The Journal of Private Enterprise 34(1), 2019, 1–14

The Durability of Legislative Benefits and the Role of the Executive Branch's Settlement Authority

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Abstract
Following the 2008 financial crisis, the US Department of Justice required several large financial institutions to pay large cash settlements for their role in the collapse of the residential mortgage-backed securities market. A fraction of these cash settlements was funneled to government-approved nonprofit beneficiaries, many of whom had seen their government grants reduced by Congress. I argue that this transfer is an insurance contract that the government uses to improve the durability of contracts between special interest groups and the legislature.

JEL Codes: D72, H27, P16
Keywords: separation of powers, contractual durability, rent extraction, administrative state, bank settlements

This power over the purse may, in fact, be regarded as the most complete and effectual weapon, with which any constitution can arm the immediate representatives of the people, for obtaining a redress of every grievance, and for carrying into effect every just and salutary measure.
—James Madison ([1788] 2001, p. 303)

In the form in which we know this division of power between the legislature, the judiciary, and the administration, it has not achieved what it was meant to achieve. Governments everywhere have obtained by constitutional means powers which those men had meant to deny them. The first attempt to secure individual liberty by constitutions has evidently failed.
—F. A. Hayek (1973, p. 1)

I. Introduction

In the wake of the 2008 financial crisis, the US Department of Justice required Citigroup and Bank of America to pay large settlements for their role in the collapse of the residential mortgage-backed securities market. A fraction of these multibillion dollar settlements, which are intended to indemnify those harmed by the violators of federal statutes, was funneled to nonprofit housing counseling organizations that had had their subsidies reduced by Congress following the 2010 midterm elections. Critics of this settlement program argued that the administration was circumventing Congress's power of the purse, thereby removing what is theoretically an important constraint on the administrative state.[1]

While this issue may seem trivial, the circumvention of the constraints intended to limit the state's fiscal activities undermines the effectiveness of the fiscal constitution, which in turn opens the door to an ever-increasing and largely unaccountable administrative state. As the opening quotation from James Madison suggests, the Constitution's framers believed that separating the power of the purse from the executive branch was an important limitation on the administration.

The power to tax is the most obvious coercive mechanism the state possesses. For instance, under a decision rule wherein any member of the polity could undertake a collective action, the likelihood that external costs will be imposed on other members of the group increases (Buchanan and Tullock [1962] 2004). Moreover, electoral rules may be insufficient to prevent the abuse of the government's taxing authority, suggesting that rational individuals would also insist on nonelectoral restraints on the taxing authority at the constitutional level (Brennan and Buchanan [1980] 2000).[2] This insight explains why the US Constitution, for example, requires that all tax legislation originate in the House of Representatives: because it is ostensibly the most responsive to the people's demands.

The settlement authority, I argue, is essentially an insurance mechanism that pays out when special interest groups lose their legislatively created benefits. In the framework I develop below, the government is treated as a vertically integrated monopoly that produces special interest legislation, or long-term contracts, between the legislature and special interest groups. This insurance mechanism is necessary because, unlike private contracts, the contracts between special interest groups and legislators lack external enforcement mechanisms that ensure performance. As a result, the durability of the benefits produced by these contracts is reduced, which in turn reduces special interest groups' willingness to pay for beneficial legislation. To counteract this defect, mechanisms such as the

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[1] See, for example, Strassel (2015).
[2] For an extension of this type argument into the provision of public goods, see Newhard (2016).

settlement authority are used to ensure the durability of legislative contracts, thereby increasing their demand.

This paper is most closely connected to the literature on the durability of special interest legislation. Landes and Posner (1975) consider the role that the independent judiciary plays in the interest-group theory of government. They argue that rather than being a check on the activities of the legislative or executive branches, the purpose of the independent judiciary is to ensure the durability of long-term contracts between special interest groups and the legislature. Building on Landes and Posner, Crain and Tollison (1979a, b) explore both constitutional change and the role of the executive branch in the interest-group theory of government. In the former case, they find that constitutional amendments are a particularly durable form of contract between the government and special interest groups; in the latter case, they find that, like the independent judiciary, the purpose of the executive veto is to ensure the durability of special interest legislation. I contribute to this literature by showing how the executive branch, by circumventing Congress's power of the purse, uses its settlement authority to increase the durability of legislatively created benefits.

In the next section, I argue that the executive branch's settlement authority increases the durability of special interest legislation by acting as insurance against legislative turnover. In section three, I provide preliminary evidence of my theory's validity by examining the three largest post-2008 financial crisis bank settlements between the Department of Justice and JP Morgan, Citigroup, and Bank of America. Section four concludes with a brief discussion of my theory's implications.

