Promiscuous Elites, The Revolving door and Inequality of Influence

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What is the revolving door?

When regulators are entering the sector they have formerly regulated.
What is the revolving door?

And when private sector employees are joining public sector agencies and having regulatory responsibilities over their former employers.
This paper has two main goals:

1. It presents a simple framework for analyzing the intertwining of the elites: Political, business and bureaucratic elites: It focuses on the revolving door.

2. This interconnection and promiscuity between the elites is one of the main reasons of the inequality of power between firms.
Zingales (2017) has stressed:

- Inequality in power among firms is a main problem in the economy...

- One of the main channels for the connected firms to acquire power is by using the revolving door...
This paper will:

- Develop a model which explains why the revolving door is tolerated by the political elite.
- Focus on the differences between firms in their capacity to hire revolvers and in the resulting distortions in the economy.
- Present an empirical part on the financial sector.
The revolving door is very frequent in the financial sector.
Examples of RD in the financial sector in the US:

<table>
<thead>
<tr>
<th>Name</th>
<th>Former public agencies</th>
<th>New private employers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alan Greenspan</td>
<td>Chair, Fed</td>
<td>Paulson and Co.</td>
</tr>
<tr>
<td>Glenn Hubbard</td>
<td>Treasury Department</td>
<td>KKR Financial Co.</td>
</tr>
<tr>
<td>Robert Zoellick</td>
<td>State Department</td>
<td>Goldman Sachs</td>
</tr>
<tr>
<td>Larry Summers</td>
<td>Treasury Secretary</td>
<td>Goldman Sachs</td>
</tr>
<tr>
<td>Jacob Lew</td>
<td>Office of Management and Budget</td>
<td>Citigroup, CEO/alt-investment</td>
</tr>
<tr>
<td>Timothy Geithner</td>
<td>Chair, Fed</td>
<td>EM Warburg, Pincus &amp; Co</td>
</tr>
<tr>
<td>Samuel Berger</td>
<td>NS advisor – White House</td>
<td>ASG</td>
</tr>
<tr>
<td>Harold Ford, Jr.</td>
<td>House of representative</td>
<td>Morgan Stanley</td>
</tr>
<tr>
<td>Warren Rudnam</td>
<td>White House</td>
<td>ASG</td>
</tr>
</tbody>
</table>

Source: www.opensecret.org
The revolving door has been denounced by the press worldwide

**Washington Post** (US): “Fed up with Wall Street Revolving Door”


**The Telegraph** (UK): “Whitehall's revolving door speeds up: ex-ministers and civil servants seeking jobs in private sector doubles”

C. Hope, December 14, 2013

**Le monde** (FR): “A New York, la Fed en plein conflit d'intérêt avec Goldman Sachs”

M. Damgé, October 11, 2013
• **Facts:**
  • Ban and You (2017) find that during the Dodd-Franck Act’s rulemaking process, comments from financial firms having hired former SEC employees were more likely to be cited in the Act’s final rule than firms’ who were not.
  
• A report from the SEC’s inspector general David Kotz pointed out the undue influence of former SEC officials working for financial firms exerted on SEC’s actions taken to slow down or short-circuit investigations that followed the 2008 financial crisis
Timothy Geithner – the former US Treasury secretary who pushed the bailout of the big banks in the wake of the financial crisis – received in 2016 through his private equity firm a $800 million credit line granted by JPMorgan (a bailout beneficiary) with very favorable conditions.
The first part of the model explains how the various elites are related. The framework we present, is different than the known framework of the revolving door.

A large span of this literature is based on the well-known regulatory capture channel, which occurs when a regulator is “captured” by one specific firm, and while strict with the others, she is lenient with this firm.

In other words, the revolving door leads to corruption.

Yet, it is difficult to believe that the revolving door, which is so much in use around the Western world, is related to unlawful behavior.
This paper takes a different approach:

- It analyzes the practice of the revolving door in a legal environment.
- The revolving door, in our paper, is related to rent-seeking, and represents an unethical yet legal behavior.

