Economic Politics Revisited

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Abstract

To what extent are the undesirable aspects of contemporary economic conditions in the United States attributable to democratic institutions? In Keech (1995) I argued that opportunistic interpretations of electoral behavior and economic policymaking did not identify seriously suboptimal economic results. That is, the incentives of democratic politics as modeled in contemporary political economy did not lead systematically to inferior outcomes.

In this paper, I re-evaluate that conclusion and sharpen the inference regarding democratic institutions. The United States remains as democratic as ever in the two fundamental senses that it has regular elections for public office, and that it has limited government (Keech 2009), but the health of the political economy of the country is not nearly as robust as it was in 1995. I find that the generic problems of unintended consequences, moral hazard and time-consistency have more to do with the problems than models of opportunism in routine democratic politics, such as the political business cycle.
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In this paper, I re-evaluate that conclusion and sharpen the inference regarding democratic institutions. The United States remains as democratic as ever in the two fundamental senses that it has regular elections for public office, and that it has limited government (Keech 2009), but the health of the political economy of the country is not nearly as robust as it was in 1995. I find that the generic problems of unintended consequences, moral hazard and time-consistency have more to do with the problems than models of opportunism in routine politics, such as the political business cycle.

The paper focuses on two major economic problems now facing the United States: federal fiscal deficits and debt, and the financial crisis of 2007-2009 with its aftermath of sluggish growth and high unemployment. The financial crisis exacerbated the deficit and debt problem that preceded it. Each of these problems happened independently, but now the financial crisis has made the fiscal situation even worse than it would have been without it.

The paper evaluates the formal and constitutional democratic institutions of elections and limited government for their role in creating the two problems, and for their role in addressing if not resolving them. Since the formal democratic institutions are a constant, they cannot be a direct or unconditional cause of the deterioration in economic conditions. The impact of democratic institutions on economic performance is not generic, but depends among other things on the nature of secondary institutions that may be formal in the sense that they are legislated or otherwise official. Or the secondary institutions may be informal in the sense that they are not written down but are patterns of behavior or norms. Alternatively, the preferences of citizens may have changed. Or random events may have shocked the system.

What are the counterfactuals to democratic institutions as potential causes of the problems? One is human nature in the context of any institutional arrangement. Another is authoritarian governmental institutions. The latter are not a serious counterfactual for the United States. Very few authoritarian governments have a good record of economic performance. Among contemporary countries, China and Singapore stand out. South Korea, Taiwan and Chile moved significantly towards efficient, modern, wealthy economies under authoritarian government, and have since become democratic. But authoritarian government is not an option for the United States.

Human nature is reflected in both authoritarian and democratic governments. The aspects of human nature that are most threatening to good economic performance are selfishness and greed, on the one hand, and a present orientation on the other. Competitive markets can harness selfishness and greed on the part of individuals for the general welfare, as Adam Smith long ago pointed out. And the separation of powers can have a comparably constructive effect of setting ambition against ambition, as Federalist #51 observed. And, as The Federalist Papers make clear, American political institutions were designed to give good government in spite of the foibles of human nature. But there are few formal institutions that work against a self-defeating present orientation. The leading example in the American context is a bicameral legislature with a Senate elected for a six year term, in order to counteract the present orientation of a House of Representatives, which is never more than two years from the next election.
The paper argues that both economic problems (debt and financial crisis) were and are in principle and in fact avoidable by policymakers and by economic agents, although there is not one single responsible agent or party, a fact which blurs accountability. Yet the paper will distinguish mistakes and foibles that are part of ordinary human nature from those that are exaggerated or formalized by democratic institutions. Specifically, the paper will distinguish mistakes that could easily be made by both democratic and authoritarian leaders from those that can be specifically linked to democratic institutions, such as regular elections or the legislative process.

Obviously, democratic institutions are compatible with good economic performance. The world’s richest nations are almost uniformly democratic, and most of them have become rich under democratic institutions. The United States has been a leading example of growth and prosperity under democratic institutions, but it has come upon hard times.

