EVERETT D. REESE RECOGNITION LECTURES

Good Intentions and Unintended Evil

The Case against Selective Credit Allocation

EDWARD J. KANE*

Relying on Adam Smith's concept of the "invisible hand," every economist can explain how markets react to individual *economic power.* Markets shape and reshape themselves to neutralize self-interested economic power by coaxing it into channels that serve the public good. But economists have devoted less attention to analyzing how markets systematically counteract coalitions of individuals' *political power.* Regulatory restraints imposed by the "visible hand" of political power shape markets just as surely as economic power does, but in ways designed to create or perpetuate economic power [15]. This paper endeavors to show that introducing political power into economic affairs initiates a dialectical process of adjustments and counteradjustments. In what resembles reflex action, markets rechannel regulatory power, as regulatees short-circuit regulator intentions

*The author wishes to thank Joseph Bisignano, Kurt Dew, William Dewald, Robert Eisenbeis, Michael Keran, Thomas Mayer, Steven Miller, and William Poole for helpful comments on earlier drafts. Much of this paper was written during the author's tenures as Visiting Scholar at the Federal Reserve Bank of San Francisco and Senior Financial Economist at the Federal Deposit Insurance Corporation.

The papers in this section were presented as public lectures at Ohio State University on April 30, 1976, in recognition of Everett D. Reese's contributions to the university. The speakers, Edward J. Kane and Karl Brunner, are the present and former holders, respectively, of the Everett D. Reese Chair of Banking and Monetary Economics.

Mr. Reese, who is a former national president of the American Bankers Association, established and fully endowed the chair that bears his name and is currently chairman of the Executive Committee of the Ohio State University President's Club.

both by finding and exploiting loopholes and by the simpler expedient of disobeying the law. Avoidance and evasion absorb resources (especially lawyers and administrators) from other uses, raising the costs of performing the previously unregulated activities. All this frustrates the coalition sponsoring the regulation and puts pressure on bureaucrats and legislators to seek new administrative remedies. The dialectical conflict can resolve itself in numerous ways, but seldom before the nation experiences a wasteful cycle of political/economic reactions. Prototypically, bureaucratic controls and market adaptation chase each other round and round, generating additional problems, confrontations, and costs for society at large.

1. THE DEMAND FOR REGULATION

Underlying this dialectical conception is the idea that political power finds economic expression in demands for (1) public goods, (2) direct or indirect government subsidization of one's own activities, or (3) government regulation of the market behavior of agents whose actions are believed to reduce one's own individual welfare. Of course, specific political demands typically cut across these categories. The principal reason for suggesting a three-way taxonomy is to provide a fuller perspective on the third class of demand: the demand for having government regulate someone else. The very existence of this demand creates a "political" market for regulation and establishes incentives for politicians and bureaucrats to supply regulation services. The interplay between exogenous developments in the market for regulation and participant adaptations in the markets for regulated goods and services stands at the heart of the debate over the "desirability" of government credit allocation.

It is important to see that the demand for credit allocation is a demand by, or on behalf of, frustrated borrowers for government intervention in their favor. It is a demand to change the rules of the economic game to assist so-called losers in credit markets (housing, small business, and nonwealthy households).[1] Whether and how the rules are ultimately changed is determined in the political arena, with economic analysts playing only a small advisory role on both sides. The economist's role is essentially to assist participants to sort out and articulate how their sectoral self-interest would fall under alternative institutional arrangements.

Professional sorting out is required because in practice credit allocation works far less predictably than proponents presume and has long-run effects quite different from its short-run impacts. Popular conceptions of how government economic programs work are marred by a naïve tendency to project the effects of government actions wholly in line with the *intentions* of their sponsors. Voters (and legislators) are prone to wishful thinking about what governmental good intentions can accomplish in the market economy. Conversely, they are prone to blame difficulties in making controls effective on the bad intentions of identifiable groups or on the incompetence of some bureaucratic system.

[1] Of course, many kinds of regulation (e.g., of entry into specific industries) are sought by economic winners as ways to increase or to consolidate their economic gains.

What distinguishes the economist's approach to these matters is an unwillingness to suppose either that loophole-proof economic regulations can be formulated or that regulatees can easily be persuaded to act against their self-interest, especially for prolonged periods of time. Faced with rationing or price controls (such as rent control in New York City, the U.S. wage/price controls of 1971-73, the prohibition of alcoholic beverages in 1919, or the network of ceilings placed on savings-deposit interest rates in the 1960s), affected parties can be expected to act to protect their economic interests: to probe opportunities to get around the controls or even to turn them to their net advantage. This effect is all too often assisted by poorly designed administrative incentives that lead bureaucrats to act directly against a program's avowed purposes.

