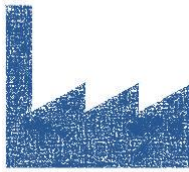# Revolving Door

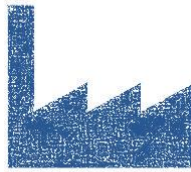## Promiscuous Elites,
The Revolving door
and Inequality of Influence

Elise S. Brezis Bar-Ilan University

Joël Cariolle, FERDI, France
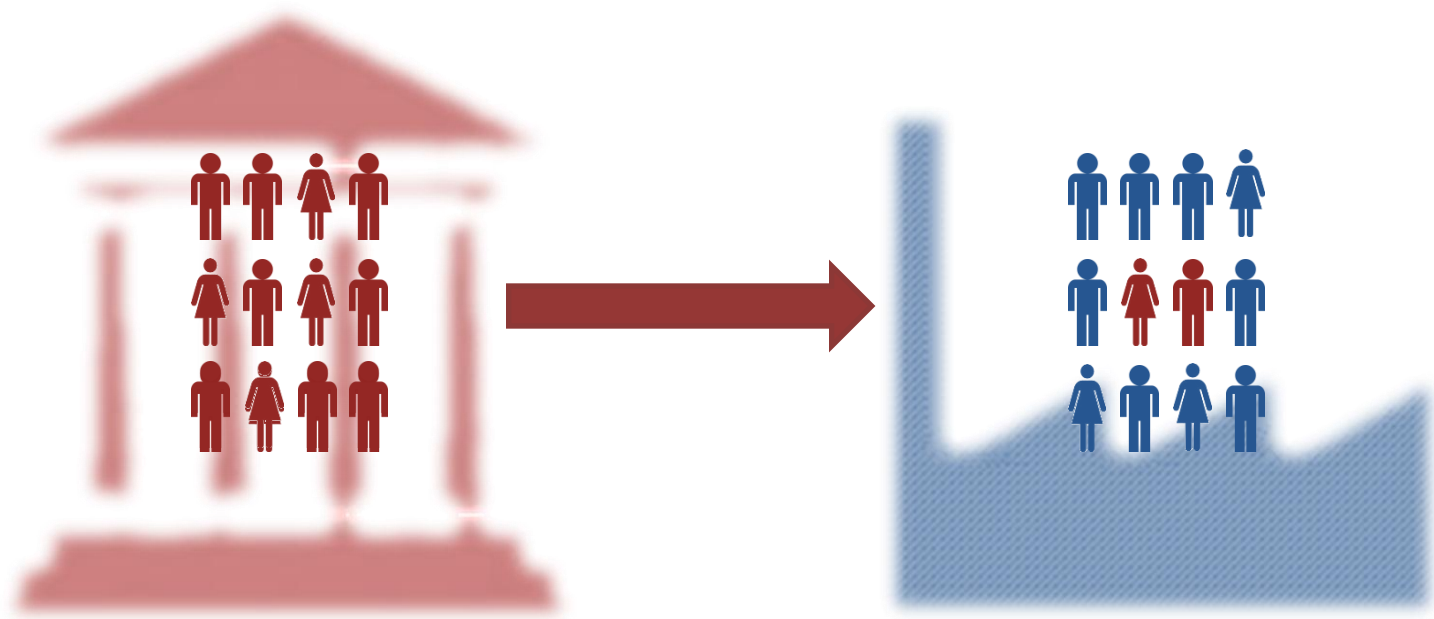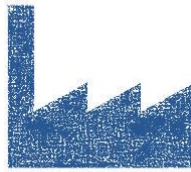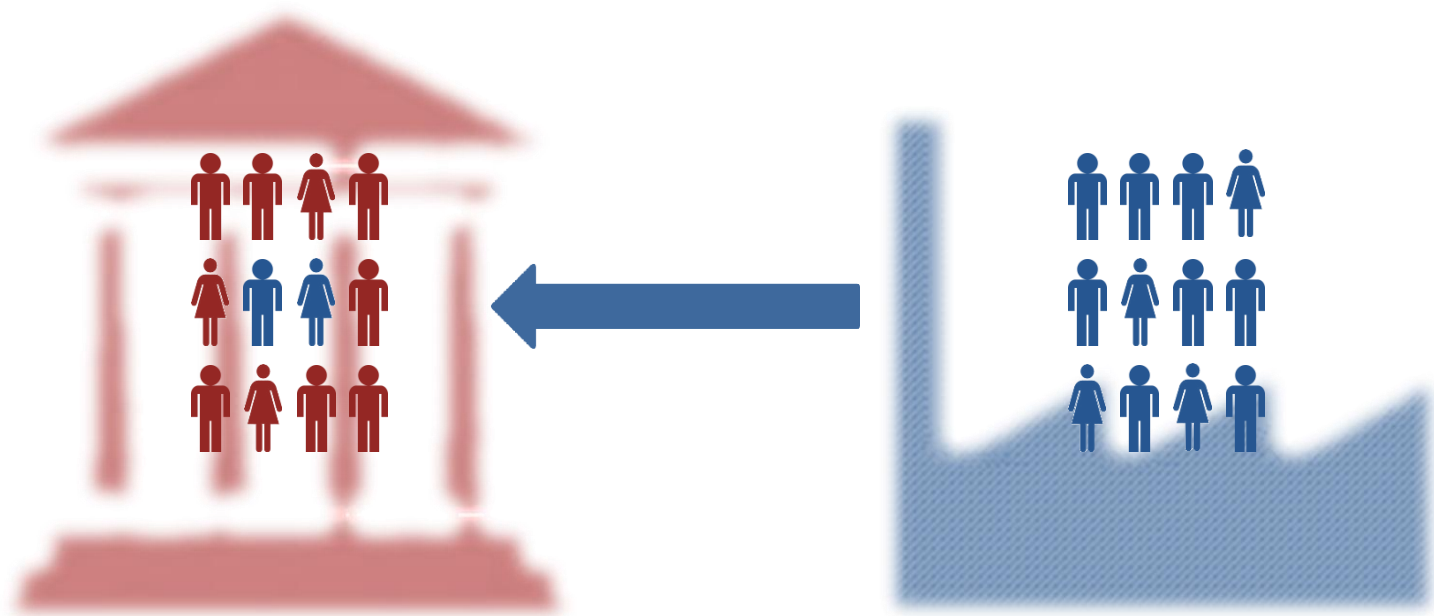
DIAL, December 2019