This paper will address the following questions: to what extent are the decisions that put the United States into and are keeping it in this adverse situation attributable in whole or in part to the fundamental democratic institutions of regular elections and limitations on government such as separation of powers? To what extent are they due to secondary formal or informal practices associated with the formal democratic institutions? To what extent are they just human nature? To what extent are they the result of adverse random shocks, or bad luck?

One important feature of democratic institutions is that they process the preferences of citizens in two ways. One is through popular elections, and a central feature of democratic institutions is that there should be no restrictions on the nature or range of opinions expressed. That is to say that the opinions and values behind voting can be sophisticated or ignorant, wise or unwise, informed or uninformed. Since there is always a possibility that opinions can be ignorant, unwise and uninformed, democratic institutions do not always assure that the choices voters make will be good ones. In this way, the policy consequences of democratic electoral institutions are contingent on the preferences that are fed into them.

Similarly, the limitations on the power of any given institutions in a system of separated powers and individual rights give a possibility of blocking constructive change. There is a bias in favor of the status quo in any system that provides institutional means of blocking new initiatives. This feature can work against good solutions to problems that threaten or undermine existing groups or privileges. But the feature can also protect a desirable status quo against misguided initiatives.

In sum, electoral contests that are simplistic or misleading, and lawmaking procedures that permit the blocking of constructive changes are just as democratic as electoral contests that are enlightening and fair, and lawmaking procedures that solve problems and make Pareto improvements. The relationship between democratic institutions and the quality of policy is an open question, and it surely varies across time and political geography.

This paper will suggest that democratic institutions have contributed more to the current economic problems in the United States through irregular mechanisms than through opportunistic models of routine politics like the political business cycles. The first section of the paper will address the long-term fiscal crisis that has developed, and how formal and informal institutions of fiscal policy have played a role, along with changes in stances toward taxation and spending in both popular and professional economic discourse.

The second and third sections will address the financial crisis of 2007-2009. The second section will show how the incentives of democratic electoral politics combined with lax regulatory practices to
create a major crisis. The third section will show how the institutions of limiting government power and of petitioning the government for redress of grievances combined to make for weak reforms that may not prevent a recurrence of such a crisis.

I Democratic institutions and fiscal problems before the financial crisis

For most of U.S. history, federal revenues have exceeded expenditures, or been within sight of covering them. With the major exception of wartimes, there has been a bipartisan commitment to balanced budgets, and an approximate balance between years of deficit and years of surplus up until the 1960s. This was done without formal mechanisms to assure a coordination of taxing and spending. Since then, this informal fiscal discipline has broken down.

The causality of taxing and spending

Kevin Hoover and two of his colleagues have investigated what might be considered regimes of causality between taxes and spending. Hoover and Siegler (2000) argue that for most of American history, taxes have caused spending, with one short interlude (1829-1847) in which spending caused taxes. One major underlying point is that there was consistently a causal relationship between the two, at least up to the 1960s or 1970s. Whichever is causally dominant in any given period, revenues and expenditures were systematically related, and unlikely to get too far from each other. This is consistent with budgets never getting too far out of balance until recently in the broad sweep of American history.

Hoover and Sheffrin (1992) show that the causal interdependence between taxes and spending broke down about 1970. After this shift, revenues and expenditures became causally independent. If the spending and revenue sides are each operating independently of the other, this removes the possibility of controlling one with the other, which seriously undermines the “starve the beast” rationale for cutting taxes (see below). These inferences are congruent with those of other observers of the budgetary process from political science as well as economics (see Hoover 2001, 246-248.)

Intellectual rationales for breaking the causal relationship

Two major developments undermined this situation, one from the left and one from the right. One is the emergence of Keynesian economics in the 1930s and 1940s, which gave a demand side economic rationale to deficit spending under some circumstances. The other is the emergence of “supply side economics,” which gave a growth and productivity rationale for cutting revenues before balancing the budget.