II. The Settlement Authority as a Guarantee of Rent Durability

In the special interest theory of government, legislative outcomes are the product of a rivalrous process wherein special interest groups compete with one another by offering pecuniary or in-kind contributions to legislators in exchange for beneficial legislation (Tollison 1988).[3] This legislation can take many forms, such as restrictions on entry or subsidies, though the former tend to be more common than the latter unless restrictions are put in place to prevent rent dissipation. Regardless of the form the legislation takes, however, the result is the same: surplus is transferred from a group

[3] See also Stigler (1971) and Peltzman (1976).

that is typically dispersed in nature, such as consumers or taxpayers, to a more concentrated group, such as bankers. The price that special interest group members are willing to pay for this legislation is, among other things, a function of the legislation's value to the group's members and the group's ability to overcome the collective action problems associated with coalitions. Thus, in the political marketplace, legislation is sold by the legislature and purchased by special interest groups.

An additional determinant of the price that a special interest group is willing to pay for beneficial legislation is the expected durability of the benefit (Crain and Tollison 1979a, b; Landes and Posner 1975). This legislation is essentially a long-term contract between a special interest group and the legislature. The longer the beneficial legislation is expected to last, the greater the price that a special interest group would be willing to pay. However, unlike private markets where legal mechanisms exist to ensure contractual performance, the political marketplace lacks similar mechanisms to guarantee that the legislature upholds its end of the bargain. The lack of such mechanisms reduces present value of, and consequently the demand for, beneficial legislation.

Two factors erode the durability of beneficial legislation: postcontractual opportunism and legislative turnover. In the case of postcontractual opportunism, a legislator could, for example, accept payment from a special interest group in exchange for favorable legislation, only to vote subsequently against such legislation. While this issue is important, I will focus on legislative turnover and the institutions that emerge to enhance the durability of special interest legislation.[4]

Legislative turnover can take several forms. First, a legislator may unexpectedly fail to be reelected, thus becoming unable provide the benefits promised to the special interest groups that supported the legislator. This scenario is akin to bankruptcy, where a failed firm has outstanding contractual obligations. The political marketplace, however, has no equivalent to the private marketplace's bankruptcy mechanism to ensure contractual performance.

The second form of legislative turnover involves a change in the legislature's makeup such that a legislator who was previously in the majority party is now in the minority party. Unlike the first case, the legislator still holds office, but the legislator's ability to produce

[4] For a discussion of opportunism's role in contracts, see Williamson (1985).

beneficial legislation for special interest groups has been attenuated by the change in the political marketplace. Again, no mechanism exists to guarantee contractual performance to special interest groups if this scenario occurs.

To see how legislative turnover affects the durability of special interest legislation, consider a situation wherein a special interest group that has thus far succeeded in securing beneficial legislation must contend with the first type of legislative turnover. When the new legislator assumes office, he may be unwilling to honor the previous agreement between his predecessor and the special interest group unless he is adequately compensated.[5] Whether the legislator and the special interest group can reach a mutually beneficial arrangement depends on the legislator's demands and the special interest group's willingness to pay for the transfer. Additionally, the new legislator may face pressure from a different set of interest groups than that of his predecessor, and this pressure will affect the new legislator's constraints. Consequently, the equilibrium pattern of rent creation may differ from the previous one, which could result in the repeal of legislation that benefits the special interest group.

If the legislation is repealed, the special interest group will likely need to write off its investment in beneficial legislation. This outcome is problematic for reasons that extend beyond simply losing the legislatively created benefit. The beneficial legislation's value will have already been capitalized into the asset values of the organizations represented by the interest group (Tullock 1975). In this case, the lack of contractual durability threatens to impose an additional capital loss on the members of the special interest group. As this example makes clear, the absence of an external enforcement mechanism to ensure that legislative turnover doesn't erode the durability of special interest legislation will reduce the demand for such legislation.

Since the total surplus in the political marketplace can be increased by increasing the durability of special interest legislation, political entrepreneurs are likely to identify mechanisms that ensure contractual performance.[6] Some examples of these mechanisms

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[5] Even if the special interest group agrees to pay the new legislator, it isn't receiving anything in exchange. Thus, legislative turnover creates the opportunity for rent extraction (McChesney 1987).

