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UNIFIED OR DIVIDED GOVERNMENT?

REBUTTAL

CUTLER: Richard seems to think the public wants a divided government in order to get more services from government without paying for them. I wonder where Richard would have been if Mr. Nixon had won the majority in the House and the Senate, which he tried desperately to do, or if Ronald Reagan had won the majority of the House and Senate, which he certainly tried desperately to do, and George Bush also tried. Would Richard now be saying that the government's performance would have been better under a divided government than under a unified government?

He switched gears very adroitly, I thought, when he said that the public is getting what it wants on most issues by opposing legislation that would tax them very highly, while still favoring legislation to get as much of the pie as they can. He ignores that the public, rightly or wrongly, deeply dislikes these deep deficits. He forgets what the public wants and says instead that deep deficits are good for us, even though every President and every congressional leader has said they are bad, and has come up with his own ideas on how one might reduce the deficit. He says that was just a scam because the administration wanted these deep deficits in order to hold expenditures down. At that point I fell off the sled. The deficit is clearly a terrible brake on our economic growth and has adverse long term effects on inflation—a cancer. Our future generations will pay for it. I will not argue those points. But think of the brake the deficit is on doing things we *need* to do when the time comes to do them.

We have the greatest opportunity of any time for the United States, that any lover of freedom could have imagined, in what has happened in the last year or so in eastern Europe. If there was ever a time for a Marshall Plan or some other form of vigorous support for the new governments of eastern Europe, the time would certainly be now. We are constricted in doing this because we have a deep deficit.

Divided government also frustrates us when the United States tries to assert a particular foreign policy, as in Central America. How can one say that a divided government really helps? I am not arguing that our President's policy or the former President's policy in Central America is right or wrong, but nothing could be worse, I submit, than for the President to be doing one thing, and the Congress check-mating him or undo-

ing his deals. Certainly in an interdependent world we can only govern by making agreements with other governments on security and economic issues. Making agreements with other governments is an extraordinarily difficult thing for a divided government to do.

EPSTEIN: Let me take Lloyd's points in order. First, I fear that he is under the mistaken impression that I am a Republican, when the truth is, that I am far more of a maverick that finds he has almost as little in common with a Republican administration as he does with a Democratic administration. But I will put that point aside and assume what is not the case, that I am a solid and consistent supporter of the Republican party.

Even if that were my political orientation, I should be in favor of a divided government. If you have a unified government, you put your eggs all in one basket. To the extent that one should be risk averse about government, then your highs when you are in power will not offset your lows when you are out of power. Assuming, therefore, that I was an ardent defender of the Reagan Administration, its highs could not offset the truly dramatic lows of a Dukakis presidency and a Democratic Congress. By taking a fifty percent chance on each of these two alternatives, the expected value, given risk aversion, is always negative. My good guys could not help me as much as your bad guys could hurt me. So as a matter of principle I would stick to my support for divided power even if I had to forego the lush years in order to avoid the lean ones.

The second point concerns people getting what they want. It seems to me that they generally do. Yes, they really want the deficit, and their talk to the contrary comes cheap. One of the points that you learn most from the study of economics is that what really matters is *revealed* preferences and not verbalized preferences. The people who manage to speak endlessly about the deficit will always give you wrong explanations as to why it is important. How do I know that? Because I have heard two wrong explanations from Lloyd Cutler in the past three minutes. His explanation is plain wrong as economics.

First, he is surely correct that there has been a government paralysis in foreign affairs, but it is not attributable to the deficit. It is attributable to the fact that we spend beyond our means. If it turned out that we had no deficit and higher taxes, we would be every bit as strapped in trying to do something overseas. It is the total level of government expenditure, not the sources of funding, that saps our strength.

If you want to do something to counteract this problem, I will make some suggestions as to proper targets. Let us first take a Republican target: Wipe out all the farm subsidies from *A* to *Z*. That will free up a lot of money. But I am nonpartisan, so now we should take on some Democratic target: Knock out the entire budget for HUD. In addition, we might go after that ongoing Ponzi scheme, which gains false respectability under the name of Social Security. Reform should surely be possible there. But wherever we start, it is mistaken to make the constant refrain that the deficits are the problem when the major issue is wasteful government programs, which no one has the political will to cut.

Second, what are the long term effects of the deficit? Sometimes it is said to be inflation, but that, too, is wrong. The question, again, is the rake-off that the state takes off the top. It is the difference between the total return that individuals can make on private investments, and the fraction of the investment that we can keep after government intervention. The size of that retained portion will be a function of the sum of taxes and deficits, and the mix between the two will be very much a second order effect. If you want to induce private investment, then you have to create institutions which preserve private returns on that investment. Generally, that means that only systems of taxation which return benefits in public services in excess of costs will work well; systems of transfer taxation in the name of redistribution will not.

