

The Financial Idea Trap: Bad Ideas, Bad Learning, and Bad Policies after the Great Financial Crisis

ALEXANDRA L. MUSSLER
AND NIKOLAI G. WENZEL

Washington College of Law
American University
Email: alexlmussler@gmail.com

Broadwell College of Business and Economics
Fayetteville State University
Email: nikolaiwenzel@gmail.com
Web: www.nikolaiwenzel.net

Abstract: The real estate boom and bust of the early 2000s presents an interesting case study on the politicization of science (and thus the regulatory process). Indeed, popular opinion—fed by a partisan congressional commission—believes the crisis was caused by greed and deregulation. However, basic history show us that the 2000s were anything but a period of financial deregulation; instead, we see a story of heavy government involvement (including artificially low interest rates, subsidies to risk-taking by banks and borrowers, and selective enforcement of regulations). Economic theory on learning, as well as public choice theory, predicts that the presence of a “big player” (in this case, the government), can thwart the process of scientific learning, as knowledge is derived from politics, rather than science. Thus, the country can get stuck in an idea trap, whereby bad ideas reinforce bad policies, leading to bad outcomes, bad learning, and more bad policies. Thus did the US adopt, in response to the financial crisis of 2007, the very same policies that caused the crisis in the first place.

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INTRODUCTION

This paper discusses the nature of learning, and the tensions between scientific and political environments for the incubation of new knowledge. It then applies these lessons to the aftermath and recovery of the Great Financial Crisis of 2007.

The effects of the crisis are easily identified; this is not so for the causes of the crisis. Of all the analyses aimed at identifying the cause, the official report of the Financial Crisis Inquiry Commission was intended to provide the most authoritative and definitive conclusion. The problem is that even this extensive analysis came up with not one, but three conclusions: “the Democratic answer,” “the Republican answer,” and a one-member dissent by Peter Wallison from the American Enterprise Institute—“the right answer.” Only one of the ten commissioners addressed the cause directly and without partisan politics. Despite the fact that the other two conclusions are politically driven equivocations, Wallison’s work was largely ignored by all. Certainly the Democrats and Republicans dismissed his research, as it did not seek to absolve either political party. The bigger

shame is that the media buried its head in the sand as well, and the general public was not informed of “the right answer.”

Identifying the true cause of the financial crisis is not about fixing blame for the past. It is a matter of taking responsibility for the future, the responsibility to prevent history from repeating itself. Given the importance of this responsibility, the Commission’s three-conclusion outcome is particularly baffling.

Section 1 outlines the impact of the financial crisis. Section 2 reviews the roots of the financial crisis in loose monetary policy and federal regulations that created perverse incentives. Section 3 examines the Financial Crisis Inquiry Commission. Section 4 analyzes the problem through an epistemological lens: we review science as a discovery process, and the distortions that can break that process, then apply that framework to the idea trap of the post-2008 recovery. The final section concludes.

1. DEVASTATION: THE IMPACT OF THE 2008 FINANCIAL CRISIS

This modern financial crisis represents the largest downturn the U.S. economy has experienced since the Great Depression. Although the crisis is generally identified as having spanned from 2007 to 2009, it is in many ways still plaguing the U.S. economy and political system. While the question of causation has been relegated to superficial allusions to greed and the need for more stringent regulations, the effects that this calamity imposed on the country are undeniable.

By August 2008 insurance giant, AIG, had hemorrhaged over \$26 billion. This was just a year after one executive, Joseph Cassano, when asked about the insurance behemoth’s subprime-related business, assured investors, “It is hard for us, and without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions” (Beachy 2012). Unfortunately, perhaps the most haunting aspect of the whole ordeal is that Cassano’s lack of any anticipation of the impending doom was the general sentiment of both the players and the public right up to the eleventh hour.

Apparently deeming it “too big to fail,” in September 2008, the Federal Reserve rescued AIG from imminent bankruptcy, providing the largest bailout in United States history (\$182 billion dollars of taxpayer money). In the preceding week the government had not only refused to bail out the bankrupt Wall Street pillar, Lehman Brothers, but also taken over mortgage-lending giants Fannie Mae and Freddie Mac as they too were approaching collapse.

Between 2007 and 2009, as housing prices and financial markets crumbled, \$19.7 trillion worth of U.S. household assets was lost. For perspective, the value of such a staggering loss is equivalent to the entire value of everything produced by the U.S. economy over the span of 1.25 years. In one eight-month period between 2008 and 2009 the average U.S. household saw nearly \$100,000 disappear from its housing and stock-based investments. Though the poor and the wealthy were affected differently, the median household endured a nearly 40% decline in wealth from 2007 to 2010. By early 2010, roughly one out of every eleven home mortgages was in default and, two years later, more than eight million households had suffered foreclosure since the inception of the crisis. For details on the cost of the crisis, see Rosenblum 2016 or Garcia 2016.

Once the financial crisis had seriously weakened the housing and financial sectors, the infection spread throughout the entirety of the economy. The vicious cycle of reduced credit, reduced business investment, and reduced consumer spending took hold and employers were eventually forced to eliminate jobs. Production levels stagnated before falling precipitously through June 2009, taking 8.8 million U.S. jobs down with them in the process. In October 2007, before the crisis, official unemployment stood at a healthy 4.7%. In the following two years this rate more than doubled, peaking at 10% in October 2009.

Fewer jobs meant more competition for those jobs, which put downward pressure on wages. From 2008 to 2009 the actual income of the average household decreased by \$5,800. By 2010, college graduates, *if they could get hired*, could expect to earn 17.5% less than those who graduated prior to the onset of the financial crisis. Analysts predicted that this trend would continue for more than ten years, resulting in recession-era

graduates suffering a \$70,000 loss in income relative to preceding graduates in their post-graduation decade.

In the first two years following the 2008 economic collapse, almost 40% of households had experienced a loss of employment, faced housing foreclosure, missed housing payments, or found that their homes were worth less than their mortgage debt. These problems seemed inescapable for most U.S. citizens, and soon the situation was not only degrading their finances, but also their psyches. People's expectations for their future well-being dropped significantly. The National Bureau of Economic Research conducted a series of surveys to track these lowered expectations. One of these surveys, taken in late 2008, concluded that one out of every five people expected to lose their job in the next twelve months. Another revealed that from late 2008 through early 2010, one out of every three people in the U.S. was consistently dissatisfied with their household income. Furthermore, dissatisfaction with life in general grew from about one out of every fourteen people just after the 2008 collapse to one out of every nine people by early 2010.

Like a wildfire in a dry forest, the financial crisis burned down the economy and no aspect of American life was safe from the flames.

2. THE CAUSES OF THE FINANCIAL CRISIS

Much ink has already been spilled on the causes of the Great Financial Crisis (see Liebowitz 2008, Schwartz 2009, Horwitz and Boettke 2009, Roberts 2010, Sowell 2010, Friedman and Kraus 2010, Friedman 2011, Kraus 2011, Allison 2013, or Barth and Kaufman 2016).

There are vibrant disagreements on details, but the literature generally agrees on three areas (see Allison 2013, p. 14 and Sowell 2010; see also Kaufman 2016). First, loose monetary policy (to which some point as a cause, and others as an exacerbating factor). Second, federal housing policy, with such lax lending standards that buyers were encouraged to buy more housing than they could afford. And third, bad or misapplied regulatory policy. We note that some sources point to deregulation as a problem (see e.g. Bidh e 2011, Crotty 2009, Krugman 2008, Stiglitz 2010). This story is somewhere between simplistic and incorrect. It is incorrect because the 25-year period before 2007 saw 4 regulatory policies for every 1 deregulatory policy (Kling 2009). It is simplistic, because (as we will see below), the problem was not an *absence* of regulation, but an *excess* of regulations, *bad* regulations that created perverse incentives, and inability (or refusal) of regulators to *enforce* regulations. Allison (2013, p. 1) bluntly concludes that government policy was the primary cause of the financial crisis.