1

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.

Revolving door
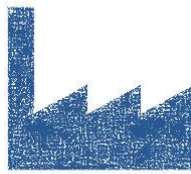
Examples of RD in the financial sector in the US:

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

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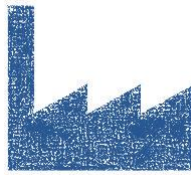
The revolving door has been denounced by the press worldwide

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

K. vanden Heuvel, July 30, 2013.

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

- <u>Facts</u>:
- 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:

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- 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 <u>small</u> number of <u>large</u> firms.

- The revolving door enables the largest firms to derive **influence over public decision-making and to maintain their dominant positions**.

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- 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 <u>new</u> database tracking the revolving door process by the <u>20</u> 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

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- This model provides a rationale for the Revolving door by developing the concept of 'bureaucratic capital'.

- Indeed, the revolving door allows regulators to supply <u>bureaucratic capital</u>, 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 <u>illegal</u> actions, as in other frameworks.

- Bureaucratic capital is not illegal, although it is unethical.

- Therefore, the <u>originality of this model</u> 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 <u>big</u> financial firms face a <u>smaller</u> cost of capital than <u>small</u> 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 '<u>too-big-to-fail</u>' firms.

- This feature has been internalized by financial markets which, as a result, reduce the <u>risk-premium</u> of big firms.

- This <u>capital market imperfection</u> 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 <u>the first result</u>.

- <u>The second result</u> of this paper is:

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

- The <u>third result</u> of this paper is:

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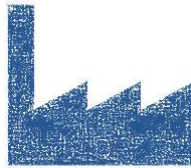
The supply side of the market for bureaucratic capital

- A regulator ("revolvers") creates **bureaucratic capital (H)** in public office - a concave function of **bureaucrat's efforts (E)**:
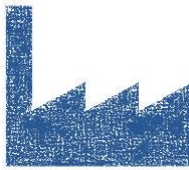
(1)

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

- After leaving her job as regulator, the bureaucrat works for a period of length **τ** in the financial industry. She receives in top of her "regular" income, Ω, a rent related to her bureaucratic capital, sold at price **q** for a number of years **τ** in the regulated industry:

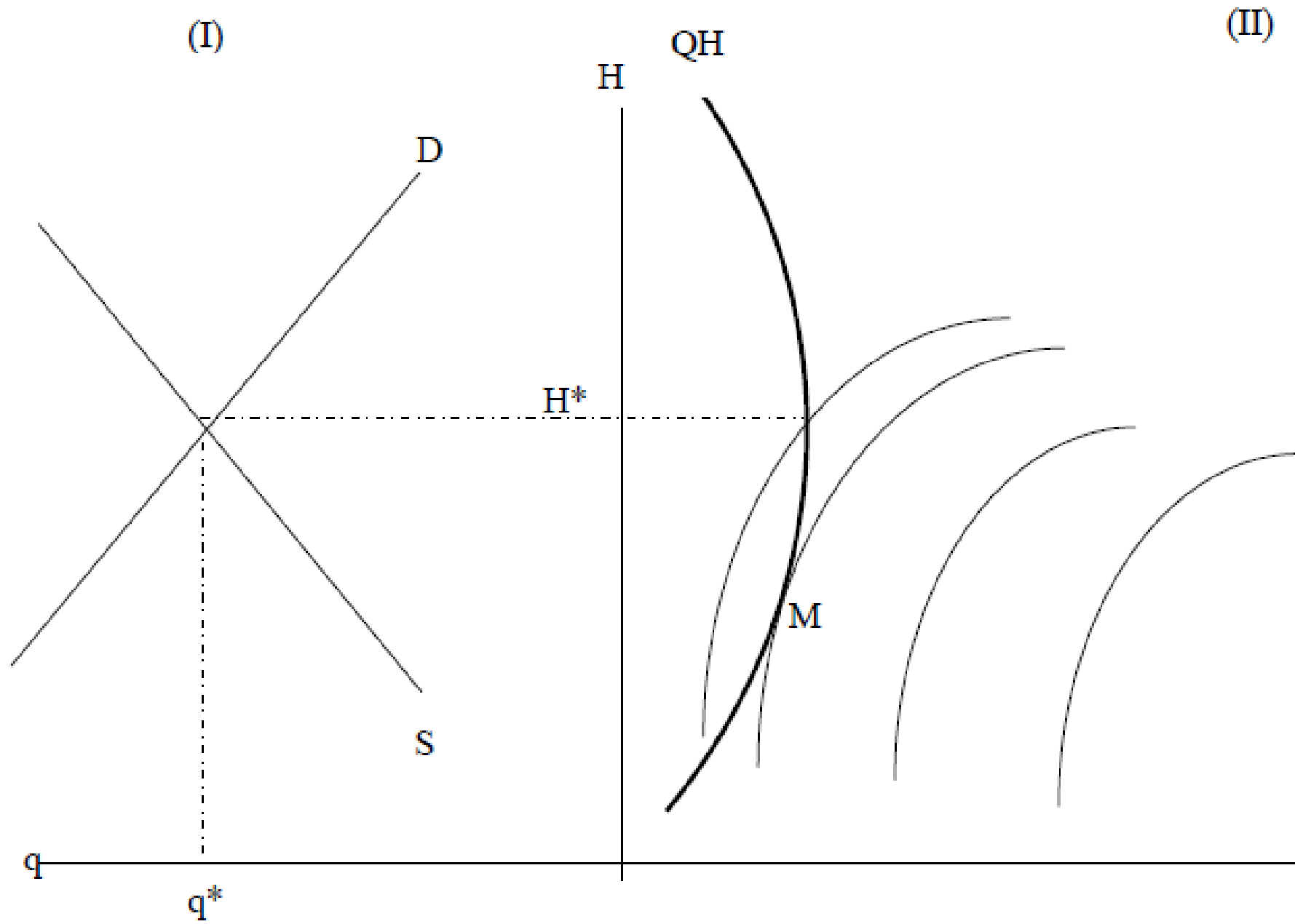$$V_l = \Omega - T E_l + \tau q H_l(E_l)$$

The model

The supply side of the market for bureaucratic capital
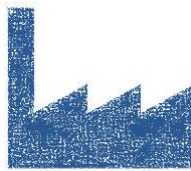
- Maximizing income, we get:

$$\hat{H}_l = T(\tau q)^{1/\gamma}$$

(I)

(II)

QH

H

D

H*

M

S

q

q*

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:

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

$$Max \, L_y^{1-\alpha} \int_0^{n_1} x_j^\alpha \, dj \int_0^{n_2} x_i^\alpha \, di - w_y L_y - \int_0^{n_1} p_j x_j \, dj - \int_0^{n_2} p_i x_i \, di$$

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

$$x_j = k_j$$

- <u>The second one</u> 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.

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- 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:

$$x_j = k_j \left(\frac{H_j}{H_a}\right)^{\phi} \qquad \phi > 0$$

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:

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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:

$$Max\,\pi_j = p_j(x_j)x_j - rk_j - qH_j$$

which becomes:

$$Max\,\pi_j = p_j(x_j)x_j - rx_j(\frac{H_j}{H_a})^{-\phi} - qH_j$$

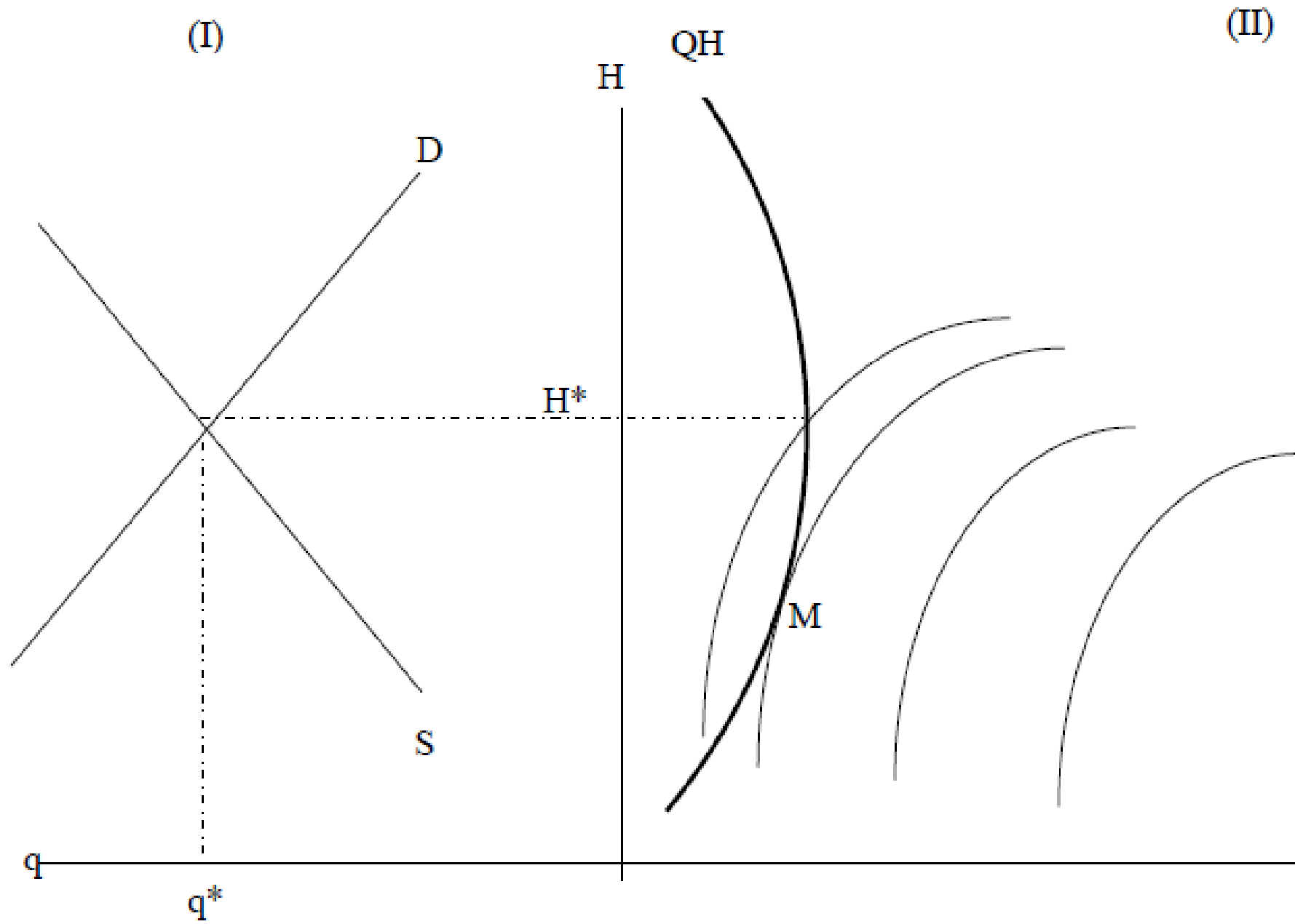- Taking the FOC for maximizing profits, we get:

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$$H_j = H_a = \frac{\phi r K}{qA}$$

- This is the demand for BC (in a symmetric equilibrium).

- where

$$K = \int_O^A k_j dj$$

- This is the demand curve for BC:

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(I)   (II)

                                              QH
                                    H

                    D

                            H*   M

                                    q

            S

q

        q*

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.

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- The relationship between ability and amount of bureaucratic capital faced by the political elite and the public is:

$$Q_i = \frac{1}{\xi}[\Omega - \frac{H_i^{1+\gamma}}{1+\gamma} + \tau q H_i]$$

- 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 <u>bureaucratic capital</u> and <u>ability</u> faced by the political elite.

(II)

QH

H

D

H*

S

M

Iso-growth curve

Q
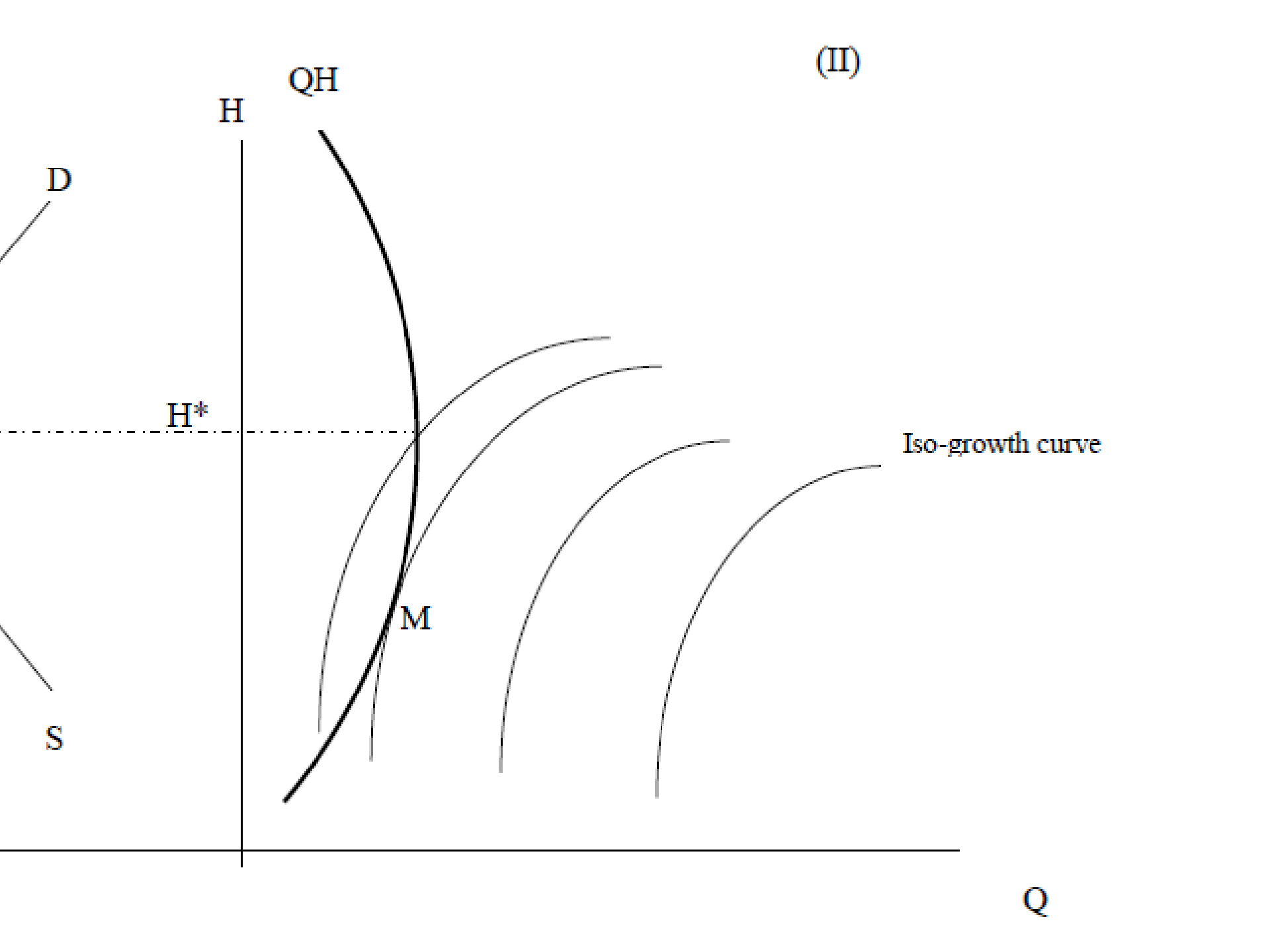
- In the following proposition, we present the optimal amount of bureaucratic capital for the economy.