These mistaken domestic decisions have their consequences in the realm of foreign affairs. Our government spending programs have been so eternally foolish that they have systematically eroded our productive base so that we just do not have the muscle, military or economic, to wield the influence that we once had in world affairs. The only way to reverse that trend and return this country to its level of greatness is to foster the development of its human capital and to get rid of this afflictive set of political institutions that hampers production at every stage.

Whenever someone talks about some social legislation as doing good, then they must be reminded that they cannot bask in the glory of redistribution *ex post* without regard to production *ex ante*. Redistribution after the fact means that there will be less to redistribute. I shall take something from you and you shall take something from me, but we will not end up as well as we started because we have to incur the deadweight economic losses necessary to secure these socially useless transfers.

In his praise of unified government in foreign affairs, we have the same problem of evaluation that we have in domestic ones. Lloyd talks only

about the good outcomes and ignores the bad ones. We had well nigh perfect unanimity in the early days of the Vietnam War, and it got us into no end of trouble. You cannot look at isolated examples to test the soundness of institutional arrangements. You have to look at the full market basket of transactions before making a choice. Unanimity may well induce a President to have the illusion of world power that could be an open invitation to political calamity.

QUESTIONS AND ANSWERS

MURIS: We are going to take a few questions. First, I want to note that if one were to take Richard's words of how awful the results of government have been over the last twenty-five years, one also has to note that for most of the last twenty-five years we have had a divided government.

EPSTEIN: But we have had the wrong constitutional regime in place for the whole period.

MURIS: Let me discuss the deficit and ask a question about how we got into this situation. Nineteen eighty-one was the crucial year in which important legislation passed, and it was not a year of divided government, unless you throw the Fed in. In 1981 the Republicans controlled the government; they controlled the White House; they ruled the Senate; and they had de facto control over the House.

Another crucial year was 1987. I was one of those involved in the budget summit negotiations after the stock market crash. One Friday afternoon leaders of the White House and of Congress were in a room. Some proposed the "two percent solution" which, among other things, would restrain Social Security cost of living allowances to two percent instead of four percent a year. There appeared to be a majority of support for the proposal, although there was some opposition. But the support and opposition had nothing to do with divided government. The problem had to do with whether one faced a close election in 1988, as did many members of both parties.

Thus, to just cite these two examples of budget history, divided government was not the problem.

CUTLER: Well, on Richard's theory, deficits were good for us. In 1981 we *did* have divided government. We had a House controlled very

strongly by the Democrats, while the Republicans controlled the White House and the Senate. We had a situation, and we have had it ever since, in which no elected member of the government could be held accountable. Everyone had his own solution for how to bring about a lowering of the deficit—everyone from the President on down. Everyone was saying quite fairly, “It is not my fault, it is those other fellows who would not go along with me.” That has been the record of the government from 1981 on—to blame the deficit on the other fellow. We do it to you, you do it to us.

EPSTEIN: Let me put aside the particulars of any given election, and explain my general point of view, Lloyd. Basically, I am in favor of small government, in which the question of unification or division turns out to be less important. Social Security is again the perfect illustration. The basic theory of government, as I understand it, holds that whenever you exert public power, you want to keep property rights as definite *after* its exertion as they were before it. The sole justification for intervention is to enhance the value of individual holdings across the board. Social Security works in the opposite direction. In effect it takes huge amounts of wealth, places it into a large pot, and says that it will always be up for grabs, always up to the political process to decide who gets what from the pot. There is no principled effort to define individual entitlements to the fund. At this point political coalitions will break out on every front. It will not be simply Democrat against Republican. There may be conflicts that pit districts with lots of families with small children against others which have many retired or elderly people. There is no principled way to resolve conflicts over who gets what.

A divided government may help solve this problem, say five or ten percent of it. But the record on this issue is so bad because the system was introduced in 1936 or 1937. Then, when it was possible, the government should not have proposed a short term fix because it results again in a Ponzi scheme, which if practiced by ordinary private pension funds would result in many people going to jail. In order to see the magnitude of the error, ask yourself how the political and economic landscape would look if all persons, including the elderly and retirees did not have Social Security, but had invested their money into a range of pension plans that allowed each to adopt the investment strategy or mix of investment strategies of his choice. Under that regime there are no pitched battles because there is nothing up for grabs in Washington D.C.