John Maynard Keynes explained the Great Depression in terms of inadequate aggregate demand for goods and services. He suggested that government might use its taxing and spending powers to run intentional deficits in order to stimulate aggregate demand. Keynes said very little about fiscal policy, but his followers developed theories of intentional deficits to stimulate the economy. Although Keynesian ideas were the initial inspiration for the Employment Act of 1946, the first policy proposal with explicitly Keynesian roots was the tax cuts initially proposed by President Kennedy in 1961 and enacted in 1964.

The economic success of these tax cuts was later claimed by a group of economists and policy advisors who called themselves “supply siders.” Supply side economics was driven by two ideas. One was that economic agents responded to higher taxes by working less and therefore, beyond a certain point, higher tax rates would bring in less revenue, rather than more. From this it was a short step to arguing that lower taxes could, and would increase revenue.
The second idea was that low taxes would be a mechanism to “starve the beast” of big government. This idea of course was based on the argument that taxes caused spending. As we have seen from the work of Kevin Hoover, there have been times in U.S. history when this might have worked, but since the late 1960s (and before the political emergence of supply side economics) that causal connection had become broken.¹

A third idea is that higher taxes hinder economic growth. There is something to this, but a specific level or target above zero is rarely articulated or defended. Nor is it widely acknowledged by tax opponents that government can and does provide public goods like transportation infrastructure, education, and research that enhance economic growth.

So in very different ways, both Keynesian and supply-side economics gave substantive economic rationales to raise government expenditures or to lower the level of taxes (respectively) that were independent of basic fiscal balance. For the Keynesians, it might not be time to balance the budget because the economy is not yet at full employment. For the supply siders, there was always a rationale to cut taxes regardless of expenditures in order to improve incentives to work and invest. James Buchanan and Richard Wagner wrote a book length essay about how, regardless of the quality of the intellectual rationale, Keynesian economics gave a political rationale for deficit spending (1977). Supply side thinking about taxes has suffused political discourse to the extent that almost no serious politician speaks of raising taxes on anybody but “the rich.”

Efforts to re-establish causality and discipline

The breaking of the causal connection between taxes and spending has, not coincidentally, been associated with the increasing regularity of annual deficits and with an increase in federal debt as a fraction of GDP. These developments have not been without a congressional response in terms of rules and procedures to enforce or encourage increased coordination of expenditures and revenues.

These responses include the Congressional Budget Act of 1974, the Gramm Rudman Hollings laws of 1985 and 1987, and the Budget Enforcement Act of 1992. The first of these established some institutions and procedures that are still in place: a Budget Committee in each house of Congress, and a Congressional Budget Office that does analysis and multi-year projections. All of them were designed to enforce the budget discipline that had been lost after the 1960s.

Since they were all passed by majority vote, they could all be over-ridden by majority vote, or just allowed to lapse. For example, the Gramm Rudman Hollings law was replaced by the Budget Enforcement Act, which had internally defined expiration dates, and finally expired without being extended in 2002. Auerbach (2008) asks whether these acts had any real impact on budgetary outcomes, as opposed to codifying Congressional intentions for what would have been done anyway. After a careful analysis, he concludes that each one did have some impact on budget policy. Sometimes there were negative side-effects, such as a pro-cyclical impact of Gramm Rudman Hollings. Their impact was never large, and, except for the Congressional Budget Act and the institutions it set up, they have all expired.

Budget developments in the Clinton administration

The Clinton administration left the country with three years of surpluses, the first such run since Harry Truman. These surpluses were the result of a budget agreement that involved both raising taxes

¹ See Romer and Romer (2007) and Niskanen (2008, chapter 15) for empirical studies undermining the “starve the beast” argument.
and cutting expenditures, and a pay-as-you-go rule in Congress that served to assure that new spending was offset by spending cuts or tax increases, plus substantial economic growth.

But even though the federal budget was balanced in the late Clinton years, easily predictable demographic shifts combined with entitlement spending institutions made surpluses unsustainable over a period of years. There was a need to address Medicare and Social Security expenditures, which would automatically grow as the population aged, especially with the retirement of the baby boom generation.

