rule, and the gainful employment rule.

Consider, for example, the ongoing policy debate over financial regulation. In the wake of the financial crisis, Congress passed the Dodd-Frank Act in an attempt to make financial markets safer and more stable. The technical execution and rulemaking in Dodd-Frank...
The SEC's proposed rule on corporate political spending disclosures is one example that arose in response to a widespread grassroots movement. After the Supreme Court's Citizens United ruling, which lifted the constraints on political spending from corporations, the Corporate Reform Coalition organized a "record breaking" effort to send more than a million letters to the SEC in support of a rule that would require public companies to disclose their political donations. The SEC formally put the rule on its regulatory agenda in response to this broad activist movement; however, the pace of the rulemaking slowed to a crawl. Ultimately, the agency’s leadership will determine what kind of rule is drafted, how long it takes to be made available for public comment, how it will be influenced and changed after the comment period, and (if eventually approved) how it will be implemented and enforced.

Finally, regulators can apply existing rules and statutes in new ways. In February 2015, the FCC came down in favor of net neutrality—the principle that all data on the internet should be treated the same and not priced differently based on factors like location, platform, or user. The ruling was a blow to ISPs that wanted the ability to charge consumers more for faster internet service. The FCC made the ruling on the grounds that broadband access should be classified as a telecommunications service and not a private good, and should therefore be regulated as telephone providers are under Title II of the Communications Act of 1934. As a result of the FCC’s decision, consumers cannot be charged extra for a faster or more reliable connection, just as they cannot be charged more for a better telephone line. This favorable policy outcome for consumers is largely a result of the strong coalition that put pressure on the FCC, and is a testament to the FCC’s ability to take into account and balance the interests of diverse stakeholders.

Enforcing Rules Against Wrongdoers
Agency personnel can influence the degree to which stakeholders actually play by official rules through enforcement actions. It is often regulators who decide when to investigate potential rule violations, prosecute criminal behavior, or impose fines or other administrative sanctions on wrongdoers. Another enforcement mechanism is the need for regulatory approval; e.g., the FTC can decline to approve a corporate merger. It is the regulatory personnel who decide whether to take companies to trial or reach...
Some agencies have a reputation for being lax, slow, or relatively backwards, while others can at times be seen as more energetic, creative, and innovative.

a settlement, whether to go after individuals for wrongdoing or just their employers, and how to gather their evidence and frame their cases.

One example of personnel discretion is in the prosecution and punishment of General Motors (GM), which covered up an ignition switch failure that caused the deaths of 124 people and was known to be a problem by GM executives for over a decade. The final DOJ settlement was $900 million, which comes out to less than 1 percent of GM’s annual revenue, and the dismissal of criminal charges against the executives who had knowledge of the defect. One of the reasons for such a weak settlement was that the DOJ focused its prosecution effort not on the deaths or the profits GM enjoyed from the cover-up, but instead on GM’s false claims of safety and misleading buyers.

Another recent example in which private power seems to have triumphed over public welfare is the DOJ’s investigation of Education Management Corporation (EDMC), a for-profit college corporation that made false claims to its students about its legitimacy as a university and its compliance with the Higher Education Act and used illegal high-pressure recruitment tactics to draw in potential students. The DOJ settled with EDMC in 2015 for $95 million despite the fact that EDMC had collected more than $11 billion from 2003 to 2011, with a significant amount coming from federal loans and grants. The settlement lacked any enforcement action for individual executives, debt forgiveness for students who were misled and saddled with debt, or clauses to prevent EDMC from collecting federal money again.

There are many similar cases of regulators pursuing weak settlements with large corporations, such as car manufacturers, financial institutions, energy providers, and pharmaceutical companies. Regulatory enforcement is not universally ineffectual, however: There have also been agencies and examples of individual cases that serve as a model for what enforcement could look like. When the Consumer Financial Protection Bureau partnered with the DOJ to investigate Hudson City Savings Bank, they found evidence of discriminatory redlining lending practices to majority Hispanic and black neighborhoods. In 2015, the CFPB and DOJ reached a settlement of $33 million with Hudson—the largest redlining settlement in history. In addition to the substantial profit loss for the bank from the fines, the settlement included provisions specifically designed to end and prevent illegal redlining. It mandated that $25 million was to be invested in a loan subsidiary program to provide more affordable mortgage loans to communities of color, with additional funds set aside for consumer education and outreach. Hudson also agreed to open new branches in previously redlined neighborhoods.