[6] This type of entrepreneurship takes place at the level of the rules rather than within a given set of rules (Leeson and Boettke 2009; Martin and Thomas 2013). Because the value of political property rights is, in part, a function of the rules that

include the procedural rules of the legislature that increase the cost of repealing existing laws and the independent judiciary and executive veto (Crain and Tollison 1979a, b; Landes and Posner 1975).[7] These latter two mechanisms are part of the separation of powers embedded in the US Constitution. Looked at from the special interest perspective of government, these and many other provisions in the Constitution are not so much a limit on government power but mechanisms to increase the value of special interest legislation.

Another previously unrecognized mechanism for providing increased rent durability is the Department of Justice's settlement authority. Under this authority, the executive branch can require organizations that have violated federal law to undertake an action that benefits both the government and special interest groups.[8] For instance, the Department of Justice could compel the violator to donate directly to members of a special interest group rather than accept the payment itself. By not accepting the money directly, the government circumvents the constitutional provisions that vest Congress with the power of the purse, thereby providing an additional mechanism through which surplus can be transferred to special interest groups.[9]

The settlement authority differs from the mechanisms that ensure contractual performance by raising the cost of repealing special interest legislation, acting instead as an insurance contract that indemnifies special interest groups if the legislature fails to uphold its end of the bargain rather than as an enforcement mechanism. In other words, special interest groups can use the settlement authority to mitigate the risk of a capital loss associated with the repeal of beneficial legislation. The presence of this insurance contract increases interest groups' willingness to pay for beneficial legislation, thus increasing the total surplus in the political marketplace.

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define the set of permissible uses of those rights, the goal of this type of entrepreneurship is to reform the rules in a way that increases the present value of these rights (Alchian and Demsetz 1973; Salter 2016).

[7] Also, see Crain (1977), who explores how political markets' structure—that is, electoral rules—affect political markets' stability. He finds evidence of significant benefits to ensuring political market stability.

[8] For an overview of the settlement authority, see Peterson (2009).

[9] See Article 1, Sections 7 and 9 of the US Constitution. This mechanism also differs from the previous examples because, in this case, the relevant constitutional provisions are an obstacle to rent durability rather than a means to achieve it. Presumably, the legislature will efficiently trade off its power of the purse for increased rent durability.

Unlike the standard model of special interest legislation, wherein small, concentrated groups secure benefits by imposing costs on individuals in a dispersed group, such as taxpayers or consumers, the settlement authority involves the extraction of surplus from one concentrated group, usually a firm, that is then transferred to another group.[10] Rent extraction is a process whereby a politician or bureaucrat threatens to extract surplus from either an organization or an interest group unless the threatened party agrees to meet the politician's demands (McChesney 1987). In the standard rent extraction model, politicians extract rents to increase their own wealth. In the model that I am developing here, however, rent extraction is a means by which politicians create benefits for other interest groups.[11]

Effective rent extraction hinges on the threat's credibility.[12] The threatened party must believe that the threat will be carried out if, and only if, the politician's demands are not met. For example, if following through with the threat is prohibitively costly, then the threatened party has little reason to acquiesce to the bureaucrat's demands. Alternatively, the politician may have a reputation for carrying out the threat regardless of what the threatened party does. Again, there is little reason for the threatened party to meet the politician's demands in this case, especially since meeting the politician's demands only to have the politician follow through with the threatened action is costlier than simply suffering the costs of the threatened action alone.

The key to successful rent extraction, then, is ensuring that complying with the politician's demands is the rational choice from the threatened party's perspective. In the case of the settlement authority, for example, the Department of Justice could offer the violator a choice: pay the settlement directly to the Treasury, in which

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[10] See Olson (1965) for a discussion of the logic of concentrated benefits and dispersed costs. See McChesney (1991), who shows that organizing into an interest group lowers the transaction costs from the politician's perspective of extracting rents. Thus, rent extraction will be more common among concentrated interest groups, such as those subject to the settlement authority, for example.

[11] There is, of course, no reason to assume that the politician or bureaucrat is not compensated for his or her role in this process. Indeed, it is unlikely that he or she would agree to do so absent some form of compensation. Nonetheless, for the purposes of my analysis, I am treating the politician or bureaucrat primarily as a broker.

[12] Since rent extraction is akin to extortion, it can be analyzed as such. See Shavell (1993) for an analysis of effective extortion.

case the firm is liable for the full amount of the settlement, which is the threatened action, or pay a fraction of the settlement directly to a specific interest group or groups, which is the politician's demand. In this case, effective rent extraction is made possible because the threat to impose costs is credible: the firm has already admitted guilt and is therefore subject to the associated penalties, and the rational choice from the firm's perspective is to meet the politician's demands, as doing so reduces the firm's settlement liability.