**Budget developments in the George W. Bush administration**

In spite of attention to these issues in the 2000 presidential campaign, several major things happened in the George W. Bush administration to undermine the surplus. First, major cuts in taxes were passed in 2001 and 2003. Second, wars were started in Afghanistan and Iraq. Third, the pay-as-you-go institutions were dropped. Regarding entitlements, there were two major developments. One was an expansion of Medicare to include a prescription drug benefit. The other was an effort to privatize Social Security that never was seriously considered in Congress. The net result was that deficits soared.

So even before the financial crisis began in late 2007, the United States faced a looming fiscal crisis that would get worse the longer action was postponed. To illustrate the serious nature of the fiscal situation before the budgetary costs and the macroeconomic impact of the financial crisis became clear, I will draw on a report by David M. Walker, then Comptroller General of the United States (Walker 2008). Walker pointed out that between fiscal years 2000 and 2007 explicit liabilities of the US government had risen from $6.9 trillion to $10.8 trillion, or 57 percent. These included publicly held debt, military and civilian pensions and retiree health. The implicit exposure in terms of future Social Security and Medicare benefits had risen from $13 trillion to 40.8 trillion, or 213 percent.

**Electoral politics and deficit spending**

What did these developments have to do with democratic institutions? In my view, they were driven by the generic incentives of electoral politics. As Buchanan and Wagner pointed out in 1977, the main incentives of budget policy are twofold: the public likes public programs, and it dislikes paying taxes. Before Keynes gave an economic rationale for intentional deficit spending, the informal norms of balanced budgets prevailed for the most part against the temptation to spend beyond what was taxed.

The feature of democracy that has the most to do with the fiscal problems is the incentives of electoral politics. This is not the electoral cycle that involves spurts to spending or growth close to elections, or the partisan theory that shows different results for inflation, unemployment and growth after elections in which parties change. The operative incentive is the natural desire to have public expenditures that one does not fully pay for, and to pay less in taxes.

And there is a bias in favor of the status quo. When public programs exist, it is much more difficult to pare them back or take them away than to just let them continue. When taxes are insufficient to cover expenditures, it is much more difficult politically to raise them than to continue them as they are.

Fiscal policy under democratic politics can run well under formal or informal rules. Since 2000 it has been running in an ad hoc way that is without discipline or principle. Much previous experience shows that such indiscipline is not inevitable in a democracy in general, and not in the United States in particular. In this country, the more irresponsible and shortsighted possibilities of democracy have come to the fore.
These possibilities reflect dangers and risks of democracy but not inevitability. The United States has lost its sense of fiscal discipline and the formal and informal institutions that support it. It remains to be seen whether the Debt Commission and other forces of long term sustainability in fiscal policy can reestablish such discipline.

II Democratic institutions and processes and the emergence of the financial crisis

The crisis that began in the U.S. in the summer of 2007 and reached its greatest intensity in the fall of 2008 is the most significant financial crisis since the Great Depression. Reinhart and Rogoff (2009, 203, passim) call it “The Second Great Contraction.” It began in the United States and spread worldwide, especially to Europe. It has caused enormous losses of wealth, income and employment.

Democracy and financial crises in general

Democracy is neither necessary nor sufficient for financial crises. On necessity, the subtitle of Reinhart and Rogoff’s survey is indicative: “Eight Centuries of Financial Folly” reflects the fact that financial crises existed well before modern democracies emerged. As to sufficiency, Gary Gorton identifies what he calls the “Quiet Period,” a span of more than seven decades lasting from 1934 to 2007 in which there were no banking panics in the democratic United States (2010, 54, passim). Of course there were some financial crises in the US in that period, such as the savings and loan crisis, the brief stock market crash of 1987, and the bursting of the dot.com bubble. But these crises were contained and did not have major systemic consequences. They did not lead to a banking panic on the order of 1907, 1929 to 1933, or 2007 to 2009.

Although he leaves the question open, Gorton suggests that we might think of this long period as exceptional and based on special conditions that no longer hold, rather than something that we know how to recreate. One key to explanation of why the US went for so many years without banking panics is surely deposit insurance, which was established in the Banking Act of 1933.