So:
We first develop a model setting a theoretical foundation for the reasons why the revolving door is profitable for the financial firms.

Then, we explain why there is an inequality among firms. The cause of this inequality is the too-big-to-fail externality, so that revolving door is used mostly by a small number of large firms.

The revolving door enables the largest firms to derive influence over public decision-making and to maintain their dominant positions.
Then, in the empirical part of the paper, the model’s prediction that regulators are moving towards the biggest financial firms is tested.

- We have developed a **new** database tracking the revolving door process by the **20** biggest US diversified banks.

- The results:
Our main results are:

- The top-five financial firms represent 80% of revolvers and revolving door movements: GS; JP Morgan, Citigroup, Bank of America, and Wells Fargo.
- Goldman Sachs appears to be the prime beneficiary of this process.
- 30% of total revolvers, having accumulated 698 years of influence in public office.
- Regulators who have created much ‘bureaucratic capital’ are more likely to be hired by the top five banks after leaving public office.
The Model

1. The First Part
This model provides a rationale for the Revolving door by developing the concept of ‘bureaucratic capital’.

Indeed, the revolving door allows regulators to supply bureaucratic capital, created during their public tenure, to regulated firms.
The bureaucratic capital are all ‘legal’ actions by the regulator which give him/her a ‘value added’ to be hired hereafter.

‘Bureaucratic capital’ is a mix of social and human capital created by regulators during public office, in the form of networking, red-tape creation, inside knowledge of regulation design and implementation, and so on.
• In return, this knowledge of regulations and these connections within regulatory agencies are valuable to the firm in the very industry the revolvers had regulatory powers.

• In other words:
• The previous regulator knows how to pass through complex regulations, and to receive a VIP service by being in touch with her previous colleagues who are in the regulatory agency.
• It should be noted that in our paper, the creation of ‘bureaucratic capital’ by regulators is the explanation for the existence of the revolving door,
• and it is a justification for this behavior, without introducing some illegal actions, as in other frameworks.
• Bureaucratic capital is not illegal, although it is unethical.
Therefore, the **originality of this model** is that it highlights a motivation why a firm will hire a former regulator at a higher salary than in the public sector.

It is so because firms are better off by acquiring the bureaucratic capital the revolver has created;

which in turn, allows the regulator to cash in on this bureaucratic capital once having left the public service.

This ‘bureaucratic capital’ is particularly valued in the financial industry as evidenced by the high salaries for the revolvers.
• Second part
Then, we introduce an inequality between firms:

In our model, firms are not equal in their capacities to accumulate bureaucratic capital, since big financial firms face a smaller cost of capital than small firms.

This is due to the externality of the ‘run on the bank’. Indeed, in the financial sector, there is the risk that the collapse of a big firm will lead to a ‘run on the bank’.

So, it is common knowledge that the government will bail out ‘too-big-to-fail’ firms.

This feature has been internalized by financial markets which, as a result, reduce the risk-premium of big firms.
- This capital market imperfection has the consequence that large financial companies can afford to hire many revolvers and benefit from their ‘bureaucratic capital’
- while small firms in the same sector cannot afford this strategy.

- Consequently, there is disparity in the levels of bureaucratic capital accumulated by large and small firms respectively,
- leading to inequality of influence and inequality in profits.
We therefore develop:

- A **supply** of bureaucratic capital by the **bureaucratic elite**
- A **demand** for bureaucratic capital by the **business elite**
- An equilibrium of this bureaucratic capital
- Then, we introduce the **political elite**, explaining why they accept the revolving door.
- Then, we introduce the differences between firms:
  - The demand will be different between big firms and small firms.
- **So we get concentration of revolving door.**
Question:

Will the political elite let the bureaucratic elite use her/his power and create bureaucratic capital?

Yes
The political elite maximize economic growth.

High quality bureaucrats are needed for reaching economic growth.