Citizens' and bureaucrats' efforts to minimize the burden placed upon them by government regulations generate what we may call *unintended effects*. Unlike a control's intended effects, its unintended effects usually are not desired by the coalition sponsoring the regulation. Moreover, the passage of time allows the identification of more and better avoidance opportunities and allows knowledge of these opportunities to spread to more and more regulatees. Hence, relative to intended effects, unintended effects tend to become more important the longer a given control remains in force.[2]

In debating the economics of any proposed new system of rationing or price control—and particularly in the continuing dialogue over the desirability of government allocation of credit—proponents stress intended short-run benefits while opponents stress unintended long-run costs. Given the gaps in their respective foci, each side finds its case so overwhelming that it comes to doubt the intellectual honesty or basic competence of its rivals. As the experts' rhetoric escalates, decisions on these matters can be made all the easier by political brute force.

If economic priorities did not differ across the population, the issue of allocational controls would never arise in the first place. Under free markets, both what is produced and who gets to enjoy it depend on consumers' willingness and ability to pay enough to offset the costs of production. Markets settle differences in priorities by tallying dollar-weighted "votes." Credit allocators seek to rerun disputed elections with individuals' preferences weighted instead by politically determined indices of social worth.

Section 2 of the paper defines credit allocation and outlines some of the many forms it takes in the United States today. This background lets us go on in section 3 to sketch a theory of the political/economic life cycle of economic regulations brought about by brute-force policymaking. Section 4 traces a few such cycles experienced in the twentieth-century United States. These cycles appear on balance to have visited high costs on the population at large. This experience suggests that, except as explicitly temporary solutions to national problems of great immediacy, rationing and price controls have little to recommend them. Over the long haul, alternative policies that would relax existing regulatory controls or adjust the tax or

[2]Friedman [4] identifies the unintended effects of a number of well-intentioned government programs.

welfare structure promise to achieve the intended benefits more reliably at less cost.

2. JUST WHAT IS CREDIT ALLOCATION?

Credit allocation describes a battery of diverse techniques intended to influence lenders and borrowers to discriminate among potential transactors in economically arbitrary but politically approved ways. Such techniques are usually distinguished from aggregate monetary policies on the grounds that the discriminatory effects of aggregate policies (e.g., on housing) are unintentional. Nevertheless, the desire to undo these unintentional effects is a prime reason for considering selective controls in the first place. The precise techniques of credit allocation are manifold, including any kind of subtle or unsubtle penalty or inducement to reduce or enhance a particular group's access to funds. The most straightforward programs employ explicit tax and subsidy inducements to change borrower or lender incentives. While not always well conceived, incentive programs are not objectionable per se. However, allocational programs that rely on moral pressure or behavioral restraint show a penchant for going astray. Except for their costs of administration, restraint programs (so-called *selective credit controls*) generate no explicit cost or subsidy entries in the federal budget. The costs associated with these programs are implicit rather than budgetary, taking the form of inefficient uses of productive resources (e.g., in additional activities required either to comply with, to enforce, or to circumvent the restraints) and falling on the public at large. This diffuseness and the difficulty of measuring these costs make them appear much cheaper to politicians than they truly are. In the United States, for example, federal insurance of mortgage contracts induces lenders to let certain would-be homeowners obtain credit on advantageous terms, whereas margin requirements on stock-market loans seek to limit the amount that an individual may borrow against stock-market collateral. The principal social costs (and even the benefits) of these programs are far from obvious and simply do not register as budgetary outlays or receipts.

Although the proximate goal of credit allocation is to channel loanable funds either toward or away from particular borrowers or financial instruments, the ultimate aim is to improve one or more dimensions of national economic performance. Selective credit controls and tax inducements represent a seductively simple way to promote any economic goal. A policymaker has only to promote the flow of credit to those who purchase or produce the "right" goods and services and retard the granting of credit to those who deal in the "wrong" ones. But the unintended effects of such policies must never be forgotten.

Forms of Selective Credit Allocation in the United States Today

Selective credit programs currently operated by the United States government are designed primarily to redistribute economic opportunities, although some arrangements stress other kinds of benefits. Many of these programs are designed to offset the unintended distributional effects of aggregate stabilization policies (see, e.g., [10]). Explicitly targeted programs include loans to small businesses, rural businesses, farmers, foreign traders, disaster victims, minority enterprises, and students; emergency loan guarantees to Lockheed Aircraft Corporation and the Penn Central Railroad; direct federal loans to New York City; and a wide variety of measures aimed at increasing credit for housing. A number of other credit-allocation schemes are currently before the Congress: (1) proposals to grant reserve-requirement and income-tax credit to depository institutions on the basis of their holdings of mortgages on low- and middle-income housing units (see [18]); (2) proposals to establish modern versions of the Reconstruction Finance Corporation to make direct federal loans to financially desperate state and local governments or troubled firms of certified high social worth; and (3) proposals to set up an Energy Resources Finance Corporation to make subsidized loans for energy development.

