In through the Out Door (and Back In): A Discussion of Industry Regulation

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Tom Heintjes: Welcome to another Economy Matters podcast. I'm Tom Heintjes, managing editor of the Atlanta Fed’s Economy Matters magazine, and today we’re joined once again by Larry Wall, an economist at the Atlanta Fed and the executive director of the Atlanta Fed’s Center for Financial Innovation and Stability. Larry has spent a good deal of time on—and devoted a lot of thought to—the regulatory environment, and I asked him to sit down and talk about it with us today. Larry, it's been a while since you've been on the podcast. Thanks for joining us—it’s good to have you back.

Larry Wall: Happy to be here.

Heintjes: Larry, when people from within an industry become appointed to regulatory positions, it creates the "revolving door" that you wrote about in your research, and eventually those regulators return to employment in that industry. In a nutshell, that's the revolving door you refer to, isn't it?

Wall: I think the term "revolving door" is applied more broadly than that. It includes the full range of government decisions that provide benefits to, or impose costs on, the private sector. For example, it would include government officials who buy goods and services from private firms, and then leave office to work for one of those firms. In my January 2017 Notes from the Vault post on the revolving door, I focused on the role of government officials as regulators because that’s their primary role with respect to the financial sector.

Heintjes: Right. When we’re talking about the revolving door, we’re hardly discussing a recent situation, are we? I imagine there have been foxes in charge of henhouses—insiders getting industry influence, and so on—for a long time.

Wall: I think the revolving door problem goes all the way back to the times when governments first started regulating the conduct of private activities. Certainly in contemporary times, the issue is neither limited to just the financial services industry nor just the United States. However, stating the problem as "the foxes guarding the henhouse" is an overly simplistic way of viewing the issue.

Heintjes: Right. When we’re talking about the revolving door, we’re hardly discussing a recent situation, are we? I imagine there have been foxes in charge of henhouses—insiders getting industry influence, and so on—for a long time.

Wall: Well, Tom, I haven’t studied the full history of the problem, but I rather suspect that the revolving door problem goes all the way back to the times when governments first started regulating the conduct of private activities. Certainly in contemporary times, the issue is neither limited to just the financial services industry nor just the United States. However, stating the problem as "the foxes guarding the henhouse" is an overly simplistic way of viewing the issue.

Heintjes: Ah, well…sorry about that [laughter].

Wall: There can be cases where existing firms benefit from stricter regulation, and some cases where some of the people within a firm gain even if the firm overall does not.
Heintjes: Well, that's not the way we ordinarily think about the incentives created by the revolving door. Let's start with what I thought was one of your more surprising claims: why would an existing industry ever want stricter regulation?

Wall: Well, there are at least two ways in which most existing firms can benefit from more effective regulation—at least, more effective regulation up to some point. First, the regulation can help increase demand for the industry's products by giving consumers greater confidence.

Heintjes: I can see that.

Wall: For example, restaurants have to undergo regular health inspections and can be closed if they receive sufficiently low marks. This imposes some costs on the restaurants, but it benefits the overall industry by giving diners greater confidence that they will not get sick from restaurant food.

Heintjes: And in the financial services industry?

Wall: This could take the form of giving depositors and investors greater confidence that the firm they're dealing with meets some minimum standards for safety and good conduct.

Heintjes: And what would be another way?

Wall: Another way would be that it can be used to enhance the competitive position of existing firms. A regulation that increases all firms' costs will not necessarily affect all firms to the same degree. For example, larger firms may be able to comply with changes in regulation at proportionately smaller costs because they can hire people specialized in complying with the regulations. Additionally, existing firms may benefit from reduced competition as stricter regulation raises the cost to new entrants.

Heintjes: Okay, now I can see why existing firms could benefit from stricter regulation. Could individual firms in an industry ever benefit at the expense of other firms?

Wall: Yes, certainly it can favor some types of firms at the expense of others. In the Notes from the Vault post, I referenced changes in U.S. equity regulations that have contributed to a dramatic change in the structure of the U.S. stock markets. These changes have arguably benefited investors, but they've clearly benefited some new markets and some market participants over other traditional markets and participants.

Heintjes: In reading your research, I note that you mentioned one other group that could benefit from stricter regulation: people inside the firm. What did you mean by that?