- **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.

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- 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.*

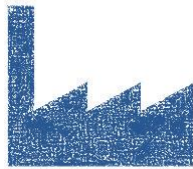# Figure 1. Supply and Demand of Bureaucratic Capital, and the Trade-off between Quality and Bureaucratic Capital
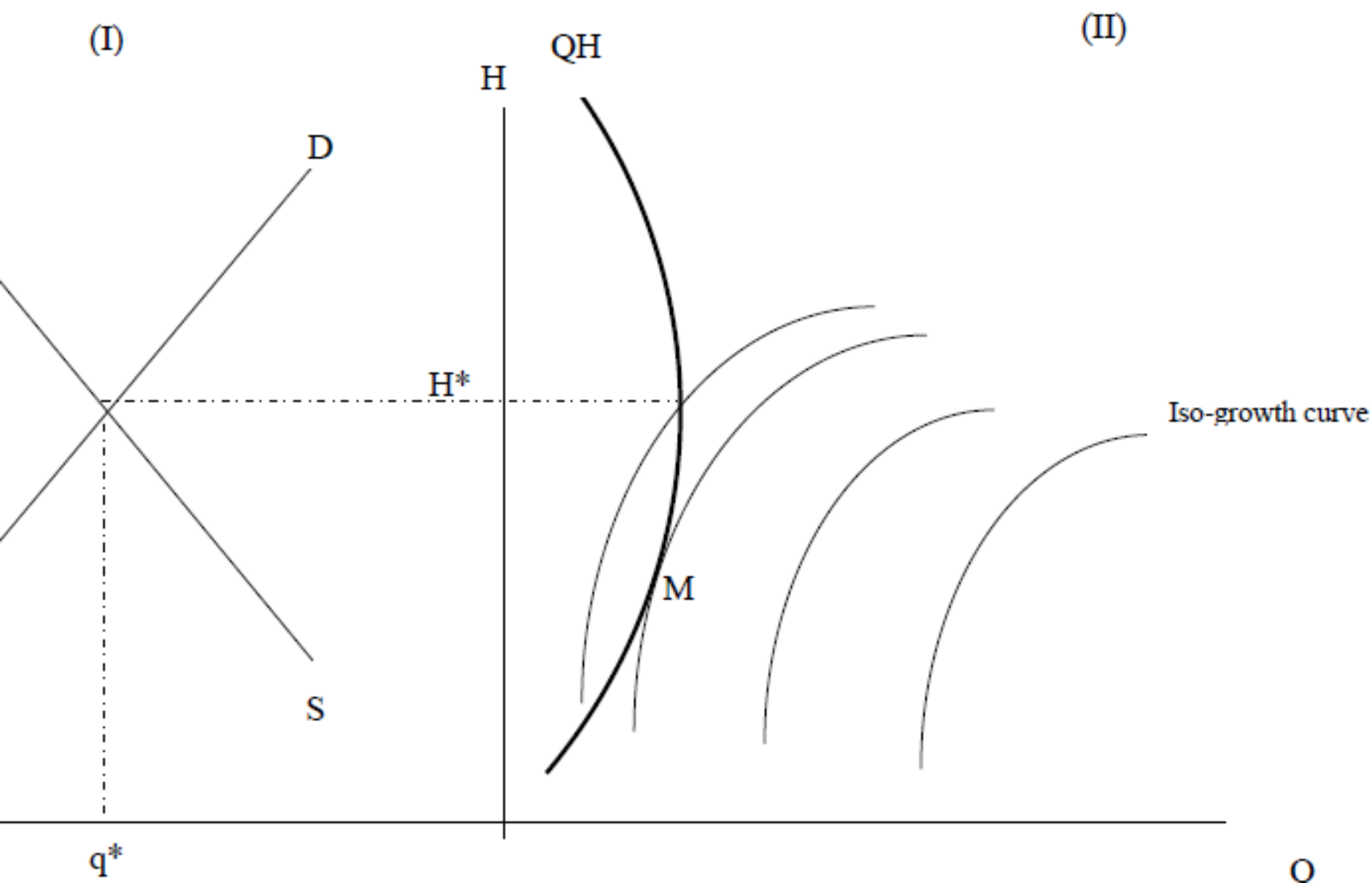
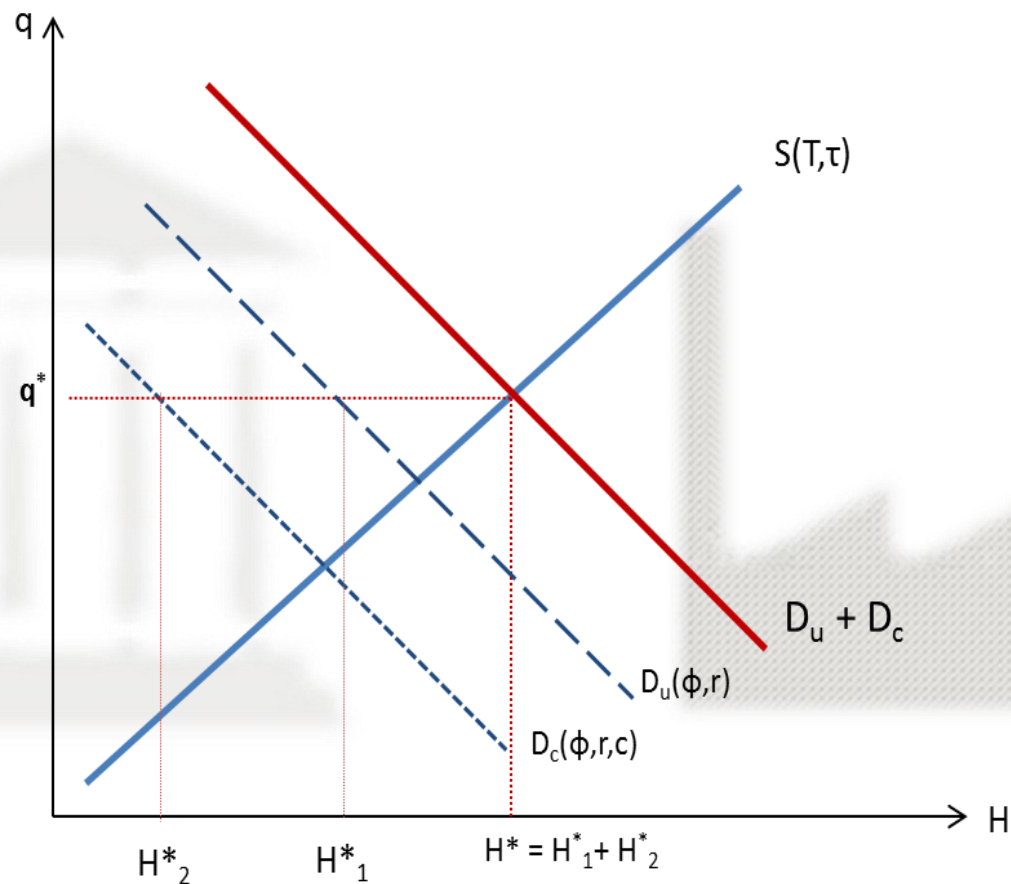- We analyze now the case when there are two types of firms: the small ones and big ones.