Such programs (which offer large benefits to a lucky few) have been marked by frequent scandals: allegations of corruption (payoffs to inspectors and influence peddlers) and fraud. For several years now, such accusations have been laid at the door of the Small Business Administration. Usually programs whose benefits are spread widely operate more serenely. These include federal deposit and mortgage insurance, differential interest ceilings and reserve requirements on various types of financial-intermediary deposits, regulations governing the eligibility of collateral used to secure loans from the Federal Reserve and Federal Home Loan Banks, and federal tax exemption of coupon interest on state and local government securities. But if one looks closely, serious unintended effects exist in these programs, too.

Some programs focus on particular markets rather than on particular sectors. Programs designed to limit activity in specific markets include margin requirements applicable to stock-market credit and recently expired controls on foreign lending (the interest-equalization tax, quantitative limitations on corporate direct investment in other countries, and foreign-credit guidelines applicable to financial institutions). Along the same lines, during wartime mobilizations in the 1940s and early 1950s, the Federal Reserve administered temporary restrictions governing the minimum down payments and maximum maturities allowable in real-estate and consumer-durable loan contracts. Proposals to restore the Fed's authority to impose such restrictions on a standby basis are almost always in the wind.

A final and ubiquitous class of allocational technique is known as "moral suasion." It consists of intermittent communications from government officials exhorting financial institutions to regulate themselves in specified ways: to favor or disfavor particular classes of borrowers during some (ordinarily brief) "crisis" period. These efforts seldom spell out either what penalties (if any) will be imposed on recalcitrant institutions or what benefits cooperative firms may expect to reap. Approaches run the gamut from *explicit suasion* (formal letters signed by Federal Reserve officials and direct but undocumentable informal—including telephone—contacts) to *reputed suasion* (rumors circulated by and for the benefit of troubled borrowers and lenders). For example, in February 1975, Federal Reserve Board Chairman Arthur Burns specifically denied that he had exercised moral suasion on behalf of such threatened institutions as W. T. Grant (now defunct), Chrysler, and real estate investment trusts, but confirmed that he had written the presidents of four Federal Reserve Banks on behalf of operators of cattle feedlots [19, pp. 210–11, 274–76, 280–81]. In August 1975, he denied that the Fed was prepared to act directly as lender of last resort to New York City. A rumor to this effect had helped securities dealers to unload the last remnants of New York's Municipal Assistance Corporation's (Big Mac's) second issue. As this example suggests, whether true or false, rumors sometimes have the impact of the real thing.

In the face of a gathering political pressure for explicit and relatively permanent selective controls, a demand for self-regulation typically emanates from centers of moral authority located within the financial industry. Efforts at *self-suasion* can develop either as a grudging response to a manifest political threat or via an enlightened reevaluation of the ethical considerations at issue. These efforts may focus on effective remedies or (especially in the former case) on placebos. Whatever its origin or intent, *self-suasion* preserves industry prerogatives to relax regulation later by making a show of immediate self-regulatory concern impressive enough to counter political pressures generated by current scandals or sectoral inequalities. Even placebos can disarm adversaries and take politicians off the spot.

The United States financial community has developed the placebo gambit to a science. The organized stock exchanges and the insurance industry have repeatedly employed well-publicized efforts at self-suasion to head off demands for tighter government regulation. The ploy is not always successful. Otherwise we would have many fewer agencies and commissions. But self-suasion works often enough to serve as the conventional first line of defense against political demands for additional government regulatory incursion.

Self-suasion lets industry leaders retain the initiative in adjusting the ground rules under which it conducts its business affairs, both now and in the future. By presenting alternative new restrictions in the form of trial balloons, industry leaders are able to determine what is the minimum politically acceptable amount of autonomy that they must surrender at the moment to maintain control of the evolution of future ground rules.

Placebo self-suasion is nicely exemplified in the life cycle of the *Statement on Bank Lending Practices* issued on September 16, 1974, by the Federal Advisory Council (FAC) [19, pp. 73–82].[3] The FAC, a group of leading bankers set up by the Federal Reserve Act to serve as a channel of communication between bankers and the Federal Reserve Board, was ideally positioned to advise banks what distributional criteria to weigh in their loan decisions without in any way compromising either the Fed's or individual bankers' desire to dismantle the guidelines at the first opportunity. Both the Fed and the bankers lobbied energetically to defeat 1975

[3]In December 1974 and March 1975, the Fed conducted loosely worded surveys to monitor the effects of the FAC's recommendations on individual bank loan decisions. In response to leading questions, most respondents claimed not to approve loans "for speculative purposes," although most of those that acknowledged that they had made such loans in the past claimed to be reducing "significantly" the proportion of speculative loans being granted. No respondent ever reported that the percentage of these loans had become "significantly larger."

legislation that sought to put the FAC allocational criteria on a statutory basis. Then, in February 1976, Chairman Burns told the House Banking, Currency and Housing Committee that guidelines against speculative lending were "dormant."

