# Project Briefing: The Political Economy of Policy Implementation

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***Rent-Seeking in the Banking Sector:*** To understand the political economy of monetary policy and monentary unions it is necessary to step back and examine how modern monetary systems create opportunities for rent-seeking in both the public and private sector. 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 - concern over market stability (fighting recession, lender of last resort) and raising government revenue (the inflation tax). There are also a 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 sectore 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 we have seen – 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 problem 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 well recognized and has given rise to a number of political movements: Pademos in Spain, Five Star 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. Withdrawal from the monetary union decentralizes regulation to member state central banks which the evidence suggests are considerably more subject to political influence than the ECB. Public policy set by public referendum might indeed lead to some improvements - but the devil is in the details and it is not practical to define detailed banking regulations through referenda, and even if it was done the policies would still have to be implemented by officials with incentives to engage in rent-seeking.

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 suborn the system in a variety of ways there are many banks and it is bankers as a whole 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.

The primary goal of this project is to analyze the internal incentives of collusive groups such as bankers, public officials and political parteis. A strong theoretical and empirical understanding of how these groups operate and how they compete with one another makes possible the design of institutions to mitigate the harm and enhance the good that these groups do.

There are two sides of this coin. On the one hand disrupting the ability of bankers or public officals to collude may make it more difficult for them to successfully engage in rent-seeking. On the other hand these groups can design positive incentives as well as negative incentives so that threats against the group as a whole may be effective. For example: if Pademos or Five Star were to propose a periodic audit of taxpayer money used to subsidize the banking sector with the threat of jailing public and private officials in response to a failed audit this officals 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 the political economy portion of the ADEMU project is 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.

At the moment we are pursuing a number of lines:

1. Dutta, R., D. K. Levine and S. Modica [2016]: “Collusion Constrained Equilibrium.” 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.” 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 studies an election between political parties through the lense 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.

5. Work in progress: An examination of the mechanisms for resolving political contests including both lobbying and voting. This is intended to create a broader framework for understanding the circumstances under which small groups and large groups are advantaged.

6. Work in progress: A study of monitoring in a network of colluding indivduals focusing on the cost of gathering information from diverse sources in the network.

7. Work in progress: A study of a dynamical system in which politicians are elected but become corrupted through lobbying. Corruption is difficult to observe and the goal is understand the best way of the timing of replacing politicians. For example: are term limits good or bad, and if they are good, how long should they be?

***Conclusions:*** Although still in the early stages there is a broad picture of political contests emerging from the work that has been completed. 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 duty this would shift advantage away from smaller special interest groups towards larger common interest groups.