Acting as the Public Face of the Agency

Regulatory agencies have the power to make new policies or to enforce existing ones, but the ways in which employ those powers can vary tremendously. Some agencies have a reputation for being lax, slow, or relatively backwards, while others can at times be seen as more energetic, creative, and innovative. The next presidential administration has the opportunity to appoint personnel who are willing to take steps to limit the abundance of corporate power in America. Presidentially appointed personnel, particularly the chairs, commissioners, and heads of agencies, serve as the public faces of those agencies and have the power to challenge or redefine how the media and public views an agency’s authority. The heads of regulatory agencies can even change the way other regulators perceive their own agencies, bringing about cultural and attitudinal shifts within the organization. By changing the external reputation and internal culture of agencies, these regulatory leaders can dramatically expand the reach and impact of the rules, policies, or enforcement agendas their agencies might develop.

In 2014, for example, the Department of Energy finalized twice as many rules as it did during the entirety of the Bush administration, even though the legal mandate of the Department had not significantly changed. The right leader can transform the role of an entire agency. Former Commodity Futures Trading Commission (CFTC) head Gary Gensler’s “aggressive streak” in regulating derivatives “thrust the once-backwater agency into the front lines of reform,” in the words of The New York Times. Under Gensler’s leadership, the CFTC effectively executed Dodd-Frank rulemaking, which led to the regulation of
The next presidential administration has the opportunity to appoint personnel who are willing to take steps to limit the abundance of corporate power in America.

previously unregulated shadow banking activities such as the swaps marketplace. Ultimately, the legacy of a presidential administration is tied to the legacy of its agency leaders.

The inverse of robust agency leadership is not merely agencies that are slow or neutral: The absence of robust leadership makes it more likely that agencies will fail to resist the influence of established industry players. Consider the case of financial regulation. One of the chief criticisms of regulatory agencies after the financial crisis was that they failed to prevent the fraud, abuse, and mismanagement in various sectors of the financial industry in years leading up to the crisis.\(^22\) Many of the head regulators appointed by the White House to supervise and police Wall Street came from Wall Street, and many returned to Wall Street after leaving their agencies.\(^23\) Given these deep ties between industry and government, regulators at times faced conflicts of interest when considering rules to limit short-term profit, enforcement actions to punish lawbreakers with fines and jail time, and other behaviors that would anger those from their industry.

The revolving door between industry and government is most pronounced in the financial sector but exists in nearly all regulated industries. In an effort to address this pervasive issue, Senator Tammy Baldwin and Representative Elijah Cummings introduced the Financial Services Conflict of Interest Act.\(^24\) This bill would make it illegal under federal bribery statutes for financial market regulators to accept bonuses or compensation of any kind that is contingent on accepting federal government positions. The bill also addresses conflicts of interests by making it illegal for financial regulators to use their official positions to influence particular matters that would financially benefit their former employers. In such cases, regulators would be legally obligated to recuse themselves from any official action. This legislation, if passed, would be an important first step to address conflicts of interest and the revolving door.

The next president will also have the opportunity through the appointments process to nominate personnel that can reverse these trends. Ideally, the next group of appointments will be active, bold regulators—those who have a proven record of tough and fair governance, and who do not predominately come from the industry they oversee. They will come from a diverse set of backgrounds and represent a diverse set of voices and perspectives. Most importantly, the next president has the opportunity to appoint personnel who are willing to take steps to limit the abundance of corporate power in America.

POLICIES TO IMPROVE THE REGULATORY PROCESS

As described above, regulation can be influenced by structural disparities in political power and by the people engaged in the day-to-day functioning of the modern regulatory state. As a result, regulators and the technical rulemaking process are vulnerable to business and elite capture. There are significant steps regulatory agencies can take in the absence of congressional or executive action. Agencies already have significant discretion to convene stakeholders and engage participants in their rulemaking or enforcement activities. Pioneering agency heads can leverage existing authorities to actively engage a diverse set of stakeholders and ensure diverse voices are heard during the rulemaking process.

Through the following actions, we can institutionalize more democratic rulemaking and ensure the rules are structured and enforced to protect the general public.

Institutionalize Stakeholder Representation and Empower the Grassroots in the Rulemaking Process

Issue an executive order requiring agencies meet a robust and meaningful participatory engagement requirement.