But

in order to hire bureaucrats of high quality, the government has to pay them higher income.

Since wages are not very high in civil service, the way to propose higher income is to let the bureaucrats accumulate bureaucratic capital, which will permit them to cash in, in the future.
• So the creation of bureaucratic capital permits to have bureaucrats of higher quality.

• Therefore, the political elite will not choose a corner solution.

and

• the optimal amount of bureaucratic capital is not zero.

• So this paper explains the fact that the political elite permits “bureaucratic capital” to be created despite its negative effect on the economy.

• This is the first result.
The second result of this paper is:

At the point of market equilibrium, we get that the bureaucratic elite is of higher quality than optimal, but creates more bureaucratic capital than the optimum for the economy.

The third result of this paper is:

Inequality of influence between big and small firms.
The supply side of the market for bureaucratic capital

- A regulator (“revolvers”) creates bureaucratic capital ($H$) in public office - a concave function of bureaucrat’s efforts ($E$):

$$H_l(E_l) = T[(1 + \gamma)E_l]^{1/1+\gamma} \quad \gamma > 0$$  \hspace{1cm} (1)

- After leaving her job as regulator, the bureaucrat works for a period of length $\tau$ in the financial industry. She receives in top of her “regular” income, $\Omega$, a rent related to her bureaucratic capital, sold at price $q$ for a number of years $\tau$ in the regulated industry:

$$V_l = \Omega - TE_l + \tau qH_l(E_l)$$
The supply side of the market for bureaucratic capital

• Maximizing income, we get:

\[ \hat{H}_l = T(\tau q)^{1/\gamma} \]
The demand side of the market for bureaucratic capital

- 2 types of firms producing intermediate-goods (financial services) in a monopolistic competition: $N_1$ firms $j$ with low c.o.c, $N_2$ firms $i$ with higher c.o.c, producing intermediate goods $x_j$ and $x_i$ respectively.

- While the intermediate-goods sector consists of monopolistic firms, the final good is produced in a perfect competitive environment:

$$Y = L_y^{1-\alpha} \int_0^{n_1} x_j^\alpha dj \int_0^{n_2} x_i^\alpha di$$

$$\text{Max } L_y^{1-\alpha} \int_0^{n_1} x_j^\alpha dj \int_0^{n_2} x_i^\alpha di - w_y L_y - \int_0^{n_1} p_j x_j dj - \int_0^{n_2} p_i x_i di$$
The demand side of the market for bureaucratic capital
– the simple model

- Let us start with only one unique type of firms:
- They have two types of costs.
- The first one is the amount of capital, \( k \) they use.
- and as Romer, we assume a simple production function

\[
x_j = k_j
\]
• The second one is that they have to pay for the bureaucrat they will take on the board.

• Why will they do that?

• When a firm \( j \) hires a bureaucrat, the production of output \( j \) becomes more efficient.

• This is so, because the regulator has a better knowledge of the system and of the loopholes that exist.

• But, the effect of this bureaucratic capital in firm \( j \) depends on the amount of bureaucratic capital of other firms, since what matters is the relative effect of the regulator.
In fact, it depends on the relative amount of bureaucratic capital by the different regulators of the different sectors.

So the production function for an intermediate good firm is:

\[ x_j = k_j \left( \frac{H_j}{H_a} \right) \phi \quad \phi > 0 \]

where \( H_j \) is the amount of bureaucratic capital produced by the regulator of firm \( j \), and \( H_a \) is the average amount of bureaucratic capital owned by the other firms.
In fact, it depends on the relative amount of bureaucratic capital by the different regulators of the different sectors.