Of course, extracting the surplus from the settlement is only one side of the transaction. Decisions will need to be made regarding the allocation of the extracted surplus, and this will involve rent seeking on the part of the special interest groups vying for a transfer. Presumably, the special interest groups seeking such a transfer will have already accumulated the human and nonhuman capital required to lobby for special interest legislation, which they can also use to secure benefits from the executive branch. Unlike rent seeking in the legislature, however, the interest groups that receive a transfer via the settlement mechanism will represent interests that extend beyond the narrow boundaries of a congressional district. For example, an interest group concentrated in a congressional district is likely not an important constituency to the executive branch. Thus, the recipients of settlement funds will represent nationwide constituencies that are important to the administration.

In sum, the framework I've developed in this section suggests three refutable hypotheses. The first hypothesis is that using the settlement authority to transfer surplus to special interest groups will be more common when legislative turnover is higher. In other words, I expect that the durability-enhancing mechanisms discussed in this section will be traded off efficiently against one another. Increased legislative turnover, in turn, can lead to the elimination of legislatively created benefits. The second hypothesis is that a settlement's recipients will be organizations whose legislatively created benefits have been reduced or repealed. Third, since these organizations will need to lobby the executive branch for the settlement transfer, these organizations will represent nationwide constituencies.

III. Evidence from the 2014 Settlements with Citigroup and Bank of America

In this section, I present preliminary evidence of the validity of the theory that the settlement authority is used as an insurance mechanism against legislative turnover. I examine the two largest post-2008 financial crisis bank settlements between the Department of Justice and Citigroup and Bank of America. The evidence presented in this section suggests that, consistent with the theory developed in section two, the executive branch used these settlements to transfer surplus from these financial institutions to organizations whose funding from Congress had been reduced following the 2010 midterm elections. Those elections altered the makeup of both the House of Representatives and the Senate.

In 2011, Congress eliminated the $88 million that the Department of Housing and Urban Development (HUD) used to fund its housing counseling assistance program, which provided funding for HUD-approved nonprofit organizations.[13] These organizations operate at the national, regional, and local levels, though the national and regional organizations receive a larger fraction of the funds available through the counseling assistance program. In 2010, the approved organizations operating at the national and regional level received approximately 60 percent of the $72 million HUD awarded despite only representing approximately 5 percent of the total number of organizations that received funding that year.[14] This disparity is, of course, not surprising given the concentration of the nationwide organizations relative to the smaller community-based nonprofits.[15] In 2011, Congress restored $45 million for the program, leaving the program's funding at 50 percent of what it was previously. Subsequent appropriations by Congress restored approximately 50 percent of the original amount.[16]

As I discussed in section two, the loss of beneficial legislation, or in this case a subsidy, can impose a significant capital loss on a firm's owners once the subsidy's value is capitalized into the organization's asset value. Thus, while Congress did restore approximately half of

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[13] See Department of Defense and Full-Year Continuing Appropriations Act (2011).

[14] See Department of Housing and Urban Development (2010).

[15] Many local organizations in the list are represented by nationwide organizations such as Neighborworks that can lobby on their behalf. Thus, many local groups are represented by an interest group at the national level.

[16] See United States House of Representatives (2016).

the original $88 million, the subsidy's reduction likely harmed HUD grant recipients. Many of these organizations were displeased with the reduced funding, including many of the largest recipients, such as the National Urban League, the National Community Reinvestment Coalition, and the National Neighborworks Association (Prior, 2011). The framework that I developed in the previous section predicts that when a situation such as this one occurs, the executive branch's settlement authority can act like an insurance policy that compensates the special interest group for the loss of its legislatively created benefits. In this case, that's exactly what happened.

In 2014, the Department of Justice reached settlement agreements with Citigroup and Bank of America that required these institutions to make large cash payments as restitution for their role in the collapse of the residential mortgage-backed securities market. Statutory authority to bring these claims against Citigroup and Bank of America, and to seek financial restitution against these institutions, came from the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which Congress passed after the savings and loan crisis. Under this law, the attorney general can pursue civil action against federally insured institutions that engage in fraudulent behavior.[17] The Department of Justice used this law to pursue civil action against the aforementioned banks and to seek financial restitution for their actions, which the Department of Justice argued included defrauding their customers, investors, and the government.[18]