Deposit insurance is a mechanism that illustrates both the constructive possibilities of democratic institutions, and also the risks. Because banks take short term deposits and use them to make long term loans, even well-run and strong banks cannot remain solvent if many of their depositors demand their money within a short period. Deposit insurance contributes to confidence in banks by avoiding the risk that rumors of bank weakness will become self-fulfilling, even for strong banks. This confidence is the constructive possibility of democracy: making rules that create Pareto improvements and solve collective action problems.

But the risk of such constructive possibilities is moral hazard, the possibility that people or organizations who are insured against risks will act less prudently and take more risks. This problem was handled with regulation. In order to become a bank, an organization had to acquire a charter from the federal or state government, and these were not easy to obtain. According to Gorton, the privilege of being a bank was like the privilege of being a monopoly, and provided an incentive to self-regulate (2010, 54). And the Federal Deposit Insurance Corporation, which administers deposit insurance, has the capacity to impose capital requirements, and to take over undercapitalized banks.
Moral hazard and democracy

In a democracy, there is an incentive to do things that will please mass publics and interest groups. Deposit insurance is a good example of something that will do so. It will please the public whose deposits are insured, and remove from them the need to monitor carefully the soundness of their bank. Banks should like it, because it makes them less vulnerable to panics and to runs on their assets. But the problem of moral hazard exists from a systemic perspective, and resolving the problems of moral hazard are unlikely to have as direct a constituency in a democracy as depositors or banks.

There is not a clear counterfactual to democracy here. A benevolent authoritarian government might well introduce deposit insurance in order to achieve the benefits for both depositors and bankers. A wise and benevolent authoritarian ruler might also worry about moral hazard. It is human nature to yield to moral hazard and take more risks if one knows that he or she will not bear the full costs of failure. So moral hazard is not a problem that is unique to democracy, but I will show how democratic institutions have been used explicitly in electoral and legislative processes in ways that have enhanced moral hazard. But first, I will provide some background on housing, which was one of the root causes of the crisis.

Housing policy in the United States

It is widely acknowledged that housing was one of the main sources of the financial crisis. The majority Report of the Financial Crisis Inquiry Commission (FCIC) concluded that “collapsing mortgage lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis” (2011, xxiii). The Republican minority report also identifies housing as one of ten causes of the crisis: a housing bubble (not just in the United States), a proliferation of nontraditional mortgages, and deterioration in lending standards (FCIC, 2011, 417-9, 422-5). These Republicans say that mainly private actions were supplemented by government policies, many of which had been in effect for decades, that subsidized homeownership but created hidden costs to taxpayers and the economy. Elected officials of both parties pushed housing subsidies too far (FCIC, 2011, 424).

Peter Wallison, a Republican who dissented from all of the above reports, argues that the U.S. government’s housing policy was “the sine qua non of the financial crisis.” If the U.S. Government had not chosen this policy path – fostering the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high risk residential mortgages – the great financial crisis of 2008 would never have occurred (FCIC, 2011, 444). So the majority and minority of the FCIC agreed that housing practices were at the root of the crisis, though they differ in the degree to which they blame the U.S. government and its housing and other policies for the crisis.

The United States government has influenced housing markets in three basic ways. The first is in tax preferences for housing. The second is by insuring home mortgages, and the third is by an effort to encourage home ownership and increase the amount of “affordable housing.” Tax preferences for housing may have encouraged overinvestment in housing, at the expense of more growth-oriented investments, but otherwise had nothing to do with the financial crisis. The practice of insuring mortgages, while innocuous enough in its own right, was extended into practices that distorted markets and made the American taxpayer vulnerable to massive bailouts. The effort to increase the amount of
affordable housing has led to deterioration in the standards used in lending, and to massive defaults and foreclosures.