You are looking at the wrong point if your first line of attack is to ask about united or divided government. The right question to ask is how much government, and to what ends. If there is too much government, and if it serves the wrong ends, then divided government is at most a welcome, but modest counterweight. It will help curb some mistakes, but it will never return the situation to anything close to the ideal situation.

My justification for divided government is second best. A first best justification requires much more fundamental reconsideration. As an outsider, sacred cows like Social Security are not particularly sacred—however difficult the situation is to correct in midstream—but within the beltway my career is over.

MURIS: Richard, let me ask you about the deficit. Regarding what happened in 1981, the common view now is that it was either planned or the Reagan Administration was a victim of its own faulty economic assumptions. But at the time no one predicted that the recession was going to occur. The Administration's economic assumptions—the so-called “rosy scenario”—were rosy on growth, but on inflation were much, much more realistic than virtually all private economists. For complicated reasons, the two effects were offsetting. Thus, even if one had used the assumptions of private forecasters we would have ended up with large deficits. This mistake explains the problem of why the American people do not like deficits, but we can not get out of them. The American people do not like the deficit and would not have willingly supported its creation. But when you ask them whether they would raise taxes or cut spending to end the deficits, they cannot agree. Assuming this scenario is true, does it bother you? When we make mistakes, would it not be easier to remedy them with a unified government?

EPSTEIN: Again the full answer requires you to take into account the problem of risk aversion. If you know what you are doing, it is a lot easier to get out of a mess in a system of unified government. But if you do not know what you are doing, it is a lot easier under unified government to get into a deeper mess than you were before.

There are enormous questions of how anyone can “run” a massive economy. Here, again, one problem with the Federal Reserve is that whenever it has discretion to vary the size of the money supply, and through it the rate of interest, there is a risk that it will work an implicit redistribution of property rights among individuals. The value of stocks

and bonds is thus subject to heavy influence by government action, and the instability, unless checked, could sharply reduce value because of public risk aversion. Again, fundamental reforms are often in order. You have to find a way to make control of the money supply relatively independent of political action, as by tying it to some objective measure like the expansion in the gross national product or the price of some market basket of goods and services. The issue here has structural similarities to Social Security. Public discretion creates indefinite property rights, which lead to destructive political jousting.

CUTLER: Well Richard, do you want a certain number of substantive legislative policy changes? You may very well be right. You are a professor; you are not a politician.

EPSTEIN: Okay, is that everything?

CUTLER: Politicians have to face the problem, even if they agree with you on the right policy, of how do you get it done? Can you get it done better with a unified government or with a divided government? If you agree with Ronald Reagan's ideas about shrinking the government, would you have been *against* electing a Republican Congress or *for* it? I am a Democrat. I disagree with a lot of those ideas, but I would rather see him have a Republican Congress so that if the results turned out as I think they would have, he and the Republicans would have been held responsible. Now nobody is responsible. Or would you hold all of us at fault?

EPSTEIN: No, I think that a lot of people turned out to be responsible. I think that if you have a complex government structure there will always be, in a sense, "no one responsible." Even if you cannot point the finger of blame at the opposite party, you should be able to identify some particular faction or interest group that has held things up. So I do not think that one can ever avoid the problem of uncertain accountability even with a single party. But Lloyd, there are also two ways to look at the overall situation.

CUTLER: And each of those interest groups contributed to both parties.

EPSTEIN: And they do so for a reason: Because dual contributions, that is some to each party, are the way to maximize political influence, once it is realized that the first dollar that is contributed to the Demo-

cratic party is worth more than the last dollar that goes to the Republicans. It is another implication of public choice theory that no private interest group will ever allow itself to be kept wholly divorced from the party in political power, because it has too much to lose when it remains outside the political orbit.

If I were in the political arena, then, these are the rules by which I would play. But there are two Richard Epsteins: Richard Epstein, the political participant, and Richard Epstein, the system builder. In this debate the focus should be on me in my second role of system building. What I hope to see happen to American politics will not happen in the short run, but it is worth working for in the long run. It is to create a system in which the size of the stakes that turn on the choice between unified and divided government will shrink, and that can be done only by limiting the discretion of political actors by keeping strong barriers against political conduct in place.

But if you are asking me what I shall do within the political system if I am unable to make structural political reforms, then I will maximize private welfare as does everyone else. As we are caught within a prisoner's dilemma game, I shall seek the unified government that works to my interest just as you shall seek the unified government that works to yours—if unified government is the order of the day. In the end, if both of us succeed from time to time, then we shall have flip-flops in power. When that happens there are sharp shifts in policy within a short period of time. But if we had to seek our self-interest within a framework of divided government, then it is more likely that we should get stalemated, which on balance I prefer to the flip-flops.

