

CENTER ON CAPITALISM AND SOCIETY

COLUMBIA UNIVERSITY

<http://www.capitalism.columbia.edu/>

Working Paper No. 70, April 2011

Rules vs. Discretion: The Judicial Alternative

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The object of this paper is analyzing the use of judicial decisions to apply the balance between rules and discretion in financial matters. At the same time Judges can control the excesses of discretion and provide a debate for the changes of rules. The starting point of this paper is the idea expressed by John Taylor that established rules are preferable to administrative discretion as a way to avoid financial, and other, crisis.

In a recent paper that gave the foundations to my own, John Taylor indicates: *At their most basic level these policy rules are statements about how government policy actions will react in a predictable way to different circumstances. They can be stated algebraically as in many monetary policy rules such as the Taylor rule, which says that the short term interest rate should be set by the central bank to equal one-and-a-half times the inflation rate plus one-half times the GDP gap plus one. (page 3)* But, of course, a rule does not have to be viewed as mechanical formula to be used rigidly. This brief review demonstrates that, from my perspective, the rationale for using rules over discretion in formulating macroeconomic policy is an economic one.

The word “balance” emphasizes that the ideal of a pure rule, without any discretion, is a theoretical abstraction. Evidence of the swing away from discretion is seen in actual fiscal policy and in the wide consensus among economists against the use of discretionary countercyclical fiscal policy in the 1980s and 1990s; it is also seen in the efforts to make monetary policy predictable and transparent, including through the use of inflation targets and actual policy rules for the instruments. The swing back toward discretion is found in the recent large discretionary fiscal stimulus packages and in deviations of monetary policy from the simple rules that described policy well in the 1980s and 1990s. ²

And Taylor quotes a reference in favour of rules as an advantage to discretion that goes back to Hayek: *Hayek wrote in The Road to Serfdom (1944) in favor of rules rather than discretion as essential to limiting government and protecting individual freedom. His concept of a policy rule is quite similar to what I just described, but the motivation for that concept is much different: political rather than economic.*

Hayek *The Road... Chapter 6. Rule of Law. “Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand – rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge.”*

To Hayek, predictability was an important characteristic of policy rules: “If actions of the state are to be predictable, they must be determined by rules fixed independently of the concrete circumstances which can be neither foreseen nor taken into account beforehand...”

This view goes against the traditional ruling that in the case of economic and other crisis; administrative discretion should be more widely accepted, even at the expense of the curtailment of

² John B. Taylor. **Swings in the Rules-Discretion Balance.** Prepared for the session “The Individual, the Market and the State: Rules vs. Discretion in Economic Policy” Conference on the Occasion of the 40th Anniversary of *Microeconomic Foundations of Employment and Inflation Theory* Columbia University. November 2010.

constitutional rights. On the contrary rules and legal institutions should be applied exclusively in 'normal' times, if those times really exist. This normative doctrine was a consequence of the Depression when the U.S. Supreme Court accepted a very wide concept of administrative discretion. The cases *Home Building & Loan Association v. Blaisdell*, 290 U.S. 398 (1934)³ and *West Coast Hotel*⁴ in the '30s, started this trend that could be hastily resumed as this: in moments of crisis Congress and the Administration know better and we should not limit their action within certain very broad constitutional limits. Particularly in the case of financial matters where the delegation of legislative powers in the Federal Reserve as is made in central banks in general, is virtually limitless. For example in his classic book on the matter 'Administrative Justice in the United States' Prof. Peter Strauss has a chapter on 'Contexts for regulation' where he describes formal and informal rulemaking by Federal agencies of the United States, in all possible subjects and where financial regulation is not mentioned at all.⁵

Rules and Innovation.

Rules do not hinder innovation; on the contrary they are part of it. However fantastic the innovation, creativity depends on the underlying structures and accumulated knowledge of the domains in which the creator builds. Rules are as much a part of a play as freedom. Play, as Renaissance creators understood, is a balance between stability and novelty, between enabling structure and out of control creation. It

³ *Home Building & Loan Association v. Blaisdell*, 290 U.S. 398 (1934), was a decision of the United States Supreme Court holding that Minnesota's suspension of creditor's remedies was not in violation of the United States Constitution.

⁴ *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937), was a decision by the United States Supreme Court upholding the constitutionality of minimum wage legislation enacted by the State of Washington, overturning an earlier decision in *Adkins v. Children's Hospital*, 261 U.S. 525 (1923). The decision is usually regarded as having ended the period when the Supreme Court applied strictly the economic due process of law

⁵ Peter L. Strauss. *Administrative Justice in the United States*. Carolina Academic Press. Durham 2002. P. 152.

is not wilderness, not chaos. ⁶ In the case of dynamist rules they protect criticism, competition and feedback, they allow the freedom to challenge established ideas and the freedom to offer alternatives. Assuring that dynamic, evolving systems have no guaranteed or permanent winners. ⁷

⁶ Virginia Postrel. *The Future and its Enemies*. Touchstone. New York 1999. P. 177.

⁷ Virginia Postrel. *The Future and its Enemies*, p. 137.

The economic theory of regulation.

Taylor continues in his paper describing the economic theory of regulation and indicating there is an unstable balance between rules and discretion.

The Swing in Balance in Favor of Rules

The general shift toward rules-based macro policy in the 1980s and 1990s is evidenced in various ways. First consider monetary policy. One indication is the increased popularity of inflation targets, either informally as with the Federal Reserve, or more formally, as with the Bank of England.