All of these policies have been motivated by good intentions, and usually they have been reinforced by the incentives of democratic politics. But these intentions and incentives often have unintended consequences. Sometimes these consequences are arguable, subtle and highly contestable, such as the first one, the suggestion that tax preferences for housing have led to less growth than a more neutral tax policy regarding housing and other investment.

The other two patterns of policy, insuring mortgages and the effort to encourage homeownership existed for years without major adverse consequences. But implementation of these well-meaning programs was extended into consequences that can be traced to catastrophes like the recent financial crisis. In this way, the incentives of democratic politics enhanced moral hazard.

Democratic government is responsible and responsive to mass publics through popular elections and to interest groups through elections and legislative processes. Such responsiveness can lead to good or to bad policies. Democratic (and other) governments can be good for economic performance when they solve collective action problems. They can be bad for economic performance when they create moral hazard or when they create (or fall into) time consistency traps. They may do these bad things in the process of solving collective action problems. So did the U.S. government play a role in causing the financial crisis by creating moral hazard or time consistency traps? And if so, did it do so in response to the incentives of democratic politics?

The U.S. government has been indirectly or directly subsidizing homeownership since the modern income tax was ratified in the Sixteenth Amendment. The very first 1040 form for 1913 allowed deduction from gross income of “All interest paid within the year on personal indebtedness of taxpayer.” So the government was subsidizing borrowing to buy homes (along with borrowing for investment and consumption). When the deductibility of all interest was ended in the Tax Reform Act of 1986, the popular deductibility of interest for mortgages was left intact, along with a new possibility of “home equity loans,” which allowed taxpayers to borrow against the value of their homes for any purposes, and to deduct that interest from their taxable income. In this way, housing got preferential tax treatment relative to other kinds of investment in 1986.

In addition to these tax subsidies, the U.S. government has been insuring some home mortgage loans through the Federal Housing Administration and other entities since 1934. Normally the borrower pays a premium at closing for this insurance, but the government is liable in case of default. Fannie Mae (Federal National Mortgage Association, founded 1938) and Freddie Mac (Federal Home Loan Mortgage Corporation, founded 1970) are Government Sponsored Enterprises (GSEs) that provide a secondary market for mortgages. They repackage loans into mortgage backed securities that they resell and provide more money for the mortgage market. Although they are private, profit making corporations, their implicit backing by the government has allowed them advantages in the marketplace.

The Financial Crisis Inquiry Commission found that the GSE’s had a deeply flawed business model as publicly traded corporations with the implicit backing of and subsidies from the federal government and with a public mission. ... They used their

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political power for decades to ward off effective regulation and oversight – spending $164 million on lobbying from 1999 to 2008 (FCIC Report, 2011, xxvi). They became insolvent after the housing bubble burst, and were taken over by the government in September 2008. Thomas Sowell estimates that the cost to the taxpayer for bailing out Fannie and Freddie will be more than the bailouts of Bank of America, Citigroup, J.P. Morgan Chase, and Wells Fargo combined (2010, 75).

The federal government has for some time been actively encouraging “affordable housing,” and endeavoring to broaden access to credit for purchasing homes. In 1992, Congress passed Federal Housing Enterprises Financial Safety and Soundness Act, which authorized the Department of Housing and Urban Development to set affordable housing goals for Fannie and Freddie in order to give prospective homeowners of modest resources better access to mortgage credit (FCIC 2011, 41). This soon became a set of requirements for the relevant GSEs, i.e. Fannie Mae and Freddie Mac to lower their standards for underwriting mortgages (FCIC, 2011, 451-454 in online version, Wallison dissent.) In 1995, President Bill Clinton announced an initiative to increase home ownership from 65.1 to 67.5 percent of families by 2000. One element of his plan was to raise the affordable housing goals for Fannie Mae and Freddie Mac. President George W. Bush continued the push to expand homeownership (Report, 2011, 41).

Loans were made available to borrowers whose credit would previously have made them ineligible for a mortgage. The agencies making these loans were no longer dominated by banks and savings and loans. And the connection between the borrower and the agency that originated the mortgage was soon broken by the fact that the mortgage was resold, and “securitized.”