3. THE SUPPLY OF REGULATION: POLITICIZATION OF ECONOMIC CONFLICT

Economic conflict concerns what productive opportunities will be exploited, in what ways, and for whose benefit. In all economies—free or managed—markets play a critical role as a peaceful and nonpolitical device for resolving social conflict. However, the scope of this role is an important and revocable political decision. Economic ground rules and market-determined settlements can be overridden by "extra-market action."

Although the market struggle focuses on individual demands and supplies, it simultaneously develops social priorities. Through processes of shopping, explanation, and negotiation, the market economy allows transactors to confront and to reconcile their opposing self-interests, albeit not to the complete satisfaction of any of the parties. Controls on prices and quantities challenge the market's solution without themselves resolving conflict. Controls perpetuate the conflict of economic interests and divert this into noneconomic channels. Every restraint that governments place on lenders and borrowers restricts financial markets' ability to resolve their conflict efficiently (because each restraint distorts market signals and encourages socially wasteful effort to lessen the impact of the restraint) and increases access to additional political channels of supplementary conflict and resolution. In this sense, government allocational devices symbolize the partial conversion of economic conflict into political conflict.[4] They provide opportunities for validating technically inefficient behavior that make economists instinctively critical of externally imposed prices and quantities.

The Political Dialectic of Controls

Supporting coalitions seek controls as ways to better themselves. Elected officials are attracted to them as a matter either of ideology (i.e., for so-called higher motives) or of self-interest. For the strictly ideological legislator, controls represent a way to bring about a better world. But for the strictly self-interested legislator, controls are voted in and voted out to win votes and/or campaign donations.[5] The more "distressing" and more "intractable" the economic problem a prospective set of controls is designed to relieve, the greater the number of votes at stake. To nonideological politicians, controls appear "twice blessed." They can score points with the electorate both when they impose controls and when they vote them out later if and when their costs have been revealed to be excessive. The painful and

[4] To cite a particularly dramatic case, economic controls imposed on American colonists by the British helped to generate and sustain the U.S. Revolutionary movement.

[5] A theory of politicians as vote maximizers is developed in [2]. A complementary theory of bureaucrats as budget maximizers traces from [12].

inflationary cycle of control and decontrol is worldwide precisely because tough problems are universal. Incumbent politicians everywhere must run on their records (even, when the possibility of coups and revolutions is considered, in totalitarian states). Voting controls in and out on demand establishes lawmakers' good intentions and disposition to act against pressing problems. It shows that they are willing and able to do something to resolve hard issues. Whenever a preponderance of the population or the platform of the opposing party clearly favors or disfavors a particular set of controls, pressure is on elected officials to go along. In general, officials will resist such pressures only when they are supremely confident in the fundamental wisdom of alternative policies.

In congressional hearings, the case for credit allocation has rested primarily on the presumption that something positive must be done to solve certain intractable problems and on the wide use of selective controls for these purposes in other countries. (See [1, 10, 16, 17]. For a review of recent European experience with credit-allocation techniques, see [5]. Recent African experience is studied in [6].) Emphasizing policymakers' intentions rather than assessing actual effects, proponents contrast the "surgical precision" of such instruments with the "meat-ax" impact of overall monetary control. They suggest that selective credit controls form a valuable part of the arsenal of any "modern monetary authority."

Although one can draw an instructive parallel with Gilbert and Sullivan's "modern major general,"[6] the essential logic is that if everyone is using these controls, they must be good for something. But for what? For helping the economy or for helping incumbent politicians get themselves reelected? An incumbent politician strives to increase the probability of his or her reelection. This probability is enhanced by pressing for actions that the electorate perceives as improving the performance of the economy. Even if a policy is not beneficial in fact or is beneficial only in the very short run, so long as the bad effects do not become clear until after the ever-threatening next election, supporting it can improve the odds of winning reelection.

Economic controls are conceived, sustained, and occasionally abandoned in the political arena. In the economic arena, ways are devised to make them less effective. Good economic laws should survive the collision, and market adaptation helps to force the eventual reversal of bad ones. Though time-consuming and economically wasteful, the dialectic of bad economic laws is straightforward. Controls are a payoff for successful political activity. Individuals who are dissatisfied with the outcome of some market process unite to press for governmental intervention. They behave like angry baseball players appealing an umpire's call to some higher authority. When a market's "call" is at issue, as long as individuals assemble enough political influence, relief is granted in the form of rearrangements in the structure of taxes and subsidies or in the form of governmental controls on the price or quantity of the good or service traded.