The inaccessibility of the rulemaking process inevitability skews public policy in ways that further marginalize people of color, women, and lower-income communities. The problem of capture has been a long-running concern for critics of the modern regulatory state.

Regulatory capture and elite influence can be effectively “counteracted by reforms that expand
the countervailing power of communities to advocate for their views, bringing it to a level closer to that of more established and sophisticated interest groups.”

Regulation has been typically viewed as a top-down, expert-driven policymaking process; however, rulemaking can be transformed into a dynamic, constructive arena that expands democratic participation and inclusion and thus produces policy that best serves the overall well-being and growth of the economy.

The 1946 Administrative Procedure Act (APA) was created to establish universal procedures by which all regulatory agencies execute rulemaking and adjudication actions. The APA continues to be the guiding framework for this critical policymaking function. This process should be modernized to include explicit mechanisms to broadly engage diverse stakeholders. Each presidential administration has issued a regulatory process executive order that usually reaffirms prior orders requiring agencies to pursue cost–benefit analysis. As a result, there already exists a legal and institutional infrastructure through which the executive branch incentivizes expertise and monitors regulation. This includes:

» The Office of Information and Regulatory Affairs (OIRA) – as part of the Office of Management and Budget (OMB), OIRA is the central authority for the administration to review executive regulations and coordinate policy across the government.

» Executive Order 12866, Regulatory Planning and Review – this executive order issued in 1993 by President Clinton provides that significant regulatory actions by the independent agencies must be submitted for review to OIRA. The order identifies what would qualify under “significant regulatory action,” such as an action that has a projected effect of $100 million on the economy or would result in any adverse effect.

» Executive Order 13563, Improving Regulatory Review – this executive order issued by President Obama in 2011 reaffirms and amplifies the order above by “encouraging agencies to coordinate their regulatory activities, and to consider regulatory approaches that reduce the burden of regulation while maintaining flexibility and freedom of choice for the public.”

Agencies can be reformed to include more direct forms of stakeholder representation. For instance, some scholars have advocated for the creation of a dedicated public interest council in financial regulation, which would be an independent government entity composed of experts and public advocates charged with conducting investigations, proposing policies, and auditing the regulations proposed and implemented by other financial regulatory bodies, all in an effort to magnify and channel the countervailing interests of citizens and prevent the capture of financial regulatory bodies by sophisticated industry players.

Citizen interests could also be effectively represented through “proxy advocacy,” i.e., the creation of a regulatory office with an explicit mission to represent the needs of a particular demographic—such as consumers, veterans, or farmers—through advocacy, providing information to other regulators, and protecting their interests in the rulemaking process. By creating advocacy offices or other forms of representation, laws can specify which constituencies should be represented and what qualifies an individual or group to represent that constituency. As argued in the Roosevelt Institute’s *Rethinking Regulation* report, “[t]hese mechanisms are not immune to the risk of capture or cooption—but, as suggested above, the creation of an institutionalized office voicing a particular constituency’s needs, combined with a mobilized and engaged civil society organization working with that constituency to engage with policymakers, can provide some protection against the risk of capture.”

It is essential to the enforcement of the economic rules that there be serious and strict penalties for illegal and criminal activities.

**Strengthen Enforcement Mechanisms**

Charge individuals and corporations and accelerate penalties for recidivist firms.
The failure to prosecute major corporate crimes has been notable in the financial sector, but it is a widespread practice across regulated sectors. It is essential to the enforcement of the economic rules that there be serious and strict penalties for illegal and criminal activities. Senator Elizabeth Warren’s office released a report in 2016 that concluded, “corporate criminals routinely escape meaningful prosecution for their misconduct.” The lack of enforcement, the report argued, was not due to a lack of regulatory authority, but because the personnel at the regulatory agencies simply chose (for one reason or another) not to use the full extent of their authority established by Congress to prosecute wrongdoing.

Currently regulators overuse “deferred prosecution agreements” (DPAs) and “non-prosecution agreements” (NPAs). One recent study found that “only 34 percent of federal corporate deferred and non-prosecution agreements from 2001-2014 were accompanied by charges against individuals.” These agreements allow companies to avoid prosecution and accountability; originally designed for small charges, they have become the government’s core tool to enforce corporate regulations and prosecute corporate wrongdoing. There should be specific rules against the overuse of these tools. DPAs can require specific organizational changes at firms that accept the terms of the agreement. However, the DOJ should be required to disclose specific guidelines for the use of these agreements and to provide specific public explanations of why DPAs are used in particular cases. Those guidelines should also include certain prerequisites, including significant fines.