So the production function for an intermediate good firm is:

\[ x_j = k_j \left( \frac{H_j}{H_a} \right)^\phi \quad \phi > 0 \]

where \( H_j \) is the amount of bureaucratic capital produced by the regulator of firm \( j \),

and \( H_a \) is the average amount of bureaucratic capital owned by the other firms.
• So the profit maximization for an intermediate good firm is:

\[ \text{Max } \pi_j = p_j(x_j)x_j - rk_j - qH_j \]

which becomes:

\[ \text{Max } \pi_j = p_j(x_j)x_j - rx_j\left(\frac{H_j}{H_a}\right)^{-\phi} - qH_j \]

• Taking the FOC for maximizing profits, we get:
This is the demand for BC (in a symmetric equilibrium).

where

\[ H_j = H_a = \frac{\phi r K}{qA} \]

This is the demand curve for BC:
III. The political Elite

- The political goal of the elite is to maximize the rate of growth of the economy in order to be reelected.

- They choose the regulator among a pool of candidates with different level of ability.

- On one hand, higher ability of the regulator leads to economic growth:

  - 2. On the other hand, attracting a higher ability regulator requires that the lifetime income earned in regulation, $V$, be greater, which means:

- Permitting to create bureaucratic capital.
• The relationship between ability and amount of bureaucratic capital faced by the political elite and the public is:

\[ Q_i = \frac{1}{\xi} \left[ \Omega - \frac{H_i^{1+\gamma}}{1+\gamma} + \tau qH_i \right] \]

• Appointing a regulator with higher ability means letting him accumulate a higher amount of bureaucratic capital.

• This equation is therefore the production possibility frontier between bureaucratic capital and ability faced by the political elite.
In the following proposition, we present the optimal amount of bureaucratic capital for the economy.

**Proposition 1**

The optimal amount of bureaucratic capital is positive. The economy has an interest that the bureaucratic elite create redundant and wasteful regulations.

In other words,

Bureaucratic capital is a social waste, but still necessary in order to have good bureaucrats.
Although point as M is optimal for the economy, is there a way that the system will bring the economy to such a point?

No.

Proposition 2

- The amount of Bureaucratic capital, \( H \) chosen by the bureaucratic elite is higher than the amount the political elite would choose.
Figure 1. Supply and Demand of Bureaucratic Capital, and the Trade-off between Quality and Bureaucratic Capital
We analyze now the case when there are two types of firms: the small ones and big ones.
The model

Equilibria on the market for bureaucratic capital

$q^*$

$H^*_2$  $H^*_1$  $H^*_3 = H^*_1 + H^*_2$

$S(T,\tau)$

$D_u + D_c$

$D_u(\phi,r)$

$D_c(\phi,r,c)$
• Conclusion of the model with 2 types of firms:

• **Proposition 3**

• *a. The amount of bureaucratic capital of small financial firms is lower than the amount for big and especially too-big-to-fail firms.*

• *b. Through bureaucratic capital accumulation, big firms maintain their profits at a higher level than small firms.*
III The empirical part
The Data

Data sources

• This part requires matching information on company officers with information on public regulators.

• Data sources are national registries of private companies, international business databases, companies’ official websites, business-focused websites, official government and public sector commission websites, social networks, and websites focused on public actors and conflicts of interest.
Then, **three types of revolving door flows** are identified:

- **Type 1, public-to-private**: Former members of a relevant ministry, administration, or legislature currently hold responsibilities in a regulated company.
- **Type 2, private-to-public**: Former executives of a regulated company are currently members of a relevant ministry, administration, or legislature.
- **Type 3, private-to-public-to-private** (two-sided): Executives have engaged in both type 1 and type 2 movements and are therefore prone to favor firms both during and after their term in public office.
Typology of revolved regulators

Then, four proxies of revolving door flows are identified:

- Proxy 1: revolvers
- Proxy 2: movements
- Proxy 3: prominent
- Proxy 4: experience
Table 1. The inequality of influence in the US banking sector.