2.1. Monetary Policy: The Dry Forest

Consider two forests; the environment of the first forest is characterized by heavy rainfall and minimal wind, while the environment of the second is extremely dry and windy. Now consider what would happen if a lit match were introduced into each of these forests. The first forest might catch fire, but the climate would render it manageable. The ecosystem would be able to recover from the damages. The second forest, on the other hand, with its dry, windy, combustible conditions, would be much more vulnerable in the face of a lit match. The flame would spread like wildfire, seriously devastating the entire ecosystem.

At the dawn of the 2008 Financial Crisis, the US economy was a forest facing the threat of an open flame, and the Federal Reserve's monetary policy had created a hopelessly dry and windy environment (see Horwitz and Boettke 2009 for federal funds rates in the 2000s). Allison (2013, p. 32) concludes that "in a fundamental sense, there could not have been a bubble... in the housing market if the Fed had not expanded the money supply...to finance the bubble."¹

In addition to implementing an expansionary monetary policy, the Fed repeatedly lowered its target for the federal funds rate. In mid-2003, the federal funds rate reached a record low of 1% and remained there for a year. This meant that the *real* rate was negative for nearly two and a half years. During that time, in terms of purchasing power, the borrower was not paying but actually gaining in relation to the amount bor-

rowed. Steve Forbes explained, “in 2004, the Federal Reserve made a fateful miscalculation. It thought the U.S. economy was much weaker than it was and therefore pumped out excess liquidity and kept interest rates artificially low” (Forbes 2008). This started a serious liquidity cycle and developed a massive demand bubble which flooded heavily into the housing market. From 2003 to 2007 real estate loans at commercial banks grew at rates of 10%-17%. The growing demand, fueled by low interest rates, increased property prices and encouraged new construction.

The loose monetary policy not only sustained below-market interest rates, but also generated a sharp decline in the dollar. These effects inflated the housing bubble even further. Investors became increasingly attracted to real assets, such as property, in order to avoid the depreciating dollar. Those same effects also explain how the financial crisis turned into a worldwide issue. By managing the world’s reserve currency, the Fed effectively transfused its “cheap money” policy into the global economy. Other countries loosened their own monetary policies to escape the negative short-term trade implications of their relatively appreciating currencies in relation to the dollar.

The Federal Reserve’s monetary policy during the Bush Administration created a housing bubble that would inevitably burst. This burst would have been damaging to the economy and likely have resulted in a financial crisis, but one which would have paled in comparison to that which occurred in 2008. Housing bubbles can develop and burst in a cyclical manner, just like a naturally occurring forest fire caused by lightning; the economy could have weathered such a crisis without widespread devastation. However, this was not the only ingredient in the recipe for the financial crisis of 2007-2009. Unfortunately, someone had driven a gasoline tanker into the middle of the forest as the lightning struck. That gasoline tanker was loose lending standards for residential home mortgages.²

2.2. Loose Lending Standards: The Gasoline Tanker

Wallison (2016, p. 75) concludes that there is “compelling evidence” that the underlying cause of the crisis was US government housing policies; Allison (2013, chapter 5), more gently refers to them as a “proximate cause” for the crisis.

Allison (2013, p. 53) explains that since the New Deal, “there have been more subsidies for housing than for any other economic activity,” with an increase during Lyndon Johnson’s Great Society. Even before the Fed’s miscalculations, “affordable housing” policies had planted the roots for the financial crisis. As a result of these policies, when the housing bubble burst, the damage was catastrophic. Starting in the early 1990s, activists began using the Community Reinvestment Act and anti-discrimination laws to claim that housing lenders who used traditional lending standards were discriminatory (because they excluded borrowers who were not credit-worthy). In 1992, two “GSEs” (government-sponsored entities), Freddie Mac and Fannie Mae, received a mandate of owning a minimum of 30% of low- and medium-income loans (this was raised to a minimum of 50% in 1999, and 56% by 2008; Wallison 2016, p. 81 and Allison 2013, p. 58). The only way the GSEs could reach these quotas was by lowering lending standards (Wallison 2016, p. 83). In the spirit of Mises (1996), we are not questioning the motivations of these activists; however, it is worth noting that, although the home ownership rate did increase during the bubble years, by 2014 it had fallen back to the same level as the pre-1992 interventions (Wallison 2016, p. 79). In the end, not only did the policies fail to increase the home ownership levels of poor and minority Americans, but these very same Americans were disproportionately hurt by the boom and bust cycle (Wallison 2016, p. 90).

The implementation of federal housing goals led to demands for lower lending standards, such as discounting bad credit history and counting unemployment benefits as income in qualifying for a mortgage. Eventually, these unreasonable demands were imposed on financial institutions through lawsuits and regulatory pressures—and a race-to-the-bottom frenzy of a bubble, as banks were forced to lower their standards in order to compete with the GSES (Allison 2013, p. 97; generally, see Liebowitz 2008).

President Clinton joined this bandwagon in 1995 when he announced the administration's comprehensive new strategy for raising American home-ownership to an all-time high. Clinton assured the public that his homeownership "strategy will not cost the taxpayers one extra cent. It will not require legislation." This basically meant that through informal partnerships with groups like Fannie Mae and Freddie Mac, the administration would make mortgages available to those "who have historically been excluded from homeownership" (Ferrara 2011). The Clinton administration forced Fannie and Freddie massively to increase the funding of subprime mortgages through their securitization practices, while lowering lending standards for all, including prime applicants (Wallison 2016, p. 84).

The *New York Times* published an article in 1999 titled, "Fannie Mae Eases Credit to Aid Mortgage Lending." The article explains that "Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people" (Holmes 1999). The article goes on to discuss the risk involved with this move to increase home ownership rates among minorities and low-income consumers: "In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s." A familiar voice is quoted on this matter within the same 1999 article: "From the perspective of many people, including me, this is another thrift industry growing up around us," said Peter Wallison. "If they fail, the government will have to step up and bail them out the way it stepped up and bailed out the thrift industry" (Holmes 1999). Long before his research for the Financial Crisis Inquiry Commission, Peter Wallison was wary of the dangers posed by over-generous government housing policies.

Once the Clinton Administration had trashed lending standards for unqualified borrowers, standards couldn't be maintained for the more qualified borrowers either. Now, well-heeled speculators were able to qualify for highly speculative mortgages, letting them in on the exuberance. This significantly increased the resulting credit risk vulnerabilities for the financial system, inflating the housing bubble even more.

When the Bush Administration first took office, times were good (or so they appeared). The President, thrilled by the increase in home ownership, continued to promote the lax lending practices. Bush aimed to increase home ownership even more while in office, proudly stating in 2003, "This Administration will constantly strive to promote an ownership society in America. We want more people owning their own home. It is in our national interest that more people own their own home. After all, if you own your own home, you have a vital stake in the future of our country."³ In the second quarter of 2004, homeownership had reached an all-time high of 69 %, up from about 64% in the early 1990s. There were 73.4 million homeowners in the United States, the most ever—and for the first time, the majority of minority Americans owned their homes.

In a sense, the Clinton and Bush administrations successfully reached their goal of increased home ownership... if not sustainably. The problem was that fully 50% of the mortgages allowing that homeownership were subprime or otherwise risky (Wallison 2016, p. 84)—and many prime mortgages were based on lax standards (see Liebowitz 2008 for details). They were doomed to default, and, sure enough, when the adjustable rates of these mortgages kicked in, the borrowers could not pay, and foreclosures increased. In conclusion, the federal government "effectively subsidized the excessive risk-taking [of the GSEs]" (Kaufman 2016, p. 13). As Sowell (2010, p. 81) explains of politicians and bureaucrats: "What they learn is that there is much political mileage to be gained by promoting more home ownership and no political price to be paid for the foreclosures that eventually follow." We note that, in this paper, we focus on the knowledge problems of policy, in the Austrian tradition (Hayek 1945, Mises 1979 and 1996). A separate study, in the Public Choice tradition, will focus on regulatory capture and incentive problems in monetary policy (Ghosh and Wenzel 2019b; generally, see Buchanan and Tullock 1962, Stigler 1971, McChesney 1987).