But again, I think that the most fundamental step is to rethink the basic functions of government. To put it another way, what is wrong with *Lochner v. New York*,¹ putting aside the current law and treating matters as one of first principle? Does it not represent a principle that we should entrench tomorrow if we were capable of doing it? Is not the right solution to keep the federal government out of labor relations altogether? Would you work with me, arm in arm, to that end?

CUTLER: Should we make a move to amend the Constitution to do it?

EPSTEIN: No, no.

1. 198 U.S. 45 (1905).

CUTLER: If we could garner 218 votes in the House we could change the labor statutes.

EPSTEIN: No, no. I do not want to address the short term political question. It is the issue of principle that comes first. I refer to the productive loss of the American labor force by virtue of what happens under the EEOC, the NLRB, and the Fair Labor Standards Act. These statutes represent massive drains on the overall operation of the economy. They are perpetual liens on the economic system whose importance far outstrips that of some nitpicking decisions made by the Federal Reserve in 1981.

CUTLER: But if you want to change modern legislative policy you have got to get the votes to do it. How do you do that with a divided government?

EPSTEIN: You can not. You can not even make these fundamental changes today with unified government. You are, or perhaps I am, just dreaming. On these matters there is too much at stake, and inertia will dominate.

QUESTION: Professor Epstein, how does a member of Congress fulfill his constitutional obligations and yet, as a matter of political reality, can he still fulfill constituency requests?

EPSTEIN: Within the system as it now stands, there is absolutely nothing that I can tell any congressman to do that differs from what he already does. If a congressman is concerned with public service obligations, like keeping an army so that the nation will not be invaded, and with local pressures, like getting a new army base for his own district, then the congressman will have to balance those two imperatives as best he can and face the perils of re-election. As far as I can see there is nothing that either unified or divided government can do to solve that question. The best that could be done, at a more fundamental, structural level, is to change the kinds of demands that constituents can make, by putting certain redistributive requests out of bounds, which is very hard to implement with defense issues.

The fundamental changes may be more important on other issues. Thus, unified government did lead to the mistakes of the Great Society, which, with a burst of enthusiasm, put major pieces of legislation in place, and we have paid the price for its consequences. But if the question here is, how should a congressman do his job, I do not have much to

say. They are a bunch of professionals who know their jobs. I have never thought that I had the temperament, personality, or aptitude to allow me to do their job, *ever*. But if you change the reward and incentive structure of public service, than different types of people will go into political life. But that will not change unless the federal government ceases to be that huge bag of water that everyone hopes to suck dry, even though all in the end suffer from the process.

QUESTION: Professor Epstein, can you assess the impact of your argument for separated powers on state government?

EPSTEIN: Well, I think that you seriously have to ask what types of constitutional limitations are imposed on state power. I would breathe new life into the fourteenth amendment, into privileges and immunities, and into the original contract clause. In addition, I would continue to stress the importance of the one useful, if somewhat doubtful, constitutional doctrine, that associated with the negative or the dormant commerce clause. I do not know how the negative clause developed from an affirmative grant of power to Congress under article I, but it is an important doctrine that should not, now that it is in place, be frittered away.

I might add a word about the fourteenth amendment before it became twisted in the courts. Essentially it was designed to see that there was *less* government by the states than there was before its passage. It provided for no new federal powers of independent regulation, but only gave the federal government power to see that the states did not overstep their legitimate powers. In a sense I view it as a close parallel to Marshall's dissent in *Ogden v. Saunders*,² which would have given the contracts clause prospective application, for that is what the protection of the freedom to contract does, or would do, under the fourteenth amendment.

Taken as a package, if there was a strong system of eminent domain protection against state regulation, and a powerful and unconditional system of exit rights, then one could limit the power of the state to undermine trade and commerce by perhaps seventy or eighty percent. But I doubt that one can do better than that, even as a wide-eyed idealist. One of the things that public choice theory makes clear is that institutional safeguards against redistribution and rent-seeking do not come cheap. The optimal system of government may have to tolerate a certain level of local abuse and expropriation, not because it is a cardinal political virtue,

2. 25 U.S. (12 Wheat.) 212 (1827).

but because there are some political evils that can be eliminated only at the cost of greater inconvenience.

QUESTION: Mr. Cutler, I was intrigued by your call for a Marshall Plan for Eastern Europe. You seem to want the United States Congress to do for them what it has done for us. I am anxious to know how you would go about picking those industries to reward and those not to reward. Would you set up boards here in Washington to certify their industries for them?