<table>
<thead>
<tr>
<th>Proxy 1</th>
<th>Proxy 2</th>
<th>Proxy 3</th>
<th>Proxy 4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revolvers</td>
<td>Total movements</td>
<td>Publ. to priv. moves</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>304</td>
<td>384</td>
</tr>
<tr>
<td>RI</td>
<td>0.79</td>
<td>0.79</td>
<td>0.79</td>
</tr>
<tr>
<td>CI</td>
<td>0.23</td>
<td>0.24</td>
<td>0.22</td>
</tr>
<tr>
<td>Goldman Sachs’ %</td>
<td>0.27</td>
<td>0.27</td>
<td>0.23</td>
</tr>
<tr>
<td>Banks, ranked by revenue</td>
<td>Revolvers</td>
<td>Total movements</td>
<td>Public-to-bank</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-----------</td>
<td>----------------</td>
<td>----------------</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>62</td>
<td>82</td>
<td>50</td>
</tr>
<tr>
<td>Bank of America</td>
<td>29</td>
<td>36</td>
<td>22</td>
</tr>
<tr>
<td>Citigroup</td>
<td>55</td>
<td>71</td>
<td>41</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>12</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>81</td>
<td>102</td>
<td>50</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>15</td>
<td>18</td>
<td>9</td>
</tr>
<tr>
<td>American Express</td>
<td>14</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>Capitale 1 Financial</td>
<td>8</td>
<td>13</td>
<td>7</td>
</tr>
<tr>
<td>US Bancorp</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Bank of NY Mellon</td>
<td>6</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>PNC Fin. Services</td>
<td>7</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>State Street Corp</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>BB&amp;T Corp</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Ally Financial</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Discover Fin. Services</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Suntrust Bank</td>
<td>4</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Fifth Third Bancorp</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Regions Financial</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>M&amp;T Bank</td>
<td>2</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Northern trust</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>304</td>
<td>384</td>
<td>219</td>
</tr>
</tbody>
</table>
Table 2. The inequality of influence in the US banking sector, by key regulatory agency.

<table>
<thead>
<tr>
<th>Fed system</th>
<th>Treasury</th>
<th>White House</th>
<th>Congress Bank&amp;Fin</th>
<th>Trade Rep.</th>
<th>SEC</th>
<th>Intelligence agencies</th>
<th>FDIC</th>
<th>CFTC</th>
<th>Total key agencies</th>
<th>Other agencies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>53</td>
<td>40</td>
<td>26</td>
<td>24</td>
<td>10</td>
<td>13</td>
<td>10</td>
<td>8</td>
<td>3</td>
<td>117</td>
<td>304</td>
</tr>
<tr>
<td>RI</td>
<td>0.74</td>
<td>0.88</td>
<td>0.92</td>
<td>0.75</td>
<td>0.80</td>
<td>0.92</td>
<td>0.90</td>
<td>0.88</td>
<td>1.00</td>
<td>0.72</td>
<td>0.79</td>
</tr>
<tr>
<td>CI</td>
<td>0.24</td>
<td>0.36</td>
<td>0.39</td>
<td>0.29</td>
<td>0.39</td>
<td>0.43</td>
<td>0.34</td>
<td>0.31</td>
<td>0.67</td>
<td>0.18</td>
<td>0.23</td>
</tr>
<tr>
<td>Goldman Sachs %</td>
<td>0.23</td>
<td>0.43</td>
<td>0.31</td>
<td>0.31</td>
<td>0.30</td>
<td>0.38</td>
<td>0.42</td>
<td>0.25</td>
<td>0.67</td>
<td>0.27</td>
<td>0.27</td>
</tr>
</tbody>
</table>
Figure 5. Bureaucratic capital and bank’s profits

- Slope = 0.026***
  - R² = 0.42

- Slope = 0.003***
  - R² = 0.37

- Slope = 0.532***
  - R² = 0.48

- Slope = 0.507***
  - R² = 0.57
• **Conclusion**

• “Power and Influence are not equal among financial firms.”

• Zingales (2015)
To conclude:

To paraphrase Orwell,

This empirical analysis has stressed that US financial firms “are equal but some firms are more equal than others”!!!