**Equilibria on the market for bureaucratic capital**

- 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.*

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- III The empirical part

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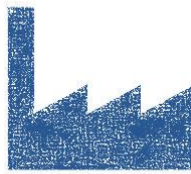
Data sources

- 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.
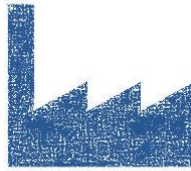
Typology of revolved regulators

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
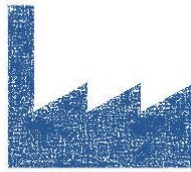
Typology of revolved regulators

Then, **four proxies of revolving door flows** are identified:

- ✓ **Proxy 1: revolvers**

- ✓ **Proxy 2: movements**

- ✓ **Proxy 3: prominent**

- ✓ **Proxy 4: experience**
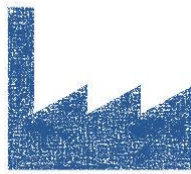
Table 1. The inequality of influence in the US banking sector.

	Proxy 1	Proxy 2				Proxy 3	Proxy 4
	Revolvers	Total movements	*Publ. to priv. moves*	*Priv. to publ. moves*	*2-sided moves*	Prominent revolvers	years in public office
Total	304	384	*219*	*142*	22	155	2256
RI	0.79	0.79	*0.79*	*0.78*	*0.86*	0.86	0.82
CI	0.23	0.24	*0.22*	*0.26*	*0.32*	0.29	0.26
Goldman Sachs' %	0.27	0.27	*0.23*	*0.32*	*0.32*	0.32	0.31