The next section explains the transmission from the real estate market into the financial markets, then the economy as a whole.

2.3. Misguided Regulation

Popular opinion holds that deregulation was to blame. But the 25-year period before 2008 saw an *increase* in regulations, rather than a decrease (for a full list of regulations in place during the 2000s, see Barth et al. 2016a, p. 340). In particular, the early 2000s saw three fundamental regulatory increases: the Privacy Act, the Patriot Act, and the Sarbanes-Oxley Act. Allison (2013, p. 136) explains that these acts, and the overall regulatory environment had three fundamental consequences: (1) bank managers shifted their focus from credit risk to regulatory risk; (2) the regulatory environment became increasingly arbitrary, with selective enforcement of incomprehensible and often contradictory rules;⁴ and (3) the acts were burdensome and not clearly linked to their stated purpose of law enforcement. Deregulations that did take place were partial. For example, contrary to popular opinion, “the Gramm-Leach-Bliley Act of 1999, which amended the Glass-Steagal Act of 1933, did not erase the distinction between commercial banks, which take deposits and make loans and investments, and the ... investment banks, which underwrite and trade securities.” Instead, “the 1999 act merely allowed both commercial and investment banks to be subsidiaries of a common holding company, but they remained subject to the same restrictions on the nature of their activities as before. These restrictions were loose in the case of investment banks but tight for commercial banks—and... the crisis took place within the commercial banks” (Friedman and Kraus 2010; see also Wallison 2009). Despite the popular misconception about deregulation, a mainstream undergraduate money and banking textbook such as Mishkin and Eakins explained *before* the crisis that financial institutions are “the most heavily regulated business in the economy”—well before the Dodd-Frank Act and other post-crisis measure (2005, chapter 1). In fact, that same textbook lists nine different categories of financial regulation: a government safety net, from mandatory deposit insurance to the Fed as lender of last resort; restrictions on asset holdings for commercial banks; capital requirements; prompt corrective action; financial supervision, chartering and examination by an army of regulatory agencies; assessment of bank risk management; disclosure requirements; consumer protection; and restrictions on competition (chapter 18). Allison (2013) explains that “financial services is a very highly regulated industry, probably the most regulated industry in the world.” So we can clearly not speak of an *unregulated* system run wild. Rather, there were fatal flaws within the regulatory apparatus, so it is more accurate to speak of a *misregulated* economy. We list them here in three categories.

First, existing regulations created moral hazard. Allison (2013, p. 40 and chapter 4) explains how the very presence of the FDIC—as insurer and regulator—encourages moral hazard among banks; the presence of mandatory government deposit insurance allowed banks to create a panoply of high-risk mortgage payments, drawing in more consumers without the fear of failure (ibid, p. 91; see also Kane 2016, pp. 377, 381). Hogan and Johnson (2016) explain how “realistic models...include the disadvantages of deposit insurance, such as the problem of moral hazard and increased risk taking that occur when depositors’ funds are guaranteed because the depositors no longer have strong incentives to monitor banks’ risk-taking activities.” Moving from theory to empirical evidence, they find that deposit insurance ends up destabilizing the banking system; they conclude that “the evidence indicates that reducing the FDIC’s role in deposit insurance is likely to increase stability in the U.S. banking system.” Parallel to the moral hazard created by mandatory, government-run deposit insurance, we have the moral hazard from the GSEs tasked with expanding the ownership society (Freddie Mac and Fannie Mae). Freddie and Fannie purchased mortgages from banks. Banks kept the origination fees and got credit for making more loans (prime and subprime), thus pleasing regulators and politicians. They also were shielded from any risk, as Freddie and Fannie purchased loans made with weak lending standards. By 2008, half of all US mortgages were subprime or Alt-A; the GSEs held 76% of these (Wallison 2016, p. 81). Banks became mere interviewers, with incentives to ignore risk and increase loan volume. Finally, the greatest moral hazard was caused by the “Too Big to Fail” (TBTF) government policy of implicit (or sometimes explicit) bailout promises. Despite this policy, the US government allowed (or even encouraged) banks to become too big to fail (Barth et al. 2016b, p. 416). Horwitz and Boettke (2009) point to 37 major government interventions between October 2007 and May 2009. Wallison

(2016, pp. 96-97) explains how financial firms (including Lehman Brothers) could have recapitalized after the federal bailout of Bear Stearns—but did not, because they expected further bailouts.

Second, government regulation caused a serious misjudging of risk. The years leading to the housing boom and bust saw the emergence of new financial instruments, especially the packaging of residential mortgages into securities (Mortgage-Backed Securities, and derivative instruments such as Credit Default Swaps). Alas, the market was never given a chance properly to value and regulate these new instruments, as government stepped in too early. In 2001, through the so-called “Recourse Rule,” federal regulators declared at the stroke of a pen that these new financial instruments were low-risk, as long as they were rated AA or AAA, or were issued by a GSE (Friedman and Kraus 2010; see also Wallison 2016, p. 94). In addition, the aftermath of the crisis showed that the cartelized credit-rating agencies were issuing bad information about the risk of financial instruments (Allison 2013, pp. 82-83 and chapters 8 and 14 generally; see also White 2010). In more technical terms, American commercial banks “were required to spend 80 percent more capital on commercial loans, 80 percent more capital on corporate bonds, and 60 percent more capital on individual mortgages than they had to spend on asset-backed securities, including mortgage-backed bonds” (as long as they were highly rated or issued by a GSE) (Friedman and Krause 2010; see also Friedman 2010, pp. 26-27). Naturally, banks responded to incentives and invested heavily in such assets—the very assets that turned out to be built on low lending standards. Barth et al. (2016b, p. 402) conclude that the major cause of the financial crisis was “the choice and maintenance of regulatory and supervisory practices that permitted and, in some cases encouraged, excessive risk-taking by financial institutions.”

Third, for a variety of reasons, regulators did not enforce financial regulations. The regulations themselves were poor or misguided (Calomiris 2009, Friedman 2011). But regulators could not or would not enforce existing regulations. Due to the complexity of regulations—but also the complexity of the market they were trying to regulate—regulators were unprepared (Kaufman 2016, p. 20). What is more, by and large, they simply didn’t regulate. Allison (2013, p. 139) and Kane (2016, p. 379) point to the incentives for selective enforcement: in good times, regulators don’t want to be seen as killjoys who are hampering economic growth; they also fear undermining consumer confidence if they ramp up enforcement (Kaufman 2016, p. 23). When the economy crashes, however, they will return to being risk-averse bureaucrats and over-enforce regulations, at the very time that the economy needs unhampered growth to recover. These two factors (excessive complexity and bureaucratic risk-aversion) are compounded by a third problem: lobbying. Kane 2016 (pp. 383-384) points to bureaucratic capture of regulators, while Allison (2013, p. 63) explains how lobbying and other political considerations killed movements in Congress to increase capital requirements for Freddie Mac and Fannie Mae in the midst of the bubble. Alas, economic theory accurately predicted regulatory failure. Regulators failed to require sufficient capitalization of banks (Kaufman 2016, p. 17), but they also allowed backdating of capital injections (Kaufman 2016, p. 19).