Wall: Tom, not everybody within a firm is affected by regulation the same way. People in some parts of a financial firm can benefit from stricter regulation that increases the value of their jobs to the firm. For example, those employed in compliance can benefit from stricter consumer regulation. Stricter regulation increases the demand for these people, and increases their importance within the firm, and potentially their salaries. Similarly, those in the risk management function can benefit from complicated bank prudential regulation, such as risk-based capital and the stress tests.

Heintjes: Right. Well, Larry, what are we able to infer from cases where an industry or firm actually favors stricter regulation—or should we be wary of inferring anything from such cases?

Wall: An important point that I want to make about all these cases where an industry, firm, or individual in an industry favors stricter regulation: their potential gains from stricter regulation is independent of whether that regulation would be a good idea.

Heintjes: That's a good distinction.

Walls: That is, just because an industry, a firm, or an individual advocates for stricter regulation for selfish reasons, that doesn't mean that stricter regulation is a bad idea. Conversely, just because somebody is arguing against regulation for selfish reasons, that doesn't necessarily mean that stricter regulation is a good idea.

Heintjes: Right. So I see that the revolving door is not simply a matter of "foxes guarding the henhouse"—perhaps I was being too glib there, but—nevertheless, it still often results in insiders using their regulatory authority to enhance their future position, rather than picking the best policy for society. Is this a matter where Congress would step in, or needs to do something?

Wall: Congress couldn't completely solve the problem, as regulatory agencies are going to retain some discretion in how they enforce the rules. However, Congress could substantially reduce the incentive or the ability to implement self-interested policy by making one change.

Heintjes: What would that be?

Wall: At present, the laws passed by Congress tend to give the financial regulatory agencies a general goal and a defined set of authorities. It's then up to the agencies to determine how to use their powers to achieve their understanding of Congress's goal.

Heintjes: For the sake of this discussion, let's use the Dodd-Frank Act as an example.

Wall: The Dodd-Frank Act passed in 2010, and has 2,300 pages of text. That sounds like a lot.

Heintjes: Yes.

Wall: The act directs the regulators to write more than 400 new rules, and these rules by one estimate have resulted in more than 22,000 pages of regulation. Certainly if Congress were to give the agencies more detailed rules, the regulatory agencies wouldn't have to write so much in the way of regulation and would have less scope for self-interested policies.

Heintjes: Right. So why doesn't Congress write more detailed financial regulatory legislation?

Wall: We can observe that Congress follows similar practices in other industries—it's not just the financial services—and they've been doing this for some time, so obviously there must be some good reasons. In my Notes from the Vault post, I discussed two of these reasons. First, in order for
Congress to write more detailed regulation, its members and staff would have to spend considerable time working on what are often rather technical and arcane issues. From their perspective, it’s just easier and more efficient to rely on the regulatory agencies’ expertise to flesh out these details.

Heintjes: Okay, that’s one explanation. Is there a second one?

Wall: Well, yes. Even before the ink dries on new regulations, someone in the industry is likely to be looking for ways to comply with the letter of the law while completely avoiding its intent. If Congress writes detailed legislation, it would need to frequently revisit old legislation to deal with this regulatory avoidance. On the other hand, if Congress delegates the power to the regulatory agencies, then the agencies will have a somewhat easier time revising their rules to deal with the regulatory avoidance by the industry.

Heintjes: So there are good reasons why Congress is not likely to solve this problem. Could the problem be solved, just hypothetically, by the president nominating people that don’t have these sorts of conflicts?

Wall: The president certainly could reduce this problem, but that’s at the cost of creating other problems—again, this is a longstanding practice. It must make sense to the people involved. Look at the problem from the perspective of any administration: at a minimum, they want somebody that’s competent to run the agency, and ideally they would like someone who is probably going to further the president’s agenda. Both of these considerations favor appointing someone who’s already working in the area. People who have already worked in the industry have had a chance to demonstrate their grasp of the issues facing the industry, which helps get at the competence question. Someone coming in from outside the industry might well prove competent…

Heintjes: There’s probably a risk to that, right?