55

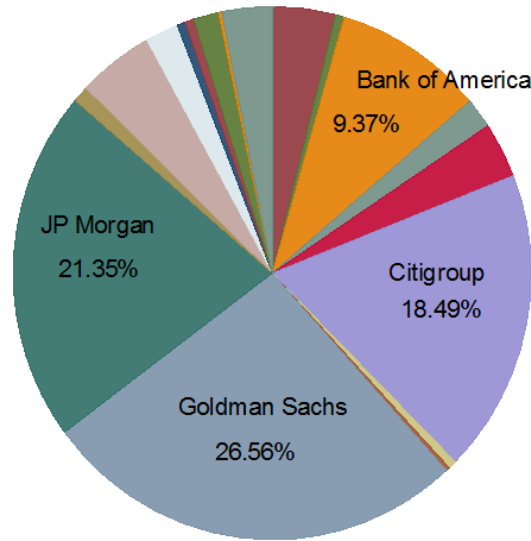| Banks, ranked by revenue	Proxy1	Proxy 2				Proxy 3	Proxy 4
	Revolvers	Total movements	Public-to-bank	Bank-to-public	Two-sided	Prominent revolvers	years in public offices
JP Morgan	62	82	50	27	5	32	436
Bank of America	29	36	22	12	2	20	227
Citigroup	55	71	41	25	5	28	401
Wells Fargo	12	12	10	2	0	4	87
Goldman Sachs	81	102	50	45	7	50	698
Morgan Stanley	15	18	9	8	1	5	75
American Express	14	15	9	5	0	4	75
Capitale 1 Financial	8	13	7	4	2	1	48
US Bancorp	1	1	0	1	0	1	3
Bank of NY Mellon	6	7	4	3	0	3	35
PNC Fin. Services	7	8	5	3	0	1	53
State Street Corp	2	2	1	1	0	0	3
BB&T Corp	1	2	1	1	0	0	7
Ally Financial	0	0	0	0	0	0	0
Discover Fin. Services	2	2	1	1	0	1	29
Suntrust Bank	4	6	4	2	0	1	26
Fifth Third Bancorp	1	1	1	0	0	1	26
Regions Financial	2	2	2	0	0	1	18
M&T Bank	2	4	2	2	0	2	9
Northern trust	0	0	0	0	0	0	0
Total	304	384	219	142	22	155	2256
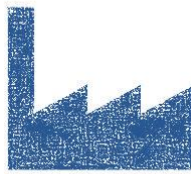
Table 2. The inequality of influence in the US banking sector, by key regulatory agency.

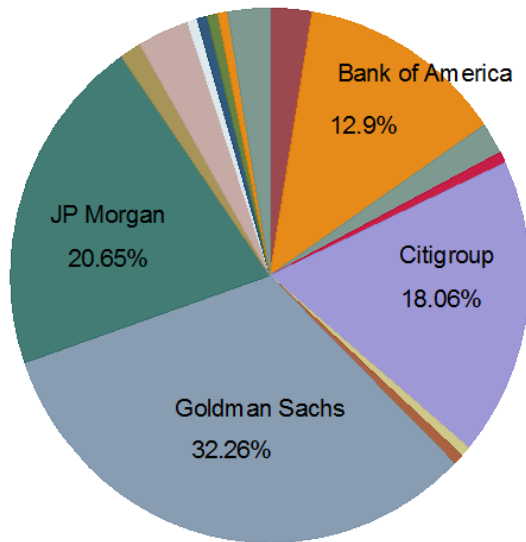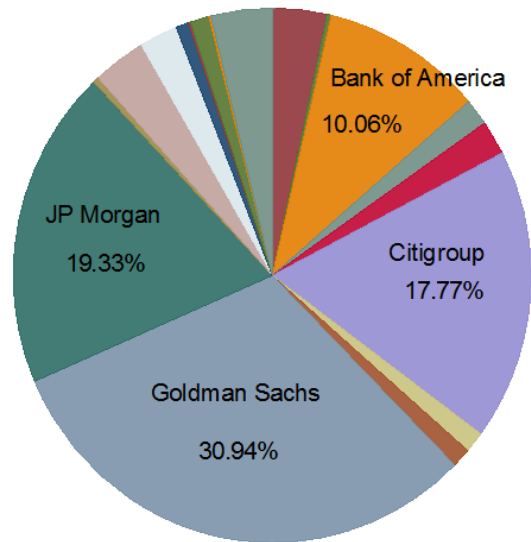|	Fed system	Treasury	White House	Congress Bank&Fin	Trade Rep.	SEC	Intelligence agencies	FDIC	CFTC	Total key agencies	Other agencies	Total
Total	53	40	26	24	10	13	10	8	3	**187**	117	**304**
RI	0.74	0.88	0.92	0.75	0.80	0.92	0.90	0.88	1.00	**0.83**	0.72	**0.79**
CI	0.24	0.36	0.39	0.29	0.39	0.43	0.34	0.31	0.67	**0.28**	0.18	**0.23**
Goldman Sachs %	0.23	0.43	0.31	0.31	0.30	0.38	0.42	0.25	0.67	**0.33**	0.27	**0.27**

Proxy 1: revolvers
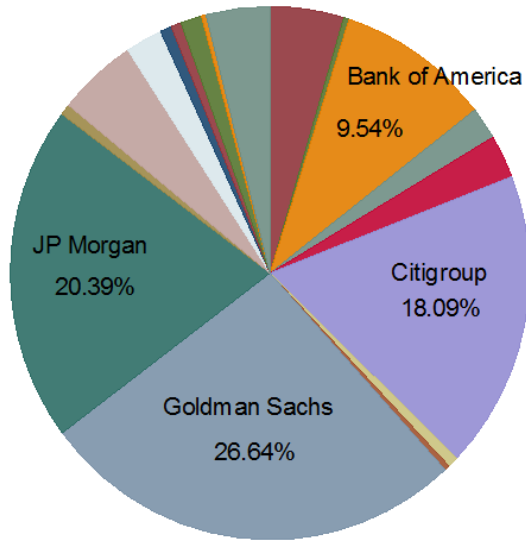
Proxy 2: revolving door movements