Kaufman (2016, p. 22) explains that regulators already had the authority under the 1994 Home Ownership Equity and Protection Act to restrict features of residential mortgage contracts deemed inappropriate—but didn’t apply regulations until after the start of the crisis.⁵ Kaufman (ibid) speculates that the housing euphoria led to congressional and industry push-back, coupled with worries about disparate impact on poor and minority borrowers, against enforcement of regulation. Barth et al. (2016a, p. 350) conclude that the regulations necessary to prevent the Great Financial Crisis were in place, but not used, because of regulatory capture (see also Barth et al. 2016a). Barth et al. (2016b, p. 401) explain that, at several key points during the housing bubble, regulators “identified growing risks and yet did not act.” As early as 2004, the Federal Reserve was aware that many banks were undercapitalized, but did nothing (Barth et al. 2016b, p. 418). The SEC “became willfully blind to excessive risk-taking” (Barth et al 2016b, p. 420). And, for 80% of the banks that failed, the FDIC had identified a problem... but in 95% of cases, did not take “prompt corrective action” (Barth et al 2016b, p. 421). While some point to regulatory capture as a cause for the lack of enforcement, others simply point to the overwhelming nature of excessive regulations. As complexity increases, regulator ability and accountability fall (Barth et al. 2016b, p. 423 or Haldane and Madouros 2012; generally, see Hayek 1945 or Mises 1979).

In sum, overly complex regulation led to three undesirable consequences: the need for more complex derivatives for banks to hedge against regulatory risk; the increase of bank risk, in search of increased revenue to offset regulatory costs; and the offloading of risky mortgages to GSEs (Allison 2013, p. 114; see also chapter 12).

2.4. Conclusion

The following list summarizes the causes of the Great Financial Crisis. We return to this list in section four.

- 1 Artificially low interest rates
- 2 Lax lending standards
- 3 Moral hazard for lenders
- 4 Moral hazard for financial institutions
- 5 Regulatory encouragement of excessive risk-taking
- 6 Non-enforcement of regulations (because of capture or inability)

3. LEARNING FROM THE CRISIS... OR NOT: THE FINANCIAL CRISIS INQUIRY COMMISSION

3.1. Background

The Financial Crisis Inquiry Commission was created in 2009 to examine the causes of the crisis in the United States; it held its first hearing on January 13, 2010.

The Commission was to be composed of ten prominent United States citizens, each nationally recognized as having significant experience in fields such as banking, taxation, finance, economics, regulation of markets, consumer protection, and housing. The ten members were to be appointed on a bipartisan and bicameral basis. Six members would be chosen by the congressional majority, the Democrats. Three of these six Democrats would be appointed by the Speaker of the House and three by the Senate Majority Leader. The congressional minority, the Republicans, would choose the four other members of the Commission. Two of these Republican members would be appointed by the House Minority Leader and two by the Senate Minority Leader. The Commission's chair was to be jointly selected by the congressional majority leadership and the vice chair was to be jointly selected by the leadership of the congressional minority. Given this approach to selecting members, one might have anticipated that the Commission would seek to promote certain political agendas rather than commit itself to finding the truth.

The Commission was given the task of examining the role of 22 specific financial/economic factors in the crisis. These special considerations included, "monetary policy and the availability and terms of credit," lending practices and securitization, credit rating agencies in the financial system, and "fraud and abuse in the financial sector."

In order to carry out its inquiry the commission was authorized to:

- a) hold hearings, sit and act at times and places, take testimony, receive evidence, and administer oaths and
- b) require, by subpoena or otherwise, the attendance and testimony of witnesses and the production of books, records, correspondence, memoranda, papers, and documents.

Over the course of its research and investigation, the Commission:

... reviewed millions of pages of documents, interviewed more than seven hundred witnesses, and held nineteen days of public hearings in New York, Washington, DC, and communities across the country that were hard hit by the crisis. The Commission also drew from a large body of existing work about the crisis developed by congressional committees, government agencies, academics, journalists, legal investigators, and many others.

The Commission released its report on January 27, 2011. Not surprisingly, the vote on adopting the final report was split along party lines. The six Democrats voted for its adoption and the four Republicans, disagreeing with the report's final conclusions, all dissented. Furthermore, among the four Republicans there were two different dissenting opinions. Three of the Republican appointees co-authored one dissenting conclusion, while the fourth wrote his own separate conclusion. With four of the ten members dissenting from its final report, one can conclude that the Financial Crisis Inquiry Commission failed.

3.2. A Dysfunctional Commission: Politics over Science

Congress' approach for structuring the Commission bred partisanship from the very start, making it nearly impossible to conduct an objective investigation or come to a unanimous conclusion regarding the causes of the financial crisis—the truth was politicized from day one.

Throughout its investigation, the Commission was riddled with controversy and dissension. One member of the House of Representatives, Daryl Issa, even launched an investigation of the commissioners, because he believed that the FCIC was chock-full of conflicts, partisanship, and waste. Issa stated, “the Financial Markets Commission report should be free of accusations of political showmanship and a partisan slant that have tainted current investigations. This Commission is not the place for partisanship or Congressional meddling. It is a place for the American people to get answers.” When Representative Issa requested access to FCIC documents for the purpose of carrying out his investigation, Chairman Phil Angelides dismissed the request as “silly, stupid Washington stuff” (Perino 2012).

Another mark of the Commission's dysfunctional nature was the inconsistency in defining its actual purpose. Chairman Phil Angelides first defined the Commission's goal as “writing the official history of what brought our financial and economic system to its knees.” On another occasion he stressed, “It's important that we deliver new information, we can't just rehash what we've known to date.” On yet another occasion his tone was entirely less dispassionate, as he stated that the Commission's goal was, “to examine the greed, stupidity, hubris and outright corruption in the financial industry.”

This lack of consistency and objectivity can also help explain why the commissioners were so at odds when it came to adopting a final report. As the deadline for the final report approached, Vice Chairman Bill Thomas argued on behalf of the Republican commissioners that the Democrats were preparing a “hit piece” on Wall Street banks. In late 2010, unable to come to an agreement on the final report across party lines, Angelides announced that the Commission would not meet its December 15, 2010 deadline and that it would release its report in late January 2011. Despite this postponement, when the final report was released, it was clear that no further agreement had been reached. In their dissent, the Republicans argued that the report was “more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is.”

Regarding the specific way in which the Commission carried out its work, the Republicans felt that it could have done with less investigation and more objective analysis, but that Angelides, their Democratic Chairman, was “inflexible and a micromanager.” As for the Republican Vice Chairman, he had previously been ranked among “the ‘hottest-tempered’ lawmakers in *Washingtonian* magazine polls of Congressional staffers” (Perino 2012).

Although each party accused the other of gross partisanship, the six to four ratio of Democrats to Republicans particularly disincentivized any efforts to compromise for the majority. One example of this occurred in the spring of 2010, when Commission Chairman Angelides “sought to close off further discussion and analysis of Commissioner Peter Wallison’s theory that government housing policy was solely to blame for the financial crisis.” Not a surprise, considering Angelides’ sentiments quoted above. “For what I have seen,” Angelides wrote, “the staff has spent more time responding to your questions and requests for information than any other Commissioner.” Perhaps this was because Wallison was the only commissioner truly interested in a thorough analysis. Wallison replied by saying:

I don’t like being told that I disagree with everything. You should know that I have no compunction about filing a separate statement if I am not persuaded by data, by facts that have been tested and are not subject to dispute . . . I hear that we should accept the point of view of “experts” as evidence, as in a trial. As we all should know, in a trial each side can select its experts. All the experts I have ever suggested for the Commission’s hearings have been rejected or ignored.

Keeping this exchange in mind, it is interesting to note the following passage from Wallison’s dissent, in which he outlines an example of this dynamic. The passage also provides some insight into the workings of the Commission and how the outcome was almost preordained; it is worth quoting here at length. Wallison wrote:

One glaring example will illustrate the Commission’s lack of objectivity. In March 2010, Edward Pinto, . . . who had served as chief credit officer at Fannie Mae, provided to the Commission staff a 70-page, fully sourced memorandum on the number of subprime and other high risk mortgages in the financial system immediately before the financial crisis. In that memorandum, Pinto recorded that he had found over 25 million such mortgages... Since there are about 55 million mortgages in the U.S., Pinto’s research indicated that, as the financial crisis began, half of all U.S. mortgages were of inferior quality and liable to default when housing prices were no longer rising. In August, Pinto supplemented his initial research with a paper documenting the efforts of the Department of Housing and Urban Development (HUD), over two decades and through two administrations, to increase home ownership by reducing mortgage underwriting standards.

