11 The political economy of policy implementation

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As we have seen during the Greek crisis, for example, the Economic and Monetary Union is heavily influenced by political concerns and issues. Tools for studying the impact of political concerns on the EMU are inadequate.[1] The work of ADEMU in the area of political economy has been to develop the theory needed to deal with these issues. In this chapter, we lay out some of the main concerns and questions and indicate how ADEMU's political economy research has created a framework for addressing them. We focus on rent seeking in the banking sector.

Rent seeking in the banking sector

To understand the political economy of monetary policy and monetary unions, it is necessary to take a step back and examine how modern monetary systems create opportunities for rent-seeking in both the public and private sectors. Governments maintain substantial monopoly power over money. To enhance this power, governments interfere in borrowing and lending markets in a variety of ways, ranging from issuing taxpayer-backed debt to imposing controls over the issuance of securities of virtually every type. There are positive reasons for the role of government – concerns over market stability (fighting recession, lender of last resort) and raising government revenue (the inflation tax). There are also negative reasons – monopoly and the regulation associated with it creates opportunities for government officials to seek rents.

1 Katsimi and Moutos (2010) document the political dimensions – notable also in their paper is the absence of theoretical analysis.

Much of the monopoly power in the monetary sector is decentralised in private banking. The banking sector is regulated by requiring banks to hold government licenses and to abide by a variety of government regulations concerning the types of economic activities allowed and the structure of investment portfolios permitted. This regulation both limits and enhances opportunities for private-sector and public-sector rent seeking. The primary regulatory agency charged with overseeing these controls is the central bank. To reduce public-sector rent seeking, central banks are supposed to be 'independent' of direct political control. There is a large literature in economics on the importance of central bank independence from politics. As has become clear, unfortunately, central banks are far from independent from *private*-sector rent seeking. In case the problem of appointing bankers to head central banks is not clear, a salutary story from the US may clarify the impact of private bank rent seeking on central banks. On 16 September 2008 the US central bank – under pressure from the Secretary of the Treasury, a former CEO of Goldman Sachs – bailed out the insurance group AIG. It later emerged that the primary purpose of this bailout was to save the creditors of AIG – most important among them, Goldman Sachs.

The banking sector has been extremely innovative in defeating measures designed to combat rent seeking and this poses a problem both to taxpayers who get to pay the bills and to the stability of the system. Bankers construct high leverage portfolios that give high immediate returns with a small risk of catastrophic failure. The high return is pocketed in part by bankers in the form of high salaries and bonuses and in a variety of political payoffs, ranging from subsidised financing for political parties and politicians, to high-paying, undemanding jobs for retired government officials. Unfortunately, when the catastrophic failure occurs, the cost is largely borne by taxpayers. Investors have a somewhat intermediate position – they also wish to profit from public subsidies, but hope to pocket the money themselves and not have it go into the pocket of the bankers.

Regulatory capture and collusive groups

The heart of the political problem in banking is the capture of regulatory institutions – those charged with supervising the monetary institutions are suborned by the institutions they are supposed to regulate.

The problem of corruption is well recognised and has given rise to a number of populist political movements, including Podemos in Spain and Cinque Stelle in Italy. The policies proposed by these movements – withdrawal from the monetary union, public policy set by referendum – are unlikely to have much impact. This leaves open the question of what policies are likely to work and whether the popular discontent in these political movements can be harnessed to improve matters.

To get to grips with what might be feasible, we start by observing that public officials and politicians do not operate in isolation. While individual banks can be influential with regulators and governments and can suborn the system in a variety of ways, there are many banks and it is bankers collectively who pose the greatest threat to both taxpayers and system stability. Bankers can and do collude in their efforts, yet each has an incentive to let the other bankers do the work. And so it is with public officials, few of whom are individually influential, but who as a group wield great power.

Our primary emphasis was on developing tools to study the internal incentives of collusive groups such as bankers, public officials and political parties. This strong theoretical understanding is leading to an empirical understanding of how these groups operate and how they compete with one another. Ultimately, this will make it possible to design institutions which mitigate the harm and enhance the good that these groups do.

Disrupting versus enhancing collusion

Collusive groups endogenously generate and enforce social norms that achieve group objectives. There are two sides of this coin. On the one hand, if groups such as bankers or public officials are engaged in rent seeking, disrupting their ability to collude – for example, through policies that make it more difficult to monitor each other – can reduce undesirable behaviour. On the other hand, groups can design positive incentives as well as negative incentives. This means that if threats against the group as a whole cause them to change their objectives, then it is desirable to enhance rather than inhibit their ability to collude.

A case in point is the EU rule that prohibits tax-financed subsidies of particular industries, banking in particular. This has been used to prevent members state governments from bailing out banks. An Italian response to this rule is of interest – the Atlante initiative taxed successful banks to pay for failing banks. It is unclear whether this is a genuine initiative or simply a legal cover for government subsidisation (for example, by implicitly or explicitly promising the successful banks future government favour in exchange for short-term funding). If the initiative was real, then on the face it is a nonsensical – the malincentives of taxing the winners to pay the losers should be self-evident. If we view this through the lens of collusive lobbying, however, the issue is less clear-cut. The successful banks are 'guilty' of something – they are guilty of lobbying efforts that made it possible for large-scale banking failures. If banks believe that in the future they will collectively be responsible for failing banks, then they have incentive to lobby for regulation – such as increased leverage requirements – that reduces the ability of their competitors to drag them under.

This is one example of how changing group incentives can act to subvert subversion. There are broader threats that could be effective as well. For example, if populist movements such as Podemos or Cinque Stelle were to push for a periodic audit of taxpayer money used to subsidise the banking sector with the threat of criminal penalties against public and private officials in response to a failed audit, these officials and bankers would have an incentive to collude to promote good rather than bad behaviour. The policy of jailing bankers and officials in response to banking crises has been used with substantial success in a number of countries such as Chile.

Economic theory at this point does not provide good answers about how collusive organisations operate. The heart of our work has been to address the issue of collusive groups – bankers, government officials, political parties and other collective entities – to see what sort of policies and regulations are likely to succeed in the face of rent seeking. We are developing theoretical tools and beginning the process of applying them to practical problems.[2] Among our tentative initial findings is the idea that increasing the

2 Theoretical tools are developed in Dutta et al. (2016) examining the nature of equilibrium between self-organising groups and Levine and Modica (2015) studying the nature of incentives and enforcement schemes that may be used by self-organizing groups.

cost of lobbying favours special interests, while decreasing the cost of lobbying levels the playing field between special interests and broad general interests.[3] With reference specifically to the EMU, a substantial amount of independence of central banks from the political process has been achieved through institutional design. It seems that independence from the banking sector could be improved, for example by restricting the appointment of former bankers to central bank positions and by strong prohibitions on former officials joining banks.

Conclusions

There is a broad picture of political contests emerging from our work. The relative influence of large and small groups depends to a key extent on whether participation by individuals is a chore (meaning that there is a fixed cost of participating) or a duty (meaning that there is a benefit to the individual of at least a modest level of participation).[4] We generally think of lobbying as a chore and voting as a duty – but this need not be the case. For example, if we could establish as a social norm that active participation in lobbying of public officials is a civic duty, this would shift advantage away from smaller, special interest groups towards larger, common interest groups.

References

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3 The theoretical tools developed in Dutta et al. (2016) and Levine and Modica (2015) are deployed to study lobbying in Levine and Modica (2016).

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