CUTLER: I have heard it said tonight that almost every major piece of New Deal, Fair Deal, and other domestic legislation has been a disaster for us. I did not know there were people around who thought the Marshall Plan, the original Marshall Plan . . .

EPSTEIN: Oh yes, there are!

CUTLER: . . . was a disaster. Maybe they think so because we have so many Mercedes-Benz and BMWs in the country. But I think it is off the subject we are on. Let me say only that while it is going to take a long while before the east European states figure out how to put in a market system where a state system existed before—and there are very few economists who know how to do that—there are measures of assistance that they seriously require: an eastern European development bank, such as the European Economic Community has put together, and to which the United States is a very reluctant and small contributor at the moment; direct investment guarantees; and many of the things that were done in the Marshall Plan.

Some of those countries are not yet in a position to develop that kind of economy, but Hungary certainly can. It has its greatest export crop, its economists, who have risen to the top in virtually every western economy. Czechoslovakia certainly can. There is help that can be given, that we are constrained by our deep deficit and our own problems from giving today, at a moment of enormous opportunity. We have an opportunity that is almost embarrassing to us because we are just not ready to take it.

EPSTEIN: May we never seize it. I do not think that it is the deficit really.

CUTLER: We will send them Professor Epstein.

EPSTEIN: The first rule of foreign aid is to be sure that the State Department has no say whatsoever in the distribution of funds. To give the State Department a role is to render aid from government to govern-

ment, and thereby, to begin anew the cycle of top-down planning. It will dissipate twenty, thirty, forty percent of the gains achieved so painfully to date. What should be done is to insure that private banks can form whatever consortiums they choose, lend to whatever individuals they want on whatever terms and conditions they see fit—without, of course, government guarantees.

The only way in which these banks will be prepared to make loans is, as Frank Easterbrook keeps reminding me, if the countries to which the loans are made have convertible currencies that will make foreclosure and sale of the mortgaged property possible. The odd point is that, by encouraging a regime of private lending only, foreign governments will have to reform their laws and the currencies in order to attract outside capital. I fear that Lloyd Cutler is arguing for a situation in which we may bring our own systems of price controls, as with oil and gas, to the folks in Hungary and Czechoslovakia. I can not think of anything more ruinous than to give them that sort of advice.

What do I think about the Marshall Plan? Well, there is this distinction, at least. One weakness in laissez-faire theory is that it does not do well by pure public goods. There may well have been some justification for loans to build up the government infrastructure, which had been destroyed by war, and that might have justified some parts of the Marshall Plan. But I do not think that precedent justifies any of the more grandiose schemes that Lloyd supports. Maybe there is yet another argument for divided government. It may be less likely to make economic mistakes in foreign affairs.

QUESTION: Mr. Cutler, this question is directed to you. What should be done with monetary policy? It was monetary policy that created the Great Depression and led to the New Deal. It was monetary policy that led to the big deficits we have now. Should monetary policy be totally under the control of the government or should it be a separate power with no accountability?

CUTLER: I am not an economist, and I will be glad to talk to you about it afterwards, but that question takes us very far afield if we get into whether the Fed ought to be independent or under the control of an elected President. The point that I am trying to make is that to change government policies, which most of us, the majority of us disapprove, you have to have the political muscle to pass laws, and you have to be able to hold somebody accountable for the bad laws and vote them out of

office. Divided government blurs accountability and makes it virtually impossible to do that. When divided government continues, as it is continuing, it is very hard to change the status quo—we have demonstrated that over the last nine or ten years.

EPSTEIN: On monetary policy, the vast deflation that we had in the 1930s worked, in effect, an enormous implicit redistribution of wealth from debtors to creditors, and resulted in all sorts of foreclosures, mortgage moratoria, and bank failures. Second best remedies, such as moratoria, will not work because they will simply create new defects in other, related private markets. What you have to do is keep a reasonably stable currency, by which I do not necessarily mean a constant dollar, but a predictable and uniform rate of inflation.

But to return in closing to the question of divided government. The difference between Lloyd and myself is that he has faith that, on balance, government projects have net positive expected utility. My view is that his is not an accurate account of the way the world works. The first government project, that is, maintain some semblance of public order, is probably one that has net positive public utility. Virtually all of the rest hold serious risks of substantial negative utility.

A system of government, a system of divided government, is an effort to help assure that consensus arrangements, those with high expected utility, get through when other more dubious projects fall to the ground. That requires a three part program. There must be jurisdictional limitations on the power of government. There must be protection of individual rights of property and liberty. And there must be separation of powers. We have only shreds of one of them left today—separation of power. We are living, therefore, in a world with an inferior constitutional design to that which was our constitutional legacy. May James Madison rise again.