Many firms, particularly banks, have been repeat offenders because they are able to pay whatever fines and other minor, non-binding penalties are imposed on them. Regulators should be required to establish a public recidivism scale that assigns points based on instances of wrongdoing and should revoke a firm’s right to operate after repeat offenses.

**Reform the Use of Cost–Benefit Analysis (CBA)**

Cost-benefit analysis can be useful, but to mandate their use for financial regulations will lead to more uncertainty and worse rule-making.

Modern regulatory reformers have turned to new developments in social science, economics, and CBA in an attempt to provide a more objective justification for regulation. There is robust debate on the merits of CBA when it comes to accurately predicting and assessing the quantitative costs and benefits of regulatory actions. Leading scholars, such as Cass Sunstein, who later became the chief “regulatory czar” as the head of OIRA under President Obama, have argued that CBA could do more than simply count economic impacts. Instead, analyses should incorporate assessments of equity, environmental impacts, and other qualitative outcomes to provide a fuller, more objective picture of which regulations are truly socially beneficial.

CBAs that take into consideration the comprehensive impact of a rule can provide legitimacy and ensure that regulatory agencies do, in fact, serve the public good. However, in many instances, there are inherent challenges to conducting these assessments accurately. Financial regulation is a prominent example of an important regulatory arena in which CBA may be inherently problematic.

There have been several discussions about mandating CBA for independent financial regulators such as the CFPB and the CFTC. This should be avoided. For one, financial systems are complex.

The benefits, and many times the costs, of a financial regulation depend significantly on a chain of trade offs and cascading effects that even economic theory and algorithms struggle to accurately predict. For example, there are major disagreements on the costs of the financial crisis. Low estimates of the crisis calculate trillions of American dollars lost. The wide range of estimates among economic scholars and analysts does not ensure quality or accuracy, but instead invites courts and others to pick and choose estimates based on self-interest and ideological priorities.

CBAs should incorporate assessments of equity, environmental impacts, and other qualitative outcomes to provide a fuller, more objective picture of which regulations are truly socially beneficial.
Secondly, CBAs of financial regulations need to take into account the existing rules of the financial market and predict how the market will evolve and innovate in an effort to evade the new regulations. Market innovation and arbitrage are prevalent characteristics of financial market regulation, and accurately predicting how the market will adapt to a new rule is an impractical if not impossible exercise for regulators. Financial markets are continuously innovating, and because of this, cost benefit analysis is not an effective tool or exercise for regulators to predict the impact of the new rules.\footnote{Mandating CBA will cause many of these analyses to be exaggerated based on economic science that cannot accurately forecast the cascading impact one rule may have on complex financial markets.}

Currently, there are proposals from the White House to double the funding of the SEC and CFTC.\footnote{Both agencies have been underfunded, especially since the passage of Dodd-Frank in 2010, which legally expanded both agencies’ mission and scope of regulatory actions. This is an important immediate action that requires congressional action through the appropriations process.} Congress should go further and give the CFTC and SEC their own source of funding outside of the appropriations process, such as charging service fees to regulated industries. This would match the funding stream of other financial regulators like the Federal Reserve, FDIC, Office of the Comptroller of the Currency (OCC), and CFPB.

The Internal Revenue Service should also have its funding restored to levels from before the Great Recession. According to estimates from the Center on Budget and Policy Priorities, the IRS has lost 17 percent of its funding since 2010 and experienced a reduction in staff of about 13,000, or 14 percent of its workforce.\footnote{For every dollar spent on the IRS, general estimates have a return of $4 from enforcement, and specific actions have even higher returns.} Congress should go further and give the CFTC and SEC their own source of funding outside of the appropriations process, such as charging service fees to regulated industries. This would match the funding stream of other financial regulators like the Federal Reserve, FDIC, Office of the Comptroller of the Currency (OCC), and CFPB.