Focusing only on controls again, as long as supporters remain united and politically powerful, the balance of true social benefits and costs (if unfavorable) remains secondary to the intended benefits. For a long while, unintended distortions caused by controls can be portrayed as consequences of educational and administrative

[6] *Pirates of Penzance* (1880).

difficulties summarized in the phrase "imperfect enforcement." However, over time, unintended effects tend increasingly to reduce the intended benefits and to expand a program's social costs. This process simultaneously undermines the sponsoring coalition and strengthens a growing countermovement. For controls to be jettisoned, the countermovement must beat what's left of the sponsors at their own game.

The Gap Between Intended and Unintended Effects

Economic controls are designed to coerce citizens and firms to act against their perceived self-interest, supposedly for the common good. Enforcing such behavior is difficult and not always worth the trouble. Just as legal prohibitions against bookmaking or the sale of alcohol, drugs and sex, supporting sanctions cannot work without community consensus. The longer controls remain in force, the more time there is for interested parties to undermine that consensus through educational and political activity. The more controversial the problem that controls are intended to solve, the more unstable the operative consensus is likely to be and the more energy is likely to be directed to undermining it.

On the economic front, biting controls build up sizable rewards for those either bold enough to defy them or clever enough to devise ways around them. The longer controls remain in effect, the more time evaders and avoiders (black and "gray" marketeers) have to search for loopholes, to perfect their enterprises, and to inform the public about the alternatives their operations create. By outlawing "honest" avoidance activity, bureaucrats steadily extend the reach and complexity of the control network. But unless reinforced by the force of strong community disapprobation, their efforts tend to lag seriously behind those of the regulatees both in time and in quality. Employees and managers of private firms tend to outclass, outnumber, and outwork their counterparts in the civil service, who have almost no personal stake in the outcome. Without broad community support, regulating the flow of proscribed goods and services becomes like trying to make a school of hungry fish swim away from food falling through the water.

Once installed, systems of economic controls are seldom abandoned quickly or gracefully. A set of controls typically feeds on its initial failures. Since in a democracy a control must be politically popular to begin with, for a long while after its introduction its strategic infirmities are attributed instinctively to petty imperfections in implementation and program design. The less effective a set of controls appears in its first few months, the tougher and more widespread its penalties and reporting requirements tend to become. In large part, this follows from legislators' penchant for viewing the success of such programs as a test of both their sincerity and their authority. Adaptive market responses that minimize the personal costs of controls to individual transactors are perceived as disturbing evidence of growing disrespect for the government and its laws.[7] During a control's "honeymoon

[7]Of course, as long as these responses remain within the letter of the law, they are no more disreputable than income-tax avoidance, an activity for which in managing their personal affairs elected officials and other high-income taxpayers show a natural (if—as determined subsequently by the IRS—occasionally excessive) flair.

period," administrators' most pressing pursuit becomes to reorganize bureaucratic operations to root out and punish such behavior.

Customarily a network of controls continues to expand unless and until the budgetary cost, social inconvenience, economic waste, and distributional inequity associated with the system become painfully obvious even to the ordinary citizen. This necessitates a political reassessment. If the controls have outlived their political usefulness, only self-interested parties and ideological diehards will support their continuance. However, even if the intended social purpose has lost its high priority, as long as the hard-core adherents are well enough placed, the controls will survive in some form or other.

4. A FEW ILLUSTRATIONS FROM RECENT UNITED STATES HISTORY

United States experience both under Prohibition (1920–33) and with ceilings on savings-deposit interest rates at banks and thrift institutions (since 1966) can be used to illustrate the dialectical process. Prohibition of alcoholic beverages was desired to gain the benefits of a more "temperate" population: a better-ordered and more productive society. In 1919 when it was adopted, the now-despised Eighteenth Amendment was a relatively popular measure, as shown in its eventual ratification by all but two state legislatures (Connecticut and Rhode Island). The supporting coalition had been gathering influence for over a century. After a honeymoon period of less than a decade, the coalition foundered on unintended social costs: (1) the magnitude of the "illicit liquor traffic," the often poor and sometimes dangerous quality of its product, and its role in fostering organized crime; and (2) a palpable disrespect for the law and the government engendered among ordinary citizens by having to live under an increasingly unenforceable law.