Additional evidence of a rules-based policy was the move toward a more predictable and transparent decision-making process with a focus on expectations of future policy actions. The Fed started announcing its interest rate decisions immediately after making them. It also started explaining its intentions about the future.

Next consider fiscal policy. In the early 1990s cyclical movements in the budget deficit were dominated by the automatic stabilizers. In a paper in 2000, I concluded that "in the current context of the U.S. economy, it seems best to let fiscal policy have its main countercyclical impact through the automatic stabilizers....It would be appropriate in the current circumstances for discretionary fiscal policy to be saved explicitly for longer term issues, requiring less frequent changes."

Another measure of the benefit of the more predictable behavior was the response of the private sector. Recognizing that the central bank's interest rate settings followed more rule-like responses to inflation and real GDP, the private sector took these responses into account in projecting future variables and in developing their own rules of thumb for making decisions.

The private sector and other public sector institutions developed rules of thumb that depended on the rule-like behavior of the monetary authorities. These rules of thumb improved the operation of the economy.

The Swing in the Balance in Favor of Discretion

In the past few years, there has been a dramatic shift back toward discretionary macroeconomic policy.

My research shows that a higher rules-based federal funds rate would have prevented much of the boom and bust.

Was It Simply an Emergency? *One explanation for the shift back to discretion is that the financial panic of 2008 and the Great Recession were so large that they required the large discretionary packages; the unprecedented actions were necessary because of the emergency. But the first three items on the list of discretionary interventions were taken before the panic in the fall of 2008.*

This is a common problem in decision making, as Milton Friedman pointed out many years ago in a debate with Walter Heller (1969) over rules versus discretion: “The available evidence...casts grave doubt on the possibility of producing any fine adjustments in economic activity by fine adjustments in monetary policy – at least in the present state of knowledge...There are thus serious limitations to the possibility of a discretionary monetary policy and much danger that such a policy may make matters worse rather than better...The basic difficulties and limitations of monetary policy apply with equal force to fiscal policy....Political pressures to ‘do something’ ...are clearly very strong indeed in the existing state of public attitudes. The main moral to be had from these two preceding points is that yielding to these pressures may frequently do more harm than good. There is a saying that the best is often the enemy of the good, which seems highly relevant. The attempt to do more than we can will itself be a disturbance that may increase rather than reduce instability.”

Rules vs. Discretion.

Finally Taylor raises the conflict between the importance of rules in monetary policy, which is the case for ‘strong scientific evidence’ and how political pressure won the day.

Bernanke and Mishkin (1992). Their paper raised doubts about the use of rules for the policy instruments and made the case for using a considerable amount of discretion in monetary policy making. They said that “Monetary

policy rules do not allow the monetary authorities to respond to unforeseen circumstances."

One question about this explanation is how the politics can cut through the economics. In other words, if the economic case for rules-based policies was so strong and convincing, how did it lose out to political pressure? One way is through what I call "discretion in rule's clothing." One interested in a discretionary policy move might argue that the traditional policy rule has become outdated, or was wrong in the first place, and needs to be changed. One can justify just about any discretionary intervention in this way.

When policy rules become highly complex and hard to explain, they are likely to shift the rules-discretion balance toward discretion. But more research is needed on this possibility. The political explanation is based on the rationale for rules as a way to limit government and protect individual freedom. Though not a factor in the research on policy rules described in the previous paragraph, including my own research, it may have been a force moving toward rules in the 1980s as attitudes toward government changed. It too is less straightforward as an explanation of the swing back toward discretion, because the swing started before the obvious political realignments in early 2009. It requires that some other event – perhaps 9/11 – changed attitudes about role of the individual, the market and the state. More research is needed on this possibility too.

The point raised by Prof. Taylor is not exclusive of economic policy. The conflict between rules based on scientific evidence versus discretionary policies is pervasive in all administrative regulation. I feel that the solution is the same used to limit discretion in administrative regulation, although is rare in financial matters, the judicial control of administrative or political discretion. Particularly we can explore the possibility of using regulation through litigation in economic and financial matters.

The judicial control of administrative discretion.

There is a vision of the philosopher king that had a remote origin in Plato and it had an introduction in economic theory by Keynes: that a group of gifted, patriotic officials could by their sapience and acting rapidly in discretion could solve all the problems. This is nonsense. A Public Choice answer comes rapidly to the mind, simply by reminding us of the agency problems, the conflict of interest between this group of sages and the 'public interest'.

But rules need to be debated and eventually changed. The proposed alternative could be the debate between the interested parties in front of a judge using a formal and established procedure. This process for the creation of rules has been called dialogical by Jürgen Habermas.

Is this a question only applicable to the division of powers in three different branches of government as is in the American Constitution? Apparently not, the Conseil d'État, France's ultimate court of administrative review, that seems to suggest a quite different view: namely, that even where formal separation of powers claims are weak or nonexistent, the differences between a specialized agency on the one hand, and any generalist, multimember, complaint-activated reviewing body on the other, will produce not only deference but degrees of deference that vary with the character of the challenged component of the agency decision.

In spite of the lack of separation of powers are missing, many of the themes of deference to expertise, fact-law-policy distinctions, and so forth that are so prominent in United States law appear in France.

French administrative law has the same “project” as our own, “control of illegal and abusive discretion.”⁸

Three features catch the eye immediately: like federal courts, the Conseil is generalist, multimember, and reactive, reviewing only at the instance of complaining parties. For the federal courts, of course, the last feature flows from the case or controversy requirement and thus in part from separation of powers.

