The Political Economy of Policy Implementation

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Overview: As we have seen, for example, during the Greek crisis, the European Monetary Union is heavily influenced by political concerns and issues. Tools for studying the impact of political concerns on the EMU are inadequate. The work of ADEMU Political Economy has been to develop the theory needed to deal with these issues. Here we lay out out some of the main concerns and questions and indicate how ADEMU 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 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 tax-payer 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.

Much of the monopoly power in the monetary sector is decentralized 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 about the importance of central bank independence from politics. Unfortunately – as has become clear – central banks are far from independent from private-sector rent-seeking.

The banking sector has been extremely innovative in defeating measures designed to combat rent-seeking and this poses a problem both to tax-payers 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 subsidized 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 born by tax-payers. 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 to 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 recognized and has given rise to a number of populist political movements: Podemos in Spain, Cinque Stelle in Italy, to name a few. 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 come 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 tax-payers and system stability. Bankers can and do collude in their efforts, yet each has incentive to let the other bankers do the work. So it is with public officials, few of whom are individually influential, but who as a group wield great power.

Our primary emphasis had been 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 empirical understanding of how these groups operate and how they compete with one another. Ultimately this will make possible to design of 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 behavior. 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 causes 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 if this is a genuine initiative or simply a legal cover for government subsidization – for example, by implicitly or explicitly promising the successful banks future government favor 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. However: if we view this through the lens of collusive lobbying the issue is less clearcut. That is, 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 in favor of regulation – such as increased leverage requirements – that reduce 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 subsidize 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 behavior. 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.

Theoretical Work: Economic theory at this point does not provide good answers about how collusive organizations 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.

During the project we have published a number of papers developing the fundamental tools of contests and incentive constrained groups needed to analyze the political elements of the banking union:

1. Dutta, R., D. K. Levine and S. Modica [2016]: “Collusion Constrained Equilibrium,” *Theoretical Economics,* forthcoming. This paper addresses foundational issues that arise in game theory when colluding groups such as competing lobbying organizations interact with each other.

2. Levine, D. K. and S. Modica [2015]: “Peer Discipline and Incentives Within Groups,” *Journal of Economic Behavior and Organization*, forthcoming. This paper examines the internal disciplinary mechanisms used by collusive groups to overcome free rider problems.

3. Levine, D. K. and S. Modica [2016]: “Size, Fungibility, and the Strength of Lobbying Organizations,” *European Journal of Political Economy*, forthcoming. This paper looks at competition between competing lobbying organizations such as bankers versus “everyone else” and asks why and when the interests of a smaller group are able to be pushed ahead of the broader common interest.

4. Levine, D. K. and A. Mattozzi [2015]: “Voter Participation with Collusive Parties.” This paper studies an election between political parties through the lens of group collusion and monitoring. It examines the relative strength of groups of different sizes. It provides a formal model of voting and elections that is compatible with the theories of sociologists and political scientists about group participation.

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. 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.