Wallison continued:

This research raised important questions about the role of government housing policy in promoting the high-risk mortgages that played such a key role in both the mortgage meltdown and the financial panic that followed. Any objective investigation of the causes of the financial crisis would have looked carefully at this research, exposed it to the members of the Commission, taken Pinto’s testimony, and tested the accuracy of Pinto’s research. But the Commission took none of these steps. Pinto’s research was never made available to the other members of the FCIC, or even to the commissioners who were members of the subcommittee charged with considering the role of housing policy in the financial crisis. Accordingly, the Commission majority’s report ignores hypotheses about the causes of the financial crisis that any objective investigation would have considered, while focusing solely on theories that have political currency but far less plausibility.

In an indictment of politics over science, Wallison concluded that “this is not the way a serious and objective inquiry should have been carried out, but that is how the Commission used its resources and its mandate.” Given the content of Pinto’s report, this account exemplifies the overwhelming partisanship of the Commission. Since neither party could deny the role of subprime mortgages in the crisis, it was politically imperative that they avoid the role of government policy in subprime mortgages.

3.3. Serving Political Agendas

Although it may be apocryphal, Groucho Marx is said to have written that “politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies.” Alas, vaudeville art mirrors reality.

The conclusions of the Commission are understandable, based on the politics involved. The Democrats, of which there were six members, had no interest in condemning the policies of the Clinton Administration that resulted in the GSEs explicitly reducing their standards for mortgage applicants (which meant that they were willing, for the first time, to purchase substandard or subprime mortgages). In order to stay competitive, the banks and financial institutions on Wall Street that compete with these federally-backed (and thus subsidized) entities had no choice but to lower their acceptance standards as well. The result of this policy, which was aimed at increasing minority home ownership, was that very large numbers of mortgages were given to people who would eventually not be able to pay them, resulting in a massive number of defaults. This policy failure, if not deftly handled by the Democrats on the Commission, would result in a Democratic Administration being blamed for the crisis. Instead, the six Democratic commissioners proceeded to use the financial crisis, and the authority they had been given as commissioners, to promote their own political agendas. They did this by concluding that the crisis would have been entirely avoidable if only there had been heavier and more diligent government regulation of the big banks.

The Republicans, of which there were four, faced a similar dilemma. After Clinton, the Bush Administration continued the flawed lending practices and celebrated the increase in home ownership. The Bush administration is doubly at fault by also tolerating the Fed’s irresponsible monetary policy of sustaining below-market interest rates.⁶ The expansionary monetary policy made everyone look good at the time, so no one was willing to suggest that this unbridled enthusiasm for lending should slow down. The Republican commissioners needed deftly to avoid any implication that the Bush Administration was at fault for the crisis. So, just as the Democrats had done, they tailored their 27-page conclusion to serve their own political agenda. Certainly unable to accept the Democratic conclusion that the crisis was avoidable had there been more regulation, they concluded that the crisis was, in fact, unavoidable. They claimed it was the natural result of economic cycles and that because it was not only a U.S. problem but one of international proportion, it could not have been the result of flawed government policies.

One commissioner, Peter Wallison, turned out to be a politically independent thinker and, therefore, the only truth seeker. With thorough analysis, he addressed all of the positions and conclusions of the other nine members in his independently authored 93-page dissent. Wallison argued convincingly that the cause of the crisis was flawed government policy, a policy that resulted in 50% of the mortgages in the U.S. being of subprime quality.

What is particularly fascinating is that Wallison’s work was attacked with great effort to undermine and dismiss his conclusions. The media did not celebrate his independent thinking—instead it promoted the “Wall Street greed” explanation. A story that blames rich, greedy bankers sells much better than one of flawed government policy.⁷ *The Big Short* (2015), a Paramount Pictures feature film about the few men who anticipated the financial crisis, further served to feed this erroneous explanation to the American people. It vilifies the banks, blaming them (and only them) for the entire financial crisis. The movie explains that the greedy banks practiced predatory lending, taking advantage of the working class, in order to make themselves richer. Never, in this critically acclaimed, Academy Award-winning film, is there any mention of government policy—not once. As recently as March 11, 2016, the *Wall Street Journal* published an article, “Analysis of the Financial Crisis Inquiry Commission Documents Release.” The article reviews an extensive list of documents, *none* of which ever mention the Wallison conclusion—a glaring omission, considering his dissent is the largest individual document included in the report.

4. A Theoretical Framework

We now turn to an epistemological framework, and discuss science as a self-correcting discovery process. We then discuss three pathologies that can break that process: first, the presence of a big player that can distort scientific inquiry (in this case, government funding of science); second, the tyranny of experts; and third, idea traps. We then apply that epistemological framework to the post-2008 recovery policies.

Science is a complex phenomenon of feedback loops and self-correction. Because human knowledge is limited, institutions that create and transmit knowledge are of great importance (see Hayek 1960). The market is one such institution, as it gathers the preferences and abilities of consumers and suppliers and feeds them into the market process, thus aggregating preferences and sharing information. Furthermore, the profit and loss mechanism actualizes this information, as entrepreneurs receive feedback about the value they are adding (or not) for consumers. Prices thus have an epistemic function, as they guide the actions of consumers and entrepreneurs by giving them relevant information (Horwitz 2000). Beyond basic microeconomics, price controls and other interventions are distortionary, because they break the process of information transition (Mises 1979). Scientific knowledge emerges in a similar manner (see Kuhn 1962), through the “Publication-Citation-Reputation” (PCR) process of discovery and correction (Butos and McQuade 2012; see also Butos and McQuade 2006):

Scientists publish speculations and observations; other scientists who find these useful to their own work (or who wish to criticize them) cite them; the citation feeds back to affect the reputation of the publishing scientist; and a scientist’s reputation not only affects the notice given to his future publications and citations but also his ability to attract funding or to advance in academic positions. This recursive set of procedures and feedback loops, hereafter referred to as “PCR” (for “Publication-Citation-Reputation”), implements the knowledge-generating characteristics of the scientific order.

4.1. Big Players and Political Science

The presence of a big player can distort the discovery process (see Koppl 2002). Consider, then, the fact that the federal government today funds more than 50% of basic research in the US (Butos and McQuade 2006; see also Butos and McQuade 2012).

Butos and McQuade (2012) offer a taxonomy to analyze the process by which the scientific process responds to funding, and the problems that arise with centralization of funding (when the government is a big player in the funding process). They start by differentiating among three effects of spending on science (regardless of the source, whether private or public): direction, destabilization, and distortion. As we will see, the first two are not problematic, regardless of the source of funding—because science is a self-correcting process of discovery. The third, distortion, however, *is* problematic because it can break the PCR process of self-correction.

4.1.1 *The Direction of Scientific Funding*

Funding affects the direction of science: “directional effects are treated here as outcomes which result from changes in the amount and focus of funding but which do not induce any changes in the PCR processes and which therefore do not result in the production of invalid science” (Butos and McQuade 2012). Any funder of science, whether government, industry, or non-profit, will have spending priorities. Some areas of science will receive more funding than others (especially if the priorities are set politically, rather than scientifically—that is, if the government emerges as a big player in science funding). But the scientific process itself will not be broken (on the unintended consequences of politicized science, see also Kealy 1996).

4.1.2. Destabilizing Scientific Inquiry

Funding affects the stability of scientific inquiry, as priorities shift. Butos and McQuade (2012) explain that “in a funding regime of a small number of large funding sources, the shifting priorities of the funding institution may result in a phenomenon of ‘boom and bust’ within scientific disciplines. The boom is initiated as generous funding policies make funding more generally available and easier to obtain, and as ‘popularity’ (for both real and political reasons) of a particular subdiscipline makes funding for that subdiscipline easier to get.” This means that research will often progress in cycles; in the boom phase, “research projects that under earlier funding conditions would not have been attempted are now able to be funded.” Later, “the bust will come when it becomes apparent that many of the research projects in the subdiscipline enjoying the boom cannot be completed, either because, due to a shift in funding priorities, the funding for the projects is scaled back or terminated before the projects are completed, or because reality manifests itself in the form of lack of experimental validation.” Just as with the directional effect, the shift in funding priorities for a big player will affect scientific research (in this case destabilizing research institutions and individuals), but there is no effect on the very process of scientific inquiry (the PCR process of self-correction).