Currently, the limited resources of regulators are outmatched by the massive budgets of the corporate stakeholders they are tasked with regulating. Slow reductions in funding have reduced regulatory agencies’ ability to do their jobs. Reduced funding means fewer personnel for rule-writing and enforcement. It also means less consistent actions, creating uncertainty and confusion and incentivizing rule-breaking and bad conduct. It also distorts enforcement. With additional funding, agencies should invest greater staff resources in facilitating and fostering participation from diverse stakeholders. To make participation effective and integrated with conventional forms of expertise, “three critical tasks will require intensive work: curating participatory and deliberative meetings, providing briefings for the participants on the relevant data and issues, and facilitating discussion to lead to concrete, usable recommendations.”\footnote{To achieve this, Congress should immediately take action to boost the funding of financial regulators.}

**CONCLUSION**

Ensuring an inclusive and responsive regulatory apparatus is exceptionally important given Congress’s growing tendency to produce broadly framed statutes, leaving regulators to fill in many of the details of actual policy. The next administration has an opportunity to influence and enact a range of policy solutions across various sectors, from environmental productions to trust-busting policies, through the administrative rulemaking process. We have identified key solutions to ensure the regulatory institutions are functioning effectively, which means both writing the rules in the best interests of the public and monitoring and enforcing new and existing rules that shape our economy. Rules will not matter if they cannot be effectively implemented and enforced. The next president must take these matters seriously and appoint a team committed to making the critical changes that will ensure equitable and sustainable economic growth.
Conclusion

The last four decades of economic policymaking have failed average Americans. Trickle-down economics has channeled wealth to the top without spurring the productive investment, robust growth, or rising wages that its advocates promised. Now we are at a critical political moment as American workers increasingly perceive that the rules of the economy do not work for them. Their justified anger could be harnessed for good or ill by the next administration. We view the policies in this report as the foundations of a stronger, more equitable economic future.

We believe that implementing the kind of comprehensive agenda needed to level the playing field will remain an uphill political battle unless we start by checking the power of the untamed corporate and financial sectors, which have skewed the economic system for their own benefit. Moreover, we believe any agenda to truly combat stagnating growth and rising inequality must include some mix of the policies proposed in this report.

However, we also know that the proposals contained in Untamed are not sufficient to solve the problem of inequality in the U.S. This agenda to tame the top is structured to work in lockstep with efforts to promote racial and gender equality, strengthen workers’ rights, expand social insurance, and protect the environment. We believe it is essential to combine our proposed economic agenda with the broader progressive social agenda.

Inequality is not inevitable. It is a conscious choice made by policymakers over the past 40 years. The proposals we have outlined hold the promise of a new era in which private and public investment work together to channel wealth into opportunity, innovation, and growth.
INTRODUCTION


ON THE RACIAL IMPACT OF THIS ECONOMIC AGENDA


10 Op Cit. Flynn et. al.


15 Author’s calculations from Bureau of Labor Statistics.
RESTORING COMPETITION IN THE U.S. ECONOMY


2 Ibid.

3 Ibid.


17 Op Cit. Furman and Orzag.

18 Wright, Joshua D. 2013. “Section 5 Recap: Defining the Federal Trade Commission’s Unfair Methods of Competiton Authority” Commissioner, Federal Trade Commission. Remarks at the Executive Committee Meeting of the New York State Bar Association’s Antitrust Section, June 19, New York, NY.


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11 H.R. Rep. No. 67-350, at 10-11 (1921). The tax rate also was much higher then, 58 percent.


The corporate rate figure includes taxes paid on dividends and other corporate payouts Sullivan, Martin A. 2011. “Passthroughs Shrink the Corporate Tax by $140 Billion.” 130 TaxNotes 987.

17 Ibid.


20 Ibid.


Footnote References


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**TACKLING TOO BIG TOO FAIL**


12 For a broader look at financial reform, see: Konczal, Mike and Marcus Stanley. 2013. *Choosing the Road to Prosperity: Why We Must End Too Big To Fail.* Washington, DC: Americans for Financial Reform.


**SHADOW BANKING**


2 Ibid.


4 Ibid.


6 Ibid.
SAFEGUARDING FAIRNESS IN PUBLIC FINANCE


4 Ibid.


8 Ibid. (Author’s calculation).


25 Ibid.


28 Ibid.


30 Ibid.


37 Ibid.

38 Ibid.


42 Ibid.


Until economic and social rules work for all, they’re not working.

Inspired by the legacy of Franklin and Eleanor, the Roosevelt Institute reimagines America as it should be: a place where hard work is rewarded, everyone participates, and everyone enjoys a fair share of our collective prosperity. We believe that when the rules work against this vision, it’s our responsibility to recreate them.

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