In its settlement with Citigroup, the Department of Justice required the bank to make restitution worth $7 billion. Among the settlement's provisions, Citigroup was required to donate at least $10 million to the same HUD-approved housing counseling agencies that had lost a fraction of their funding after 2011. Moreover, the settlement incentivized Citigroup to donate to these organizations by allowing them to retire $2 of settlement obligations for every $1 dollar donated. The settlement with Bank of America followed a similar pattern. The Department of Justice required the bank to pay

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[17] An additional feature of this law is that the burden of proof required to impose financial penalties is lower than it would be in a criminal trial. The attorney general need only show that a preponderance of the evidence indicates that the charged institution is guilty. In the context of rent extraction, this reduced burden of proof has important implications for the credibility of the politician's or bureaucrat's threat. By weakening the evidentiary burden, the law makes compliance with the politician's demands more likely.

[18] See Department of Justice (2014a, b).

$16.65 billion for financial fraud, $20 million of which was to be donated to HUD-approved organizations. Again, donations made to these organizations retired $2 of settlement obligations for each $1 donated.[19]

Taken together, these settlements restored at least $30 million to the organizations whose funding had been reduced following the legislative turnover caused by the 2010 election. Between the $47 million approved by Congress in 2015 and these two settlements, funding for the housing assistance counseling program totaled $77 million in 2015, $11 million shy of its pre-2011 amount. Moreover, because Citigroup and Bank of America were incentivized to donate more than the minimum amount required by the settlement, this number is likely much higher. However, to the best of my knowledge, the data on excess donations are not available, making it impossible to determine exactly how much surplus these financial institutions transferred to the HUD-approved organizations. Regardless, the evidence is consistent with the model developed in section two. The settlement authority acted as an insurance mechanism that compensated special interest groups whose legislatively created benefits were reduced because of legislative turnover. Additionally, the organizations that received a transfer from the settlement are not concentrated in a congressional district, or even in a region. Instead, these organizations, the larger ones, are a nationwide constituency, which is consistent with the model's third hypothesis.

IV. Concluding Remarks

In this paper, I have argued that the lack of contractual durability leads to use of the executive branch's settlement authority as an insurance mechanism that indemnifies interest groups whose legislatively created benefits have been either eliminated or reduced because of legislative turnover. I have presented preliminary evidence that supports the theory, though additional qualitative and quantitative research is necessary. The evidence presented only looks at two settlements that were temporally close to one another. Additional case studies and statistical research should be produced that examine the use of the settlement authority over much longer periods to determine my theory's predictive power.

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19 Moreover, the Bank of America settlement includes a provision that could potentially result in an additional $490 million being transferred to Neighborworks America.

An additional issue that future research must address is why the use of the settlement authority in the manner described herein would vary systematically with administrations. For example, following the change in administrations, Attorney General Jeff Sessions reversed the policy of requiring or encouraging banks to donate to organizations as part of settlement agreements (Horwitz 2017). One possible explanation consistent with the theory presented in this paper is that there are currently more efficient means of ensuring contractual durability, though again a more systematic treatment of this issue is warranted. Of course, since the decision to use the settlement authority in the manner described in this paper is essentially up to the attorney general, the policy could always be reversed in the future.[20]

This paper also provides additional support for the special interest theory of government by illustrating how the legislative and executive branches collude with one another to ensure the durability of legislatively created rents. This view contrasts with the separation of powers theory of government that sees the distribution of power between the three branches as an effective constraint on the state's activities. An important implication of this difference is that constitutional provisions that prevent collusion among the branches of government will be circumvented when it is efficient to do so. That is, rather than limiting the executive branch, Congress's power of the purse will simply be ignored when the benefits of collusion are high enough. Unfortunately, this implication suggests that efforts to limit government through such provisions are not likely to be as effective as their proponents hope they will be.

Last, the executive branch's ability to independently raise and allocate revenue is troubling. By freeing itself from the fiscal constraints imposed on it by the constitutional provisions that vest the power to tax and appropriate revenues with Congress, the executive branch can greatly expand the scope of its activities free from congressional oversight. Coupled with other provisions that have greatly expanded the administrative state's power, the executive branch essentially possesses the ability to make laws and fund them unencumbered by the constitutional constraints that were intended to

[20] From a constitutional political economy perspective, the situation is currently one of constitutional anarchy (Buchanan [1985] 2000). As it stands, whether or not the executive branch circumvents Congress's power of the purse is largely a matter of the individual who holds the office of attorney general.

prevent such a situation from occurring.[21] Thus, the separation of powers embedded in the US Constitution has either enabled such a state of affairs or has failed to prevent it.

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[21] See, for example, the doctrine of Chevron deference.

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