The generalist is obviously at a disadvantage against a specialist on the latter's turf. The assumption of agency “expertise” may be a source of innocent merriment in academic analysis of agency-court relations, but agency staffs typically are expert even where agency heads are not. Particularly in scientific matters, but even in technical financial matters, a panel of generalists must at a minimum invest a great deal of time to reach a confident conclusion that the specialists erred. Thus, scarcity of resources in the reviewing body, particularly time, compels a degree of deference. It inclines the reviewers to concentrate on the issues that keep coming back to them, such as procedural requirements and broad aspects of substantive law, but not the more interstitial ones often characterized as application of law to fact. On the recurrent issues, the return on investment of effort will be greatest.

Working in panels, as judges do, also militates for deference--it blurs edges and discourages the taking of any strong line. This is just the flip side of the framers' provision for a unitary executive. As the concentration of responsibility in a single person permits “energy” in the executive, its diffusion in a panel saps energy. Even when administrative authority is vested in a multimember agency, at least the possibility of presidential influence may save the potential for vigor.

The many-headed character of a review panel is most obviously disabling when an issue involves allocation of agency resources, as do attacks on agency delay or nonenforcement decisions. The

⁸ Stephen F. Williams THE ROOTS OF DEFERENCE Yale Law Journal January, 1991, 100 Yale L.J. 1103

compromises, blurring, and averaging that are common to multiple decision makers--not to mention the inconsistencies that flow from accidents of group decision-making, such as the sequence in which issues are addressed -are at least at cross purposes with the prerequisite of resource allocation: a willingness to "zero out" some worthy projects. Drastic action is uncollegial. Not surprisingly, we find great deference to agencies on matters of timing and a presumption of no reviewability for nonenforcement.

Finally, having a jurisdiction limited to resolving the complaints of affected parties induces deference in the reviewers. Again the issues of agency resource allocation, which lie at the root of most disputes over agency delay or nonenforcement, illustrate the point most powerfully. A president can get an overview of a department's total operations and decide that one set of programs is weak or even counterproductive, while others have unrealized promise. He may err, and the department may well resist his orders, but few will argue that the president has stepped out of his role. Not so for a review panel activated only by the complaints of burdened parties.

Of course, the formally distinct features of the federal courts--constitutional life tenure, the case-or-controversy requirement, and the insulation from other branches and from informal influences--reinforce the predispositions that flow from the attributes fully shared with the Conseil d'État. Why should a body so constituted interfere with an executive agency's policy judgment, except to bring it into conformity with law?

The United States Supreme Court in *Chevron U.S.A. Inc. v. NRDC* 467 U.S. 837 (1984), establishes a now famous supposition that Congress delegated to agencies those interpretive issues that it did not resolve with reasonable clarity seems to rest on a notion that even though such issues are, in a sense, ones of "law," they are also issues of policy. Placing their resolution in the politically responsible executive branch, limits the courts to enforcing what Congress has said (either explicitly or by implication from its explicit language). *Chevron* is the Court's clearest articulation of the doctrine of "administrative deference," to the

point that the Court itself has used the phrase "Chevron deference" in more recent cases.⁹

An agency's order must have adequate underpinnings in fact, law, and policy. The three "modes" of thinking interact. An agency's caution in one domain may require it to extend itself in another, just as a stretch--going to the edge--in one may enable it to occupy safe territory in another. A broad law-policy judgment by the agency might have sustain its rejection of passive restraints despite the frailties of its science, but to chose a narrower view of its mandate would need "stronger" science. Every agency order hangs on a kind of chain, and the challengers naturally go for what they perceive as the weakest link; the court must decide if it is strong enough. The effect is to impute to courts rather fanciful opportunities to choose among modes and thus degrees of deference.

If there are differences between agency and court, but only noninstitutional ones, the answer is similar. Suppose it were shown that judges are smarter than agency heads, or have more time on their hands, or have cleverer clerks than agencies' staff. Even if all this were true, the simple solution would be to replace the agencies' current personnel with those who now serve as judges and clerks, and drop judicial "review." Why not get things right the first time? (This approach is hard to realize in the light of judicial tenure, but for the moment we disregard institutional peculiarities.) That seems to drive us to institutional distinctions as the only justification for having two separate decision-making phases. Finding the courts' role must start with asking about their peculiar institutional traits.

Judicial review's source of legitimacy is to be its contribution to sound governance, its role to serve as an alternative forum for decision making. Of course judicial activism also depends on the ideology of the judge.

⁹ United States v. Mead Corp., 533 U.S. 218, 226 (2001).

What about the conservative judge reviewing a liberal agency's action he or she considers wrong-headed? Does sound governance review invite wholesale nullification of executive actions with which willful judges disagree? Sound governance review would bring the willfulness out into the open, with emphasis on "the personal virtue of self-revelation. The diversity and the independence provided by life tenure and tradition make it likely that the pluralism of political and social life generally will be reflected in the wills of judges.

Courts have a duty in appropriate cases to curb agency lawlessness, and carrying out that duty contributes to sound governance. But just as masons building a cathedral should not supplant the architect, even though both are creating a work of art, a judge should not supplant the politician or administrator though all are seeking sound governance.

DISCRETION or discretion?

All agencies, including the Federal Reserve or Central banks in general, are quite distinct in this respect from, say, a Department of State or a Department of Defense, which exercise a kind of discretion that makes them, as Chief Justice Marshall wrote in *Marbury v. Madison*,

“the mere organ by whom [the President’s] will is communicated. The acts of such an officer, as an officer, can never be examinable by the courts.”