Butos and McQuade 2012 give two short examples where government funding influenced the direction and stability of scientific research, but did not distort it. In the wake of the 1957 Sputnik launch, the US shifted national research priorities to “physics, mathematics, astronautics, and space science research”—but “interest and funding fell markedly” after the moon landings. Likewise, in the 1980s, in response to a perceived Japanese threat, the US government doubled funding for computer science (and especially AI), only to shift its attention elsewhere when the Japanese project failed and commercial computers surpassed government capabilities.

4.1.3 Distorting Scientific Inquiry

Finally, “distorting effects are those effects which work to impair or circumvent those evolved institutions fundamental to science’s functioning as an adaptive classifying system. When the procedures and feedback loops crucial for the long run viability and robustness of science are bypassed or impaired, the functioning of the scientific order becomes maladaptive to science’s normal environment and the so-called knowledge generated in these conditions is tainted, if not totally invalid” (Butos and McQuade 2012). Note that this distortionary capacity does not include individual (or even institutional) fraud in scientific research; indeed, as long as the PCR process is functioning, fraud will be both deterred and corrected. The real, systemic, problem is “the potential for distortion that derives from pressures external to science—in particular those inherent in the characteristics of the funders and the degree of decentralization of the funding environment. In an environment composed of many funders, effectiveness of the any single one to interfere with the PCR processes and their operation is likely to be small. They lack the ability to impose their will on a significant segment of the scientific order” (ibid).

For example, Hobbs and Wenzel (2019) explain that “starting in the 1960s, the sugar industry was able to promote saturated fat as a culprit for heart disease; Coca-Cola has successfully funded research downplaying the link between sugar and obesity.”⁸ In both these cases, however, the sugar industry and Coca-Cola lacked two things that the government presents: an assumption of neutrality, and the ability to distort the entire process. Things can be different when the government, as a big player, enters the field. Consider the case of US nutritional advice. Butos and McQuade explain how the US government has been involved since the 1950s in the provision of nutritional information. The government “turned a scientific question into a political one.” Hobbs and Wenzel (2019) explain that

informational regulatory capture is obvious in the case of US dietary guidelines. Nestle (2007, p. 30) states it bluntly: “dietary guidelines necessarily are political compromises between what science tells us about nutrition and health versus what is good for the food industry.” From the initial

1968 congressional hearings on the subject, federal dietary guidelines have involved regulatory capture (Nestle 2007, pp. 38-50 and chapter 2). Early on, agribusiness was opposed to the emerging scientific consensus about decreasing overall caloric intake, as well as caloric intake from animal fats specifically. The USDA's first "food pyramid" of dietary guidelines, in 1991, was surrounded by industry disapproval. Within two weeks of its release in April 1991, the first food pyramid was retracted by USDA, because of agribusiness disapproval. Leading the charge, the meat and dairy lobbies objected to what they perceived as a governmental campaign to encourage consumers to eat less of their products (Nestle 2007, pp. 53-61). In 1992, "a year and a day and \$855,000 after the announcement of [the 1991 pyramid's] withdrawal" (ibid, p. 63), the USDA released its revised food pyramid.

Government funding has also caused distortions in climate science, while compromising the objectivity of research (Butos and McQuade 2015; see also Wojick and Michaels 2015). The presence of government as a big player has led to politicization of science, and quashing of dissent. Those who question climate change, or accept it but question its anthropogenic roots, are ridiculed, isolated, fired, or poo-pooed as "deniers" (see Michaels and Knappenberger 2016 or Michaels and Balling 2010). The point here is not whether climate change exists, or if it's anthropogenic—that is for scientists to decide. The point is that the debate is one-sided, and dissent is not treated scientifically, but politically. One can hardly imagine a physicist being fired or ridiculed for advancing the theory that the Higgs boson doesn't exist . . . or being disparaged as a "Higgs boson denier." As an illustration of the overwhelming weight of government, Oreskes and Conway (2010) point to corporate-funded attempts to disparage the thesis of anthropogenic climate change; it is unfortunate—but expected—that some private interests will attempt to manipulate science. But they don't have the weight of government, or the imprimatur of (alleged) public interest—and they were ultimately unsuccessful at quashing dissent in the marketplace of ideas—unlike the government, which has successfully done so by shutting down that market because of its "big player" status.

Butos and McQuade (2012) conclude that the government presents one more problem, beyond being a big player:

concentration of the funding environment is not the only characteristic of public funding with distortion potential. Government funding of science comes equipped with political or even constitutional prerogatives for overseeing science not available to private funders, and these are ordinarily justified as providing the oversight and accountability taxpayers sometimes expect from government. The use of regulatory vehicles (with access to an arsenal of resources—staff, lawyers, and raw political muscle), such as Congressional hearings and access to media outlets can, whether intentionally or not, exert an influence [on] scientists' scientific reputations for good or ill, and can lead to the circumvention of standard evaluative procedures and criteria used to review and ascertain the publication worthiness of scientific work. There is a clear sense, then, in which the simple expedient of government funding science may generate incompatibilities with the institutions of science.

Turning back now from theory to the financial crisis, we have one last example of the presence of a big player in scientific funding. White (2005) found that 74% of academic articles on monetary policy, published in 2002 by US-based economists, appeared in journals published by the US Federal Reserve, or were co-authored by a Fed economist. This leads to a status quo bias, in what Milton Friedman had earlier called "a sort of oligopoly on monetary opinion" by the Fed and its affiliates (Fettig 1993). White (2005) concludes that "Fed-sponsored research generally adheres to a high level of scholarship, but it does not follow that institutional bias is absent or that the appropriate level of scrutiny is zero." It is not surprising, then, that mainstream economists believe in central banking and monetary policy, and that both popular and politi-

cal opinion ignored the role of the Fed in causing (or exacerbating) the financial crisis through loose monetary policy.

4.2 *The Tyranny of Experts*

In funding science, government qua big player and qua political entity can distort the process of scientific discovery. But there is a second problem: government's imprimatur, its veneer of neutrality (over "self-interested" corporations), and "the tyranny of experts" (Easterly 2014).

The applications are broad. Easterly (2014) decries a technocratic approach to international development, whereby "experts" in development agencies impose policies on developing countries, without taking into account local knowledge, conditions, or individual rights (see also Boettke et al. 2008). In the field of nutrition, Williams (2012) worries that "the biggest problem... is the misconception that the federal government is the sole source of assurance of safe food.... New regulations pile on top of old ones. The government has no ability to enforce them, yet regulations give consumers the illusion of control." This sentiment is echoed by a former member of the US Food and Nutrition Board, who explained that "The US government is as big of a pusher as industry. If you say what the government says, then it's okay. If you say something that isn't what the government says, or that be parallel to what industry says, that makes you suspect" (in Butos and McQuade 2012). In the financial world, Horwitz (2012) decries "the expertise of the mathematicians who guided the models used by financial institutions [,] the expertise of those who developed new kinds of mortgage instruments that required very low payments, [and] the expertise of US policymakers who told us that new regulations to encourage more widespread homeownership would be an engine of economic growth and prosperity." While consumers will (rightly) consider a report from Coca-Cola that exonerates sugar, or a report from Ford in favor of automobile tariffs, and take it with a grain of salt, the state enjoys a veneer of neutrality, legitimacy, and service to the common good (see Klein 2005). Following Public Choice theory, we cannot simply assume that policy-makers are acting in the common good (Buchanan and Tullock 1962); rather, they are typically beholden to a variety of interests (Olson 1965).