Wall: Yes, there’s a bit of a risk to that. And even if they do prove competent, odds are they’re going to need some time to learn about the industry before they can start developing new policies. In terms of the person’s policy views on an industry, the people who are most likely to express those views are the people that are working in that industry and have had reason to express views.

Heintjes: So, putting in an outsider is no silver bullet.

Wall: No, and that only deals with the first part of the revolving door. The second part—leaving the regulatory agency and going into industry—would still remain as a possibility. And moreover, once you’ve spent several years in a regulatory agency, that’s where you built up your contacts, that’s where your human capital is, so that’s the natural place to go looking for a job after you leave the agency.

Heintjes: So, I’m left conclude that we’re kind of stuck, and there’s nothing to really be done?

Wall: Just because a complete solution would cost more than it would benefit—at least the people making the decisions—that doesn’t mean nothing can be done. As you might expect, the most obvious cases of self-dealing are criminal offenses that apply to everyone. Here at the Fed, they have us go through an annual class that reminds us that we are subject to criminal prosecution if we participate in a decision in which we would directly benefit. Additionally, each of the financial regulatory agencies has its own set of ethics rules that apply to both the leaders and their staff.

Heintjes: So to your mind, Larry, what additional steps could be taken to reduce the problem of the revolving door? Some people have proposed some interesting ideas about postregulatory employment, and having to limit the gains that could come from accepting a position affiliated with one’s industry. What is your thinking along those lines?

Wall: You’re right, Tom. There are a variety of proposals out there, some of which have been implemented in some other countries, that would limit a former regulator’s ability to profit after they leave the government agency. At one extreme, it would be possible to simply ban someone who worked at a regulatory agency from working in that industry. A less extreme proposal would be to limit their ability to work in the industry for some fixed period of time—say, one to three years. Another somewhat less extreme proposal, and one advocated by Tennessee law professor Glenn Reynolds, is to tax the increase in earnings that a former regulator receives after going to industry. Now, that tax wouldn’t apply forever, but would apply for a fixed number of years and greatly reduce the benefits.

Heintjes: That’s a very interesting concept. Well, Larry, it would seem like the most effective way to stop the door from revolving from the regulatory agency to industry would be to prohibit such moves—but there must be some costs to doing so. What are those costs?

Wall: There are a least two costs from restricting the movements. First, such restrictions limit the incentive of talented people to become a regulator in the first place. After spending several years regulating an industry, most of a person’s contacts, and a large fraction of their human capital, are going to be based on that industry. If you tell them they can’t go to that industry, they may face a reduction in their earnings. Moreover, look at the problem from the perspective of someone considering a job with a regulatory agency that prohibits going back to industry. You would have to be concerned about what you would do if the agency ever laid you off for any reason.

Heintjes: That’s one cost. And another?

Wall: Another is that both the regulators and industry can benefit to some degree from former regulators helping firms to understand what they need to do to comply with the regulations. This is somewhat of a double-edged sword. Federal Reserve Bank of New York economist David Lucca and some coauthors point out that this does create an incentive for people in regulatory positions to prefer regulation that is more complex. Nevertheless, if we want firms to be better about understanding what the regulators want in fulfilling those needs, then it helps for the firms to be able to hire former regulators that can help them understand the problem.

Heintjes: Well, do we have any actual evidence of either of the costs that you mentioned?

Wall: Unfortunately we have very little evidence of either of these costs. So here we will get to our own problem of people recommending what’s in their self-interest, and I’ll remain true to the economics profession and suggest that more research on the topic is needed.

Heintjes: You are a true economist, Larry. I should note that on our website we’ll have a link to the paper you just mentioned. Well, Larry, you’ve certainly given us a lot to think about today. It’s going to be interesting to see how events unfold in the current environment. And I want to thank you again, Larry, for spending some time with us today and sharing your insights, and giving us a lot to think about.
Wall: Thanks, Tom.

Heintjes: And that brings us to the end of another Economy Matters podcast. We’ll have a link to Larry’s research that I’ve been referencing today on our website. Join us again next month when we’ll talk to Mike Johnson, executive vice president of the Atlanta Fed’s Supervision and Regulation Division. He’ll discuss how 2017 looked from a banking perspective, so it should be an interesting conversation, and one I hope you’ll be here for. Join us again next month, and thanks for listening.

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