As long as house prices kept going up, the weakness in borrowers’ ability to meet their mortgage could be addressed by refinancing. And go up they did. “Since 1891, when the (Case-Shiller) price series began, no housing price boom has been comparable in terms of sheer magnitude and duration to that recorded in the years culminating in the 2007 subprime mortgage fiasco” (Reinhart and Rogoff, 2009, 207).

Another government related reason for the housing bubble was that excessively loose monetary policy, which kept interest rates lower than economic conditions warranted. Between 2001 and 2006, Federal Reserve had kept interest rates below rates consistent with rules that guide the economy in response to interest rates and output (Taylor 2009, chapter 1).

Links to democratic institutions
The effort to increase “affordable housing” and to broaden homeownership had very wide public appeal. For the Democrats it appealed to the low income and minority part of their clientele. For the Republicans, the “ownership society” rang with traditional conservative values. And there was almost no direct federal expenditure or other obvious budgetary consequence.

Raghuram Rajan (2010) has suggested that these policies were a response to the rising inequality in American society (2010, chapter 1). The rich have been getting much richer while the middle class and the poor have barely kept pace with their previous incomes. This is, according to Rajan, due to the returns from education, which increase with technological advance. In a country where there is little popular support for direct redistribution, or even for a denser safety net, easy credit is a way to
enhance the living standards of those whose incomes are not rising. The result, of course, is mounting private debt, (along with risk to the government in some cases of default).

Mian, Sufi and Trebbi (2010a) show a more directly democratic process that involves legislation. They show that campaign contributions from mortgage oriented financial institutions and that subprime borrowers in congressional districts contributed to policies that led to the subprime crisis, and also to relaxing of regulation. Mian et al. show how elections, electoral competition, constituency interest all combine into a pattern that created moral hazard.

Similarly, Igan, Mishra and Tressel (2009) suggest that lobbying of Congress involves moral hazard and rent-seeking. Specifically, they start with articles in the Wall Street Journal and the Financial Times that assert that mortgage lenders fought legislation that would work against predatory lending, and that subprime originators sought to prevent tighter regulations of the subprime market (2009, 4). In a careful empirical investigation, they find supportive evidence for the hypotheses that lobbying of Congress between 1999 and 2006 was by firms that were disproportionately risk taking, ex ante, and performed more poorly ex post.

Of course, lobbying is a First Amendment right: “Congress shall make no law ... abridging ... the right of the people ... to petition the Government for redress of grievances.” But there is no assurance or requirement that lobbying be constructive, or that it not be a part of rent-seeking or moral hazard.

Here is a case without a clear counterfactual. No system is invulnerable to moral hazard, but Mian et al. show how processes associated with democratic legislative institutions led to outcomes that involved moral hazard. Democracy is consistent with moral hazard in that it resulted from decisions made through explicitly democratic institutions and processes.

One link between democratic institutions and processes and the underlying causes of the financial crisis is as follows. The general subsidization of homeownership was a way to appeal to voters in the middle class and later to minorities and poor people who were not in the middle class. These policies can be founded in beliefs about responsible citizenship and firming ties to the community as enhanced by homeownership. They are also policies that are well designed to appeal for votes in a democracy. So they fit democracy, but are not direct products of democratic institutions. For example, Canada is a democracy that did not go in this direction.

The failure to see danger signs is just human nature.

The financial crisis of 2007-2009 is in some ways the result of unanticipated consequences of normal democratic processes. But the fact that they were not anticipated does not mean that they could not have been anticipated. Reinhart and Rogoff identify four characteristics of conditions leading up to financial crises, and find that all were present in the United States before 2007: real housing prices rose; real equity index prices rose; current account deficit as % of GDP was very high; and public debt was high. Now admittedly they were sampling on the dependent variable, and do not give the fraction of countries or country-years in which such conditions were present, but no financial crisis occurred. However, these were characteristic of all financial crises above a certain threshold of seriousness.

Reinhart and Rogoff's title and theme is that countries that are otherwise vulnerable to crises have reasons