During Prohibition, the transfer of demand pressures from the regulated "medical-prescription" market for liquor to the unregulatable "bootleg" market illustrates the well-known principle that restrictions on transactions in one market create pressure in related markets to offset the effects of these restrictions. This inevitable spillover of unsatisfied demand is sometimes called the "balloon principle." Just as squeezing an inflated balloon displaces gas to the parts of the balloon that one's hands do not (and cannot) simultaneously grasp, so disallowing certain transactions transfers demand pressures to other markets.

In the case of Prohibition, parallel markets were predominantly illegal ones. But United States experience with restrictions on deposit interest rates brings out how easily financial-market restrictions may be defeated without violating the letter of the law.

Let us look first at restrictions on demand-deposit interest. These were introduced in the 1930s to prevent banks from competing excessively for demand-deposit business. But forbidding banks to pay explicit interest on demand deposits in no way stops them from competing for profitable accounts by offering *implicit* interest instead. This implicit interest takes the form of price and service concessions to valued demand-deposit customers in other areas of bank activity. In what amounts to a tied-sale agreement, a bank stands ready to perform special or routine accounting and financial services for valued customers at charges well below marginal costs. Typically, a bank also commits itself to grant loans at favorable interest rates and/or to furnish loan funds to these customers no matter how tight the bank's current financial condition may be. Although this puts households and small businesses at a disadvantage in bidding for loan funds, authorities cannot outlaw this type of compensation without seriously compromising the economic freedom of banks and bank customers or without confronting enormous and costly enforcement problems.

Through the use of computer-automated repurchase agreements, compensation for demand deposits has in the last few years become increasingly explicit for large accounts. At a growing number of banks, whenever a customer's demand-deposit balance exceeds an agreed-upon minimum, the excess is automatically lent to the bank at a predetermined interest rate via a wash transaction in marketable securities known as a repurchase agreement. The bank simultaneously sells marketable securities to the customer and agrees both to repurchase them at a specified future date and price and to pay the customer a prenegotiated rate of interest over the period that the customer's funds are tied up.

At banks, institutional arrangements for paying implicit interest are available only to large customers. But in many Eastern states, thrift-institution efforts to penetrate local checking-account markets have resulted in innovative third-party payment arrangements (exemplified by the availability of NOW accounts in New England) that let households earn explicit interest on what are essentially demand funds.

The prohibition of demand-deposit interest is intended to protect *banks* from "destructive" competition for checking accounts. Restrictions on savings-deposit interest are meant to assure thrift institutions' profit margins and to assist the housing industry by making mortgage money available on advantageous terms. During booms, when market interest rates rise, large differentials open up between open-market rates and permissible rates on savings deposits. These differentials lead borrowers and would-be depositors to find new ways of bringing their business together, so that the ceilings are prone to leak. With evolving new lending arrangements, authorities have been faced with the need both to extend the reach of these controls over more and more types of financial transactions and to give up the attempt to regulate certain types of deposits. Restrictions on depository institutions' ability to pay nonmoney "premiums" (electrical appliances, flatware, etc.) on savings accounts had to be introduced almost from the beginning. Ceiling interest rates on time and savings deposits at depository institutions have been abandoned on large ($100,000 or more) certificates of deposit. These ceilings were discontinued first on short-maturity instruments in 1970 and then on longer maturities in 1973. Ceilings on remaining savings instruments have had to be supplemented by outlawing federal-funds sales by households and nonfinancial firms and by raising the minimum denominations of short-term government securities. In addition, in 1974 firms that proposed to issue "floating-rate notes" with optional semiannual redemption dates were (by threatened Congressional action) prevailed upon to suspend the operation of the semiannual redemption feature during an issue's first two years.

Despite these efforts, pooling arrangements developing in parallel financial markets are opening the loopholes ever wider. It is becoming increasingly clear to bank regulators that—just as they could not sustain a persistent large differential between open-market interest rates and rates on $100,000 CDs—they cannot through repeated interest-rate cycles sustain a large differential between the rate paid on $100,000 and $1,000 CDs either. Money-market mutual funds, investment trusts, participation certificates, and custody accounts are competing hard for small accumulations of funds and thereby seriously undermining the effectiveness of savings-deposit ceilings. By December 1975 money-market mutual funds had themselves become a $3.7 billion industry. An increasing number of these firms allows funds to be withdrawn on demand. As more households learn of their existence and as cyclical increases in market interest rates raise their payout rates, these institutions threaten to double and triple in size. Pooling plans aggregate funds subscribed by small savers and invest them in high-rate instruments. Pooling overcomes the barriers of high minimum denominations and odd-lot transactions charges. Some pooling plans have been established or operated by banks and thrift institutions as a way to hold on to customer funds that would otherwise depart their control. Although the Fed and FDIC proposed in March 1976 that banks be disallowed from paying above-ceiling rates on pooled funds, the proposed regulation touches only a small class of investment opportunities and raises serious enforcement problems. It promises to hurt banks far more than it would hurt customers of money-market funds.