The problem with expert failure and "the fatal conceit" (Hayek 1988) is not new. In 1759, Adam Smith (1997[1759], VI.II.2, pp. 59-60) was already writing about experts:

The man of system . . . is apt to be very wise in his own conceit, and is often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it. He goes on to establish it completely and in all its parts, without any regard either to the great interests, or to the strong opposition which may oppose it: he seems to imagine that he can arrange the different members of a great society, with as much ease as the hand arranges the different pieces upon a chess board: he does not consider that the pieces upon the chess board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess board of human society, every single piece has as principle of motion of its own, altogether different from that which the legislature might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be, at all times, in the highest degree of disorder.

This literature was picked up by F. A. Hayek, who argued that experts lack the knowledge to run an economy or society (see Hayek 1945, 1974, 1978). More recently Koppl (2018) examines the problem of expert failure (see also Levy and Peart 2017). Naturally, Koppl does not dismiss experts *tout court*. Indeed, we rely every day on the advice of experts—physicians, accountants, lawyers, professors, supply chain managers, farmers, etc. Instead, Koppl (2018, p. 190) proposes a 2x2 matrix to understand the role of experts, based on: (1) monopoly experts v. competitive experts; and (2) whether the expert decides for the non-ex-

pert, or the non-expert decides (if based on expert advice). If the non-expert decides, or if there is competition among experts, we have no systemic problem. The problem emerges when monopoly experts decide for the non-expert (see also Butos 2019a). Horwitz (2012) explains this in a parallel vein: “the question of whether expertise works to the public’s advantage or disadvantage depends crucially on the institutional environment in which said expertise is located. The problem is that claims of expertise are notoriously hard to verify except perhaps by other experts. This challenge is magnified when the experts in questions [sic] also are in some sort of monopoly position over knowledge and/or action informed by knowledge.” Butos (2019b) concludes that “if a government policy made by experts is wrong, that mistake will be externalized among many people in the form [of] wasted [taxpayer funds] and the possible harm to many people” (see also Koppl 2018, chapter 11, for US policy implications).

Returning to financial institutions, Horwitz (2012) laments that “nowhere is the expertise associated with the Fed clearer in the way in which the chair of the Board of Governors is treated as the very personification of monetary policy, and how the chair has often been treated as the Wise Man who will lead us to prosperity or save us from the brink of disaster.” The problem is that “with expertise deeply enshrined in the institution due to its monopoly status, we should not be surprised that mistakes get frequently made and that error correction processes are weak, and that the institution itself is very defensive about such mistakes and relies on claims of expertise to avoid closer scrutiny or a reduction/elimination of power.” Horwitz proposes an alternate monetary regime to overcome the Fed’s expert failure: ideally, competitive money production, but as a second best, rules over discretion (see also Boettke and Smith 2016). Horwitz concludes: “Given how important money and monetary policy are for economic growth, the dangers to the economy from a monopoly of experts are significant. The history of the Fed...shows that it has frequently made these sorts of serious errors, but argued that it lacked the powers... to avoid them. The result has been that as it has accumulated more powers, it has come to rely even more on expertise in the conduct of monetary policy.”

The Great Financial Crisis abounds with experts—the Federal Reserve and financial regulators, and later, the Financial Commission—and expert failure.

4.3 *The Idea Trap*

Caplan (2003) proposes a model of policy choices, based on learning from economic outcomes. He points out that countries can get stuck in an idea trap. Policy is a function of ideas, and economic outcomes “influence policy indirectly by altering ideas about what appropriate policies are. When there is ‘positive feedback’ from growth to ideas, multiple equilibria exist and the mutual interaction of growth, policy, and ideas closely matches the stylized facts. Countries can then fall into ‘idea traps,’ where bad growth, bad policy, and bad ideas mutually reinforce each other.” Sachs (1994), for example, points out how ineffective policies that nonetheless appeal to voter emotions are particularly likely to be adopted in times of crisis; “the confusion, anxiety, and the profound sense of bewilderment about market forces are inevitable when breadwinners must worry whether income will be enough next week to feed the family...” Just as “you cannot think straight in the midst of hyperinflation,” economic crisis can lead to policy remedies that will further thwart growth. Caplan (2003) likewise explains that “public opinion diverges *less* from economists’ consensus judgments when growth is rapid, and *more* when growth is slow.” In sum, “if the market mechanism is suspect, the inevitable temptation is to resort to greater and greater intervention, thereby increasing the amount of economic activity devoted to rent seeking. As such, a political ‘vicious circle’ may develop. People perceive that the market mechanism does not function in a way compatible with socially approved goals because of rent seeking. A political consensus therefore emerges to intervene further in the market, rent seeking increases, and further intervention results” (see also Krueger 1974, Olson 1965 or Buchanan and Tullock 1962).

Bad policies lead to bad growth. Instead of adopting good policies, countries stuck in an idea trap will continue to adopt bad policies, leading to further economic troubles.

4.4. *The Post-2008 Scene: Politicized Science, Expert Failure and the Idea Trap*

We have seen how the politicization of science can break the emergent process of science as a discovery process, and how this process is compounded by expert failure. The idea trap also explains the post-2008 federal recovery programs and regulations. We now apply the theoretical framework to the post-2008 scene.

Details of the recovery can be found in Barth and Kaufman (2016, especially chapters 9, 13, 14 and 15). A summary of measures follows, grouped in three categories.

First, monetary policy. In response to the economic crisis of 2008, the Federal Reserve lowered the federal funds rate aggressively, eventually down to negative (real) rates. Rates have been at or near zero since the start of the crisis (Horwitz and Boettke 2009).

Second, bailouts. Horwitz and Boettke (2009) document no less than 37 major government interventions between October 2007 and May 2009. These bailouts were problematic because of the moral hazard they created, of course; but they also exacerbated the crisis because of the uncertainty they created. The US government was now engaging in bailouts of companies that did not have the explicit backing of the US government. And who would get a bailout? Bear Stearns was bailed out, but Lehman Brothers was allowed to fail, then, in a swift reversal, AIG was bailed out. Citigroup was bailed out, but Wachovia was allowed to fail. Freddie Mac and Fannie Mae were nationalized. In a surprise twist, the federal government bailed out the uninsured depositors of Washington Mutual, thus closing the inter-bank capital market and precipitating the crisis (Allison 2013, p. 75). The Troubled Asset Relief Program (TARP), hastily thrown together and imposed on banks, was clumsily presented, thus increasing fear and instability in the economy; although it was billed as maintaining stability in the banking system, it was aimed primarily at the big investment banks (rather than commercial banks), and it included non-banks (such as the GSEs, AIG, GMAC, and the auto industry). TARP *extended* the market's recovery period by adding uncertainty and preventing market corrections (Allison 2013, pp. 167-172). And the list goes on—including bailouts to mortgage holders (through refinancing and loan modification through the Federal Housing Administration, and the Home Affordable Refinance Program sponsored by the Federal Housing Finance Agency) and efforts to increase home ownership in the wake of the crisis. Recall that—even though the home ownership rate temporarily soared during the Bush-Obama ownership society—the ownership rate in 2014 had reverted to its pre-1992 level (Wallison 2016, p. 79). Barth et al. (2016a, p. 362) conclude that there are “strong reasons to believe” that implicit protection of large complex financial institutions will remain strong because the process remains political, because reforms increase agency discretion without judicial review or legal accountability, and because of low contractual predictability—all of which increase uncertainty.