Proxy 3: prominent revolvers

Proxy 4: years in public office

Legend:
- Ally Financial
- American Exp.
- BB&T Corp
- Bank of America
- Bank of NY
- Capitale 1 Fin.
- Citigroup
- Discover Fin. Serv.
- 5th 3rd Bancorp
- Goldman Sachs
- JP Morgan
- M&T Bank
- Morgan Stanley
- Northern trust
- PNC Fin. Serv.
- Regions Fin.
- State Street Corp
- Suntrust Bank
- US Bancorp
- Wells Fargo

Bureaucratic capital and bank's profits
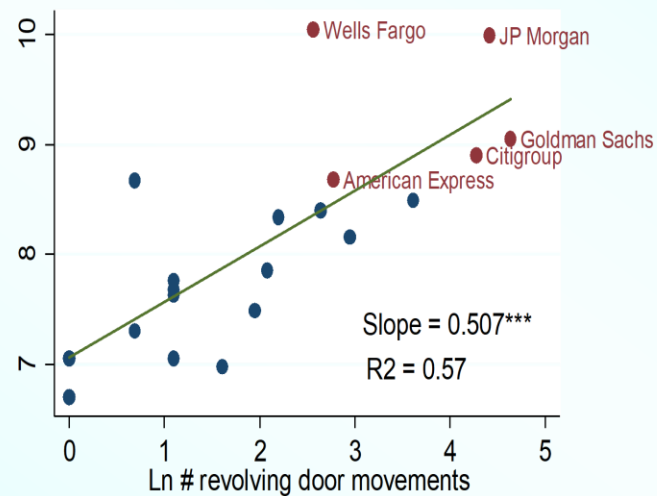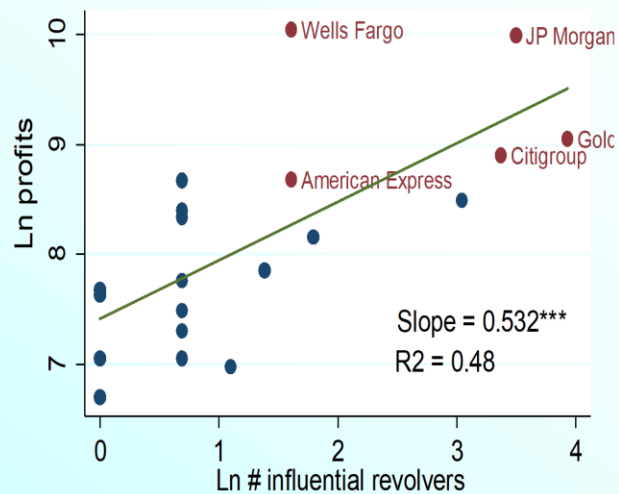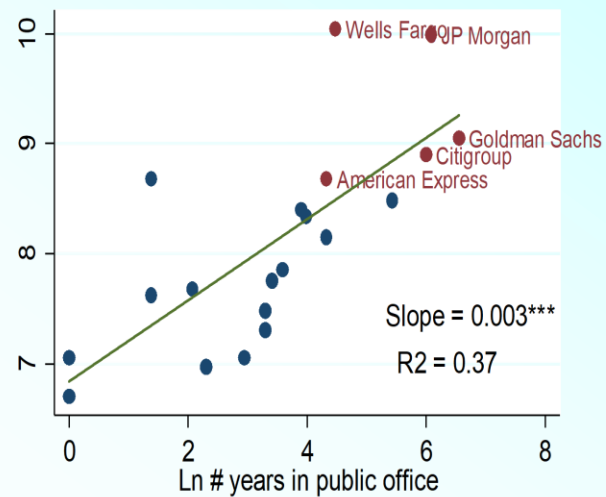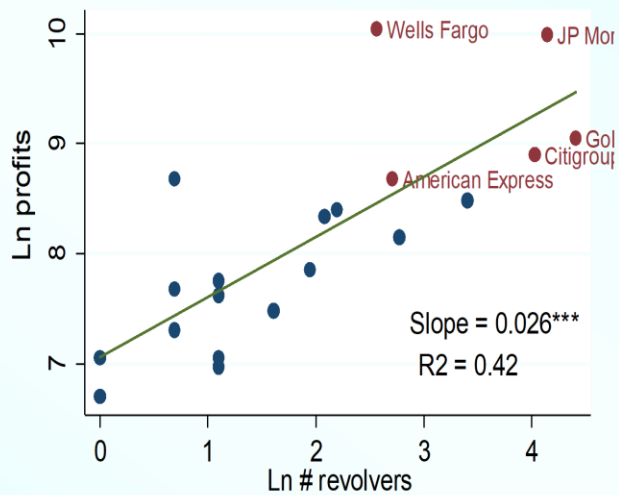
- **<u>Conclusion</u>**

- "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"!!!!