These new institutions and depository arrangements disrupt the very markets and firms that ceilings on savings-deposit interest were instituted to protect, and leave the nation's smallest savers (those with less than the minimum amount for participating in a pool) unable to earn a positive real rate of return on their wealth (see [7]). When market interest rates are high, ceilings on time and savings deposits intensify cyclical fluctuations in the flow of loans to housing and increase financing costs on average by shifting mortgage business artificially to such inefficient and fragile intermediaries as real estate investment trusts. Savings-deposit ceilings have spawned new sets of institutions whose long-term viability depends on maintaining artificial restrictions on depository institutions' ability to compete. These new institutions' lobbying muscle further complicates the political process of eventually jettisoning these inefficient and inequitable controls.

5. SHOULD THE UNITED STATES REJECT CREDIT CONTROLS EVEN FOR THE SHORT RUN?

This is a tougher question that can only be answered on a case-by-case basis. It turns primarily on adjustment costs: the costs to players of having the rules of the game change frequently. Even in the short run, credit controls are likely to do unintended harm as well as intended good. The link between specific debt flows and sectoral expenditure patterns is by no means hard and fast. There are many ways to finance any given expenditure. Offering real estate, durable goods, or financial assets as collateral in no way assures that, if the funds supported by that collateral were not available, the designated collateral would disappear from the borrower's balance sheet. Lenders' and borrowers' ability to relabel debt contracts and to substitute other less-efficient unregulated (even specially devised) forms of credit for regulated ones is high and improves steadily over time [14, 13]. In the United States, econometric studies suggest that subsidizing savings-and-loan mortgage activity at the expense of small savers has had virtually no long-run effect and at best only small short-run impacts on the housing stock [3, 11].

Even as a short-run expedient, the case for rationing credit is weak. First, the major impetus for government credit rationing comes from complaints that housing and small business fail to receive their fair share of credit when money is tight. But these difficulties trace back not to any failure of the market system, but to the operation of politically imposed ceilings on deposit interest rates [8, 9]. Removing these ceilings is a far more attractive way to deal with these problems. Second, as a method for influencing the distribution and industry composition of national output, credit controls are poorly targeted. They focus on pieces of paper (debt contracts) that are only loosely connected with production and purchase decisions. With or without credit controls, borrowers know that it is advantageous to offer attractive collateral and to claim that loan proceeds will be put to a socially desirable use. Trying to direct the flow of real resources with restrictions on particular classes of credit is something like trying to push heavy stones around with a very long and very flexible stick. Such tools work against the user's intentions as much as for them. Credit is so ephemeral and flows through so many channels that it is virtually impossible for governments to design and administer an effective credit-rationing scheme. Lenders and borrowers can and do frustrate government attempts to reallocate credit even in the short run merely by reclassifying and relabeling loan contracts to reveal a "priority" purpose and by shifting their activities to unregulated (often unregulatable) outlets. Valuable resources are wasted both in exploiting loopholes and in policing their use.

Controls that work as well as possible still impose costs as well as benefits. Against the intended improvements on targeted *dimensions of macroeconomic performance*, one must weigh inescapable adjustment costs and unintended inequities and inefficiencies introduced by forcing credit flows out of their customary channels. Rational policymakers must balance net favorable effects on one or more dimensions against unfavorable effects that develop elsewhere in the economy.

Moreover, because controls lose their effectiveness over time, policymakers need to monitor such tradeoffs continually. They must regularly assess and tabulate the net effects of any actual or proposed credit-allocation policy and act to kill any program whose continuing benefits do not promise to exceed its continuing costs.

6. SUMMARY AND CONCLUSIONS

Modern economics takes the Walrasian multiple-market auctioneer as its paradigmatic representation of the contemporary market economy. This paper tries to show that a supplementary "political" market for regulation services opens up for business as soon as the Walrasian auctioneer finishes his work. Transactions in this political market disturb the general economic equilibrium and force the auctioneer back into action again. Continuing interplay between the political and economic markets produces broadly predictable cycles in which controls are set, markets adapt, and controls are redesigned and set for yet another round.

In the political market, contracting and recontracting absorb real resources and occur in real time. This need not call into question the usefulness of comparative-static equilibrium solutions, but it does require that we focus explicitly on the transitional costs of moving from one equilibrium to another.

Analysis developed in this paper indicates that a decision to establish government credit allocation would kick off a long cycle of market and political interaction. For so ephemeral a good as credit, the period of time during which net social benefits are positive could be *very* short indeed. Credit rationing promises to make financial markets work less efficiently, to redistribute wealth in ways that could easily run counter to intentions, and to politicize further intersectoral economic conflict. It could disastrously increase political and economic alienation among the less-powerful members of society.