Third, further regulations. In the summer of 2010, Congress passed comprehensive financial regulation, in the form of the Dodd-Frank Act (for details on the Act, see Barth et al. 2016a, pp. 338, 342-351). While the Federal Reserve Act was a mere 31 pages long, the Glass-Steagal Act 37 pages, and the Gramm-Leach-Bliley Act 145 pages long, the Dodd-Frank Act came out at 2,319 pages (Barth et al. 2016b, p. 405), making it “the lengthiest piece of banking legislation in US history” (Barth et al. 2016a, p. 341). Roughly a third of those rules remain to be finalized. The Dodd-Frank Act created new agencies, and expanded the regulatory and supervisory powers of existing agencies. Three fundamental problems remain (for details on Dodd-Frank's flaws, see Allison 2013, p. 193 or Peirce and Broughel 2012). First, the Dodd-Frank Act missed some basics; it did not decrease FDIC coverage, which had been an early source of moral hazard (Hogan and Johnson 2016, Allison 2013, chapter 4); it did not curb the “too big to fail” problem (and ended up exacerbating it through unclear definitions and implicit guarantees; see Ghosh and Wenzel 2019a on banking concentration after Dodd-Frank); and it placed no restraint on the power and size of the mortgage GSEs (Allison 2013, p. 64; Barth et al. 2016a, p. 341). Second, the Act increased bureaucratic discretion without increasing political accountability, thus leading to more fears of regulatory capture and unenforced regulations (Kaufman and Nelson 2016, p. 264; Barth et al. 2016a, pp. 360, 373). Dodd-Frank increased the powers of the very culprits of the crisis (Allison 2013, pp. 251-252; Barth et al. 2016b, p. 402), rather than defining their performance or addressing the incentives they faced. Dodd-Frank increased the powers of

formal government regulators, but also the power of the unofficial, government-sponsored credit rating agencies (Barth et al. 2016a, pp. 348, 371). Barth et al. (2016b, pp. 417-418) conclude that there was too much focus on the power and resources of regulators, with too little on the “systematically poor choices” of regulators, who knew throughout the crisis that their policies weren’t working, and chose not to act until it was too late. Kaufman (2016, p. 23), also cautions us that if regulators bore a disproportionate responsibility in the crisis (as the literature clearly indicates), “this suggests caution in propagating new rules and regulations until the agency problem is solved. They may not be enforced when the regulators prefer not to.” Alas, reforms did not address the agency problem. Third, the Act added vast levels of complexity to financial regulations, leading to concerns that it will increase uncertainty, do nothing about the likelihood of enforcement, and increase the incentives for financial institutions to engage in regulatory arbitrage (Barth et al. 2016b, p. 423; Kaufman and Nelson 2016, p. 250; see also Haldane and Madouros 2012, or Haldane 2012). This complexity will also impose high costs on the financial system (hundreds of community banks have already gone out of business; see Ghosh and Wenzel 2019a); see Wallison 2016, p. 76, or Kaufman and Nelson 2016, p. 258. Naturally, with regulatory uncertainty and higher costs (amplified by increased FDIC coverage), banks face an incentive to seek greater returns through riskier activity (ibid).

In general, Barth et al. (2016b, p. 402) explain that “US reforms have intensified moral hazard,” through bailouts without explicit *ex ante* government backing, increased regulation (which decreases private monitoring and discipline), and an increase in the “too big to fail” problem. Reforms have also done nothing to address regulatory bias and regulator performance (ibid, p. 425). In sum, “US authorities misdiagnosed—or willfully disregarded—the causes of the Great Financial Crisis” (Barth et al. 2016b, p. 399). More important, for our purposes, we see that the US is caught in an idea trap: the very policies that caused the Great Financial Crisis were adopted as remedies for that crisis.

	Cause of 2008 crisis	Response to 2008 crisis
Artificially low interest rates	✓	✓
Lax lending standards	✓	✓
Moral hazard for lenders	✓	✓
Moral hazard for financial institutions	✓	✓
Regulatory encouragement of risk-taking	✓	✓
Non-enforcement of regulations	✓	✓

CONCLUSION

US policy-makers had the ability to understand the cause of the catastrophic financial crisis of 2008 but have chosen not to pursue that understanding. Given the explanations propagated by the media—and encouraged by the moral imprimatur of the Financial Crisis Investigation Commission—it is likely that if you ask most Americans why the crisis occurred, you will be very unlikely to get a response that mentions government policy, misregulation, overregulation, moral hazard, perverse incentives, or easy money.

Learning was of the utmost importance, to make sure such a crisis wouldn’t happen again. Kaufman (2016, p. 24) explains how “attempts to identify the true causes of the crisis, in order to design and adopt appropriate corrective policies, are the necessary step to breaking with the past.” Wallison (2016, p. 99) cautions us against bad learning: given the popular narrative of the crisis (that the private sector was to blame), “it is likely that the same policies will be adopted again”; that is indeed what we have seen. Barth et al.

(2016b, pp. 399, 409) bluntly concluded that the federal government misdiagnosed the causes of the crisis, focusing on the wrong factors, such that several major reforms are unlikely to improve the financial system; “by not rigorously dissecting the regulatory and supervisory failures, reform efforts have been materially incomplete” (ibid, p. 409). Allison (2013, p. 3) concludes that “unfortunately, both the popular press and many academics have provided arguments that lack basic understanding, ranging from the simplistic greed on Wall Street argument to the idea that complex derivative instruments caused the crisis.”

Because of this lack of learning, the reforms have been universally flawed. Allison (2013, p. 6) fears that “almost every governmental action since the crisis started, even those that may help in the short term, will reduce our standard of living in the long run.”

The sad result of the lack of concern for the truth behind the financial crisis is that it is only a matter of time before history repeats itself. Because of the political success of keeping Wallison’s explanation away from the general consciousness, and the absence of honest debate regarding opposing views, politicians are free to continue pursuing dangerous and counter-productive regulatory and monetary policies.

The only lesson to have come out of the financial crisis of 2008 seems to be that no lessons were learned. Science has been politicized and the US is stuck in an idea trap.⁹

NOTES

- 1 There is some disagreement in the literature on whether monetary policy was a primary cause or an accelerator of the crisis. Wallison (2016, p. 91), argues that low interest rates accelerated, but didn’t cause, the housing bubble, because the Shiller Index of housing prices was already higher in 2000, before the Fed decreased interest rates aggressively, than it had ever been. However, Horwitz and Boettke (2009) place blame squarely on the Federal Reserve as a root cause of boom and bust cycles. Likewise, Allison (2013) lists monetary policy as the “primary cause” of the crisis (with the FDIC as a “background cause” and government housing policy as a “proximate cause”). Regardless, the Federal Reserve provided the fuel.
- 2 In this paper, we adopt an admittedly Austrian approach (see Ebelling 2014). A parallel theory, which we might call neo-Georgian (after George ([1879] 1979), points to the fixed supply of land, and real estate speculation, as the major cause of recessions (see Harrison 1983 and 2010, or Gaffney 2009). While this explanation has compelling elements, we find it to be incomplete, as it does not examine financial markets and malinvestment from expansionary monetary policy. We thus point to a “Georgist-Austrian” synthesis, to complete the insights of Austrian Business Cycle Theory (see Foldvary 1997, 1998, 2007).
- 3 White House Archives, “President George W. Bush: Record of Achievement.” The White House. Accessed May 10, 2016. <https://georgewbush-whitehouse.archives.gov/infocus/achievement/chap7.html>.
- 4 As a simple, but revealing example, the Privacy Act punishes banks for sharing customer information, while the Patriot Act forces banks to share customer information with the federal government—these Acts are quite literally contradictory, and banks are caught in a catch-22, which allows for selective regulatory enforcement (Allison 2013, chapter 13).
- 5 One could also argue that market discipline would be better than regulation in general. The point here is that the regulation in place during the bubble (a) created perverse incentives; and (b) was not applied completely.
- 6 Of course, the Fed is technically independent. However, the sitting administration (and Congress) can (and do) put pressure on the Fed and coordinate economic policy with it.
- 7 Note that we are not arguing that bankers and other speculators were not greedy during the heady days. Of course many were! But greed has always existed; without the moral hazard of government subsidies and implicit guarantees, the market participants would have seen their greed tempered by the market discipline of potential loss. The “greed explanation” is thus unhelpful.
- 8 “How the Sugar Industry Shifted Blame to Fat,” by A. O’Connor, The New York Times, September 12, 2016, <http://nyti.ms/2cynHOS>. See also O’Keefe et al. on sugar industry funding of anti-fat research.

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