This discretion vested on the President, or by him on the Department of State or the Department of Defense could be called DISCRETION, in capitals since those officials have a *“power of free decision; undirected choice”*¹⁰. But in other cases where federal government agencies are involved the word discretion has a much more limited scope, we can in that case use with small letters just *discretion*.¹¹

For example, such discretion as Congress may have bestowed on the FEDERAL TRADE COMMISSION, as the Supreme Court would in effect insist, could be tolerated only if subject to judicial controls for the legality of its exercise. “For cause” constraints on the removal of one who is, to any significant degree, “the mere organ by whom [the President’s] will is communicated” would present much more difficult issues.

But the Court chose a simpler analytic route. It explained that the FEDERAL TRADE COMMISSION exercised only legislative and judicial powers. Therefore, it was not a part of the executive branch. In a government of three branches that it acknowledged must be kept

¹⁰ Third meaning word “discretion” Webster’s Collegiate Dictionary Fifth Ed. 1941.

¹¹ This game of words is taken of many conversations on the subject with Professor Peter Strauss.

separate, the Court could avoid placing the FEDERAL TRADE COMMISSION in the executive branch only by seeming to have put it simultaneously into both the legislative and judicial branches. Or perhaps it jumped back and forth between the two, depending what it was doing that day? This difficulty commentators, and perhaps for a while the Court, avoided by treating the independent regulatory commissions as elements of a headless fourth branch. But of course that characterization only emphasizes the problems involved in connecting their existence with the Constitution. Now Congress might believe it could create administrative agencies free from the President's responsibility to assure faithful execution of the laws - and the Commissioners of those agencies and others might come to share that disturbing beliefs¹²

Without for a moment wishing to deny that we are better served by judges who do not permit themselves the freedom to enact personal politics,¹³ that the "tenacity" of a taught tradition" and appropriately framed legal propositions purporting to constrain such preferences serve us well, in two notable Supreme Court cases that frame the issues for the judicial relationship to administrative action, *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.* 467 U.S. 837 (1984) and *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto. Ins. Co.* 463 U.S. 29 (1983). The issues these cases address are not new. And in my judgment the cases establish a reasonable framework for appropriate relationship between executive and judicial action.

For many decades, Congress has been assigning the authority to act with the force of law - to create legally binding, statute-like texts and/or to decide "cases" that it might have assigned to the judiciary - to executive authorities rather than exercise it completely itself, or confer the task on the courts. Problematic only at the fringes, these delegations of authority are generally accepted as valid, at least so long as they reserve appropriate relationships between those to whom the

¹² Peter L. Strauss. Overseers or "The Deciders" - The Courts in Administrative Law

¹³ Richard Posner, *Statutory Interpretation - in the Classroom and in the Courtroom*, 50 *U.Chi.L.Rev.* 800, 817 (1983)("[T]he irresponsible judge will twist any approach to yield the outcomes that he desires and the stupid judge will do the same thing unconsciously. If you assume a judge who will try with the aid of a reasonable intelligence to put himself in the place of the enacting legislators, then I believe he will do better if he follows my suggested approach.")

authority is delegated and the named authorities of constitutional government. That relationship is the relationship between agencies and courts. Courts and Congress have been speaking to the character of this relationship from the moment of its emergence – Congress’s chief, but not exclusive, present statement may be found in Section 706 of our federal Administrative Procedure Act U.S.C. 706(2); the Court’s statement may be found in a series of cases interpreting that Act or indicating its understanding of Congress’s purposes in making delegations.

A common problem is that for some issues, courts are entitled to be the deciders – influenced by agency view, perhaps, but nonetheless themselves independently responsible for the conclusions reached. For other issues, the conclusion that Congress has validly delegated authority to the agency carries with it the corollary that the agency is responsible for decision, and the court’s function is limited to oversight. Telling the two apart, and then securing judicial recognition of its subordinate role in the oversight context, has been a constant challenge. It is not made easier by recognition that the intensity of the court’s *supervisory* role varies with context. Still, for some issues courts are ultimately responsible, and for others agencies are.

Our Supreme Court forcefully identified these two differing responsibilities in *Chevron v. Natural Resources Defense Council*, today the most quoted of all its administrative law decisions. The case required interpretation of a statutory phrase, stationary source, in connection with environmental regulation; our environmental protection agency had adopted a regulation that permitted companies to treat *all* their facilities at a given physical location as a “stationary course,” which gave the companies much greater flexibility in planning industrial sites. The Natural Resources Defense Council, a non-governmental organization dedicated to environmental protection, argued that each possible stationary source of pollution on the site must be treated separately. To what extent was this issue of interpretation for the court, and to what extent for the agency?

Chevron established a two-step analysis in which some issues were independently to be decided by the courts, and others were primarily

for decision by the agency, under judicial supervision for reasonableness. Although it has proved confusing to many, in my judgment the proposition is straightforward and sensible. The two steps are best understood as separating those elements of the judicial relationship to agency action that are appropriate for *independent* judicial judgment, from those for which the judicial role is constrained to oversight. The courts have emphasized that determining questions of law is a matter for independent judicial judgment. However, two further propositions, that might be thought qualifications of this statement, also may be stated.

- In reaching its independent conclusion about meaning, a court might find reason to assign some weight to a responsible agency's judgment about the matter. Vote of Justice Jackson in *Skidmore Swift & Co.* 323 U.S. 124 (1944), decision that held that an administrative agency's interpretative rules will be given deference according to their persuasiveness.
- The court's independent conclusion of law might be that authority over some particular question of meaning (now often reframed as one of "policy" rather than "law") has been validly and uniquely assigned to the responsibility an administrative agency. If so, the court is merely following its nose when it treats its proper relationship to that question as one of oversight rather than decision.

This second proposition is associated with another 1944 opinion, *NLRB v. Hearst Publications*. 322 U.S. 111 (1944). At issue was interpretation of the term "employee" in the context of national labor legislation. Of course there are some workers who can only be regarded as employees – a person who comes daily to the factory, punches a time clock, and receives an hourly wage. There are others who could never properly be so regarded – the plumber who is called in only when his services are required. The courts set these boundaries. But there are others whose status is quite uncertain. Congress's statutes, generally fix no meaning for the term. And they put the administration of national labor policy in the hands of a National Labor Board, which is better placed to resolve this issue in light of the national labor policies for which it, not the courts, is generally responsible.

Chevron, generalized the *Hearst* approach: a court will *independently* decide what authority has been conferred on an agency. But then it will presume that in creating an agency with authority to act with the force of law, Congress has delegated to it the resolution of open legal questions. The courts, using “traditional tools of statutory interpretation,” will decide the boundaries of what the statute *could* mean; within its almost inevitable range of uncertainties, primary decision what it *does* mean is for the agency.

Notice two further propositions that seem not to be as widely appreciated in the literature as in my judgment they deserve to be.

- Defining the areas of ambiguity within which, *Chevron* says, agencies presumptively have the leading oar, is a part of the independent judicial task, the first step one. In the *Hearst* situation, again, a court would identify any classes of worker who *must* be regarded as “employees,” and any classes of worker who *may not* permissibly be so regarded. The NLRB’s authority lay in the indefinite middle ground of ambiguity, *as judicially determined*. *Chevron*’s language tends to obscure this point, but later decisions make it reasonably clear.
- As part of the first step, a court might well turn to a responsible agency’s judgment about the matter, as one weight to be considered on the scales the court is using. That is, *Skidmore* deference is one of those “traditional tools of statutory interpretation” that bear on a court’s *independent* conclusion about the extent of agency authority.

If, then, *Chevron* step one is the terrain of independent judicial judgment, cases resolved at that level have more in common with other judicial judgments about statutory interpretation than with agency review, as such.

When a court moves from *Chevron* step one to *Chevron* step two, its responsibility changes from decision to oversight. If a court finds that primary authority for a matter has been placed in agency hands, what other choice does it have? Here, Section 706(2) of the Administrative Procedure Act sets the general standards for performing that role. The most important of its standards, the one that controls the courts’ approach to the factual support for most regulations and informal

decision-making as well as an agency's exercises of discretion or judgment, instructs judges to consider whether the agency action is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

It will be evident that this is not a mathematically precise formulation. Indeed one can find in the cases a range of judicial characterizations what it means to be "arbitrary or capricious," or to abuse discretion, responding in ways the statutory formulation as such does not invite to the nature of the action under review. "Arbitrary, capricious" has one meaning for a court reviewing the judgments Congress makes when it enacts legislation,¹⁴ another when it is reviewing an important agency regulation,¹⁵ another for a court reviewing an agency's decision not to act, and another for reviewing relatively low-consequence matters, such as the grant or refusal of permission to open a branch bank.¹⁶

The "arbitrary, capricious, an abuse of discretion" formula applies not only to factual matters, but to all the stuff that lives in between fact and law – to judgments about law-application, exercises of discretion, and so forth. This is so even for matters subject to relatively close review as to factual judgment, where the agency is relying on its experience to reach judgment. Consider, for example, judgments the Environmental Protection Agency must reach in modeling air flows when assessing the possible environmental consequences of discharging a particular chemical into the atmosphere.

This last setting, checking disputable scientific or technical judgment affecting high-consequence issues, has been the domain in which "hard look" has done its most important work. The disagreement between majority and concurrence in *State Farm* offers an example. In stating its judgment that seatbelts that *could* be entered and left without detaching them (but that were nonetheless detachable) would not significantly increase seatbelt use, the NHTSA rule makers omitted the consideration that such seatbelts, once buckled, would remain effective

¹⁴ *Pacific States Box & Basket v. White*, 296 U.S. 176 (1935).

¹⁵ *Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

¹⁶ *Camp v. Pitts*, 411 U.S. 138 (1973).

until unbuckled – that one was not *required* to unbuckle such a belt to leave one’s seat, and so might not. While for a minority of the Justices it may have been relevant that there was a new President in office, NHTSA had justified its decision in terms not of politics but of science. One may suggest, further, that political controls are most virtuous when exercised as such, and not by bending science. An agency official who was an early enthusiast for “hard look” observed in oft-quoted passages

"... [D]etailed factual review of [EPA] regulations by those with the power to change them takes place in two forums only - at the level of the office of primary interest and working group inside EPA, and in court. The working group generally will understand the technical complexities of a regulation. So to a great extent will members of the industry being regulated. But the review process within the agency and the executive branch does not spur a working group to make sure that the final regulation adequately reflects these complexities. To the extent that internal review is the only review worried about, comments by the affected industry or (to pick a less frequent case) by environmental groups may not be given the kind of detailed consideration they deserve. Since the higher levels of review are unwilling or unable to consider the more complex issues, the best hope for detailed, effective review of complex regulations is the judiciary.

"It is a great tonic to discover that even if a regulation can be slipped or wrestled through various layers of internal or external review [inside the bureaucracy] without significant change, the final and most prestigious reviewing forum of all - a circuit court of appeals - will inquire into the minute details of methodology, data sufficiency and test procedure and will send the regulations back if these are lacking. The effect of such judicial opinions within the agency reaches beyond those who were concerned with the specific regulations reviewed. They serve as a precedent for future rulewriters *and give those who care about well-documented and well-reasoned decisionmaking a lever with which to move those who do not.*"¹⁷

¹⁷ Quoted by Peter Strauss op. Cit. *Overseers or “The Deciders” - The Courts in Administrative Law*

While judicial politics may influence the precise outcomes of judicial review even when the judicial look is hard, a point to remember is that agency officials do not know the composition of the appellate panels they may eventually face when they act. They dare not try to predict, then, any effect judicial *politics* may have. And for high-consequence rulemakings, the kind already also being significantly impacted by congressionally-endorsed processes of OMB review widely suspected to be implicated in some science-bending, it is hard to think such a “hard look” impact untoward.

One cannot imagine an easy fix for the possibility that judicial outcomes are somewhat affected by judges’ political orientations. It is comforting to know that these results are robust only when all three judges on the panel have the same political background. As earlier remarked, when judges of differing political orientation sit together, this effect is moderated. Could one imagine resulting legislation requiring three-judge court of appeals panels to be composed, not at random, but – to the extent feasible – as mixtures of judges who had been appointed by different Presidents, perhaps even by Presidents of different parties? Although there is some support for such a judgment in the common congressional practice of requiring bipartisan membership in independent regulatory commissions, such a measure might appear to be endorsing the proposition that politics plays a *legitimate* role on judicial review. That endorsement would cost more in its impacts on judicial *and* public conceptions of judges’ roles than any possible benefit it could deliver. The constant political bending of science is a scandal, which we hope is not widely observed.

The discussion so far has suggested that in analyzing *Chevron* decisions, step one decisions should be pooled with other cases involving direct judicial statutory interpretation, and not with *Chevron* step two decisions. There’s little reason to expect a different empirical result, but reframing the issue that way would focus our attention on the cause (political differences among judges) and not on a particular symptom.

The *Chevron* step two issue is whether the agency's judgment, on a matter within what the reviewing court has found to be the agency's delegated authority, is "reasonable." That is to say, whether it is "arbitrary, capricious, an abuse of discretion." This is the identical language as underlay *State Farm*. One might argue, perhaps, that some issues regularly associated with *Chevron* "Step two" - whether or not to adopt a bubble policy - will have less factual content and more simple political preference content - than those regularly associated with *State Farm*. How one assesses what is "arbitrary, capricious, an abuse of discretion" does vary with context. Still, "the President told me to do it" will not count as a "reasonable" basis for action unless the statute makes that a dispositive factor; the agency must have reasons that satisfy its statutory charge.

Inside the agency, hard look review "reaches beyond those who were concerned with the specific regulations reviewed. They serve as a precedent for future rulewriters and give those who care about well-documented and well-reasoned decisionmaking a lever with which to move those who do not." Those who do not," we have certainly learned, include politicians inside and outside the agency who care about results and not about science. It is important, then, to consider the gains "hard look" review might bring for "rational" decision-making in the highly freighted and significant contexts to which it seems most important. Since agency officials cannot know who their judicial reviewers will be, they can have no incentive to bend their science to particular supposed tastes. The knowledge that there *will be* review, looked at hard in the context of these difficult judgments, endows "those who care about well-documented and well-reasoned decisionmaking a lever with which to move those who do not." Why, in this context, should we wish to give that lever up?

Styles of Regulation.

When legislators or administrative officers decide to regulate the behaviour of private persons or companies they must choose how they will regulate. All regulation is both a limitation of constitutional rights and a reassignment of wealth so there is always a control of its scope and of the procedure used to approve it. Three possible styles could be conceived: Should legislators or officials impose a regulation through the rulemaking process? Or negotiate the rule with the interested parties? Or, finally, bring suit and obtain changes in behaviour as part of an injunction or settlement? Each of these choices generates a different set of political costs and benefits for the regulators and the regulated as well as for the rest of society that is also indirectly regulated.

Government officials face a set of costs and benefits that is that is different from the costs and benefits faced by society as a whole. Just as a market decision maker sometimes acts in ways that impose costs on other, because he considers only his own costs and benefits and not those borne by society as a whole, a public officer may act imposing costs on others through his decision because he considers only his own. Since when private actors act in such a manner we use the term “externalities”, for public officers actions we call these costs “regulatory externalities”.

Regulators have three choices rulemaking, negotiation or litigation. We can analyze the consequences of each for the purposes of this paper.

Regulation by rulemaking.

This is the usual way that public officers use to create rules. It typically involves the notice of a proposed rule, a comment period for any of all parties to express their reactions to the agency, and a final notice of

rulemaking that addresses the comments received from interested parties. Once a rule has been issued, those affected by agency action then have an opportunity to test the agency's rule in the courts. Asking for review of procedural issues, legal questions and some substantive points about the reasonableness of the decision taken.

Some of the characteristics of regulations by rule making are:

1. Notice to the public of the agency's proposed actions;
2. The creation of a record of public comments on the proposal;
3. The opportunity for anyone interested to comment on the agency's proposal;
4. A requirement that the agency respond to significant comments;
5. Political accountability for agency action, and
6. Judicial review of agency action to ensure that procedural requirements were met and the agency has followed the substantive law granting it regulatory authority.

Some questions appear on this process.

The first is: Are the public benefits worth the public cost? In the comment process, the ability to comment on proposed rules serves as a valuable check on agency action. Agencies may not pay close attentions to every comment they receive during rulemaking, but when interest groups or affected individuals point our problems, agencies can adjust their proposals to take into account information they may not have considered sufficiently in drafting the original proposal. There is a benefit to interest groups from participating in rulemaking because they usually invest considerable resources in ensuring that comments are placed in the rulemaking record. Beliefs revealed by actions are "revealed preferences", and indeed actions deserve a greater weight than words, in this case if people on all side of the regulatory issue see value in spending their resources on participating in rulemaking, they must have found value in the process. Particularly since if their comments do not influence an agency directly they might influence the political representatives that exercise over the agency. Comments are also an important part of the groundwork for challenges to the rules in courts. Agencies must

respond in their final rule to protect their actions in the post rulemaking litigation.

The public benefits of the comment process justify the public costs for at least two reasons:

1. People deserve a voice in the rules that affect them.
2. The comment process can improve the substantive rules by bringing new information to the attention of the agency and by giving interest groups on all sides an opportunity to critique each other's arguments and data.

But in the rulemaking process political constraints could be used to facilitate rent seeking rather than to promote the general welfare.

Statisticians refer to an erroneous conclusion that a hypothesis is true when it is actually false as a "type I error" and an erroneous conclusion that a hypothesis is false when it is actually true as a "type II error". Both types of errors afflict regulators' decisions, but both are not equally valued by the political system. By harnessing special interests to test agencies' actions through rulemaking and legal action, the rulemaking process avoids type I errors, but at the price of increasing the number of type II errors it commits. Sometimes agencies will not act when they should, because they are afraid of congressional oversight, lawsuits from affected interests or interference by political actors elsewhere in the executive branch.¹⁸

Rulemaking's offers to regulators an opportunity to test a proposal against the arguments interest groups can make in the legislature or the courts. The cost to the agency is that it leaves the agency's decisions open to challenges in the legislature and the courts, it exposes the agency's decision-making process to scrutiny and it slows agency action.

¹⁸ Andrew Morris, Bruce Yandle & Andrew Dorchak. Regulation by Litigation. Yale University Press. New Haven 2009. P. 40.

Regulation by Negotiation.

As a result of the critiques of regulation by rulemaking made from the seventies onwards, mainly that this type of regulation was highhanded and too prone to be sequestered by interest groups, regulators introduced an alternative means of creating a rule. This new system generally called regulation by negotiation allows regulators to work with groups of the regulated to narrow the range of features that might characterize a proposed final rule. In this system the representatives of the interests that would be substantially affected by a rule, including the agency responsible for issuing the rule, negotiate in good faith to reach consensus on a proposed rule. The members of the negotiated rulemaking committee determine what factual information or other data is necessary for them to make a reasoned decision, develop and analyze that information, examine the legal and policy issues involved, and reach a consensus on the recommendation to make to the agency.

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It has certain characteristics:

1. Early and continuous negotiation among included affected interests over the substance of the rule.
2. Unanimous consent, or at list consensus, to the final negotiated rule proposal.
3. Increased costs, including transaction costs, for the agency involved.
4. Use of notice and comment procedures for those not participating in the negotiation.

Unanimity or its more simplified form, consensus, ensures that all the participants support the final rule. This brings a great prestige to the final rule created, but it has certain drawbacks. It has a perverse effect, the participants in the process tend to encourage a selection of issues for regulation that are likely to succeed, reducing the possibility of including important issues that would hinder reaching consensus. Rules reached by consensus tend to be ambiguous to avoid

¹⁹ Philip Harter. Assessing the assessors: The actual performance of negotiated rulemaking. N.Y.U. Envtl. L. J. 2000. 9: 32, at 33.

heightening the sensitivity of the parties to adverse portions of the rule. It creates a lowest common denominator problem that would make rules that are less likely to promote innovation, at the same time creating an incentive to take positions on issues parties consider minor for use in negotiation, leading to inferior outcomes.

At the same time it raises an issue of political prestige. When an agency chooses regulation by negotiation it sends a signal to the public, interest groups, and the legislature that the agency is interested in negotiation and not in the imposition of rules. This gives the agency credibility both with the legislature and with interest groups.

At the same time negotiation betters the information that the agency may collect in difficult or new subjects. If the factual basis for the rulemaking is poorly understood within the agency, correctly calibrating the regulatory measure requires private information held by the regulated entities. Also this process restricts in some measure, through its insistence on face-to-face negotiations, the intrusion of political consideration at all levels of rulemaking. The restriction of outside or political influences would be a major benefit to the agency by keeping the decision "in house". But closing the door to political competition can be detrimental to the interests of the general public.

Regulation by litigation.

Regulation through litigation has two ways, in both it is a judge who determines the applicable norm, but it differs in the originator of the legal proceedings that give way to the creation of the desired rule. In the most traditional way it is one of the regulated, generally a citizen or company, who dissatisfied with the constitutionality, legality or reasonableness of a norm attacks it in a legal case. This is the most common way of regulation through litigation and it indicates that any legal rule as approved by legislators or agencies is in reality a first draft since it could be rewritten in a judicial proceeding.

The second and much more recent version of regulation through litigation happens when an agency, as originally a private actor, sues one or more regulated entities, charging them with violation of an existing statute or regulation. Regulation comes when the plaintiff persuades the regulated entity to agree to the imposition of regulatory provisions that serve as substantive constraints on the defendant's behaviour in the future, not simply the payment of fines for past behaviour. As in regulation by negotiation and regulation by rulemaking, the final outcome is a set of detailed rules that constrain future behaviour. The solution of the legal case could be through a judicial decision where the judge determines, after the debate between the parties, the content of the rule applicable for the future. Or it could be through a settlement when the parties agree on a new rule or new version of an old rule, and the judge accepts the decision and makes it obligatory.

Regulation through litigation could be thus described:

1. Only parties to the case and those who introduce a brief of *amicus curiae* are participants in the debate previous to the legal decision.
2. There is no direct oversight by the legislative and executive branches.
3. Decision is only applicable to the parties and not to the public in general.
4. Litigation has sufficient coverage of the regulated industry to serve as a substitute for generally applicable rules.

Government by Judiciary?

The idea behind "regulation through litigation," is that the threat of litigation and massive risks of liability will force behavioral change among the relevant class of defendants. While there must always remain an avenue open to litigants foreclosing the right of a litigant to

vindicate his or her right in a court of law would be tantamount to denying such a right exists--it can be argued that such a process is designed to settle disputes between parties, and not to establish public policy. A fundamental change in legislative regulation, through the authority of relative agencies and otherwise, must be effectuated. "Litigation can often help address gaps in the regulatory structure and stimulate regulatory activity."²⁰

There are some economic activities that may attract litigation, as the case of food manufacturing. In those cases the current absence of effective regulation, could bring incentives to private litigation to influence food policy, leading to changes in the conduct of food manufacturers.

There are two legal institutions that can limit the restrictions that legislation through litigation could have since judicial decisions only apply to the parties in the case. To allow other persons to give their view of the case in spite that they are not parties in it is the institution of the *amicus curiae*. To widen the effects of the judicial decision to a large number *class actions* could be used. The *amicus curiae* that bring all the interested persons to give their view of the case even if they are parties to the case. The *amicus curiae* is not a party to a case, who volunteers to offer information to assist a court in deciding a matter before it. The information provided may be a legal opinion in the form of a brief, a testimony that has not been solicited by any of the parties, or a learned treatise on a matter that bears on the case. The decision on whether to admit the information lies at the discretion of the court.

The other way to give a wider scope to litigation is through a *class action*.²¹ It is a form of lawsuit in which a large group of people collectively bring a claim to court and/or in which a class of defendants is being sued. ²² In the case of rules of general application a

²⁰ W. Kip Vicusi, Overview, in Regulation through Litigation 1, 3. W. Kip Vicusi ed., 2002 AEI Brookings Joint Center for regulatory studies.

²¹ James Wootton, Comment, The Regulatory Advantage of Class Action, in Regulation Through Litigation, W. Kip Viscusi ed.

²² Class actions are governed by Federal Rules of Civil Procedure Rule 23 and 28 U.S.C.A. § 1332 (d).

class action avoids the situation where different court rulings could create "incompatible standards" of conduct for the defendant to follow. Also class action cases may be brought to purposely change behavior of a class of which the defendant is a member. *Landeros v. Flood* 17 Cal.3d 399 ²³was a landmark case used to purposely change the behavior of doctors, and encourage them to report suspected child abuse.

While there is controversy over whether courts serve as the appropriate fora to resolve these issues, even in the absence of legislation, one of the prominent arguments against them is that they are not politically accountable to the public. This could be perceived as undemocratic, because in our democratic system of government, it is the people that should ultimately control decisions of policy through their power in the electorate. But this is a very elementary analysis, since although there is no alternative to democracy; the representative organs of government are not the "people" but the result of very complex systems of election where there are very important and unsolved agency problems between the electors and the elected. Therefore, there seems to be a choice between the lesser of two evils between policymakers and the judiciary. The judiciary needs some mechanism of enforcement when an industry seeks to take advantage of scientifically complex issues by spreading misinformation to the public and promoting political bias. As witnessed by the frequent frustration of proposed legislation and combative advertising, legislators are prone to political bias and easily succumb to the persuasive force of lobbyist efforts. Where private interest groups once created coalitions to undermine scientific studies over whether climate change exists, they now seek to stall less-favorable emissions policies. Comparatively, judges enjoy a position somewhat removed from these influences. The question is more aptly phrased: do we wish for regulation that favors lawyers or lobbyists? The answer to this is a matter of preference, but the point of this discourse is to give effect to the idea that courts may not be ideal, but in a problem as multidimensional as climate change with murky political affiliations and polarized public opinion, they may be the most effective,

²³ S.F. No. 23359. Supreme Court of California. June 30, 1976.

especially where the legislature has accepted the ramifications of climate change, but political stagnation has slowed any movement toward a legislative solution.

Baker v. Carr in 1962, the Supreme Court identified six factors as being tied to political questions. The third Baker factor precludes a court from adjudicating a case where it is impossible to decide the outcome "without an initial policy determination of a kind clearly for nonjudicial discretion." It would appear that the third factor "means something other than a requirement that the political branches identify and assign weight to broad policy considerations relevant to the controversy" before determining entitlement to relief. The more appropriate basis for the third factor is an inquiry into "whether a particular and discrete diplomatic determination by a political branch about a party to, or fact in, the specific controversy . . . must be made before the court can decide the legal issues."

The open-endedness of the third factor, however, easily lends itself to overbroad application. Courts' aversion to "regulation through litigation" could result in their dismissal of cases that seem too politically charged, controversial, or complicated. Yet it is important to remember:

1. First, the political branches through legislation, thereby rectifying any judicial policy decision that is disfavored by the other branches; may always override courts;
2. second, since questions of bias and expertise can be raised against all members of all branches, not just the judiciary, it may in fact be beneficial to have all three branches involved in some policy-making; and
3. third, judges do, in fact, make policy decisions on a daily basis.