Much of the recent unequal impact of tight money on individual sectors grows out of politically imposed restrictions on deposit institutions' ability to compete for deposit funds [8]. In view of the difficulties of keeping selective credit controls effective in the face of borrowers' and lenders' energetic efforts to subvert them—both by relabeling loan contracts to disclose a priority purpose and by substituting unregulated (often regulation-induced) instruments, a far more promising way to improve sectoral access to loan funds is to eliminate ceilings on interest rates at deposit institutions.

Speeding up the removal of these ceilings is a political problem of the first magnitude. A succession of official study groups has recommended that at least the ceilings on savings-deposit interest be eliminated. But these proposals have continually foundered on the political difficulty of designing and putting across a compromise package of compensatory changes in the nation's financial structure that would underwrite adjustment costs and otherwise reconcile the opposing interests of concerned sectors. For a political system that cannot solve such problems, introducing government credit allocation threatens big trouble.

LITERATURE CITED

1. Brimmer, Andrew F. "Multi-National Banks and the Management of Monetary Policy in the United States." *Journal of Finance,* 28 (1973), 439–54.
2. Downs, Anthony. *An Economic Theory of Democracy.* New York: Harper Bros., 1957.
3. Fair, Ray, and Dwight Jaffee. "An Empirical Study of the Hunt Commission Report Proposals for the Mortgage and Housing Market." *Policies for a More Competitive Financial System.* Boston: Federal Reserve Bank of Boston, Conference Series No. 8, 1972, pp. 99–148.

4. Friedman, Milton. *Capitalism and Freedom.* Chicago: University of Chicago Press, 1962.

5. Hodgman, Donald R. *National Monetary Policies and International Monetary Cooperation.* Boston: Little, Brown, 1974.

6. Johnson, Omotunde. "Direct Credit Controls in a Development Context–The Case of African Countries." In *Government Credit Allocation: Where Do We Go From Here?,* edited by Karl Brunner, pp. 151–80. San Francisco: Institute for Contemporary Studies, 1975.

7. Kane, Edward J. "Short-Changing the Small Saver: Federal Government Discrimination against the Small Saver During the Vietnam War." *Journal of Money, Credit, and Banking,* 2 (1970), 513–22.

8. ——. "Proposals for Rechanneling Funds to Meet Social Priorities: Discussion." *Policies for a More Competitive Financial System.* Boston: Federal Reserve Bank of Boston, Conference Series No. 8, 1972, pp. 190–98.

9. ——. "Deposit-Interest Ceilings and Sectoral Shortages of Credit: How to Improve Credit Allocation without Allocating Credit." In *Government Credit Allocation: Where Do We Go From Here?,* edited by Karl Brunner, pp. 15–37. San Francisco: Institute for Contemporary Studies, 1975.

10. Maisel, Sherman. "The Effects of Monetary Policy on Specific Sectors of the Economy." *Journal of Political Economy,* 76 (1968), 796–814.

11. Meltzer, Allan H. "Credit Availability and Economic Decisions: Some Evidence from the Mortgage and Housing Markets." *Journal of Finance,* 29 (1974), 763–78.

12. Niskanen, William A. *Bureaucracy and Representative Government.* Chicago: Aldine-Atherton, 1971.

13. O'Brien, James M. "The Incidence of Selective Subsidization and Taxation of Asset Income: A Multi-Asset Market Approach." Mimeographed. Federal Reserve Bank of Philadelphia, 1975.

14. Rao, D. C., and Ira Kaminow. "Selective Controls and the Real Investment Mix: A General Equilibrium Approach." *Journal of Finance,* 28 (1973), 1103–18.

15. Stigler, George J. "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science,* 2 (1971), 3–21.

16. Thurow, Lester C. "Proposals for Rechanneling Funds to Meet Social Priorities." *Policies for a More Competitive Financial Sector.* Boston: Federal Reserve Bank of Boston, Conference Series No. 8, 1972, pp. 179–89.

17. U.S. Congress, House, Committee on Banking and Currency. *Activities by Various Central Banks to Promote Economic and Social Welfare Programs.* Staff Report. 91st Cong., 2nd sess., December 1970.

18. U.S. Congress, House, Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions, Supervision, Regulation and Insurance. "Discussion Principles for Study by Banking, Currency and Housing Committee–Financial Institutions and the Nation's Economy." Mimeographed. Washington: Nov. 3, 1975.

19. U.S. Congress, House, Subcommittee on Domestic Monetary Policy. *An Act to Lower Interest Rates and Allocate Credit.* Hearings on H.R. 212. 94th Cong., 1st sess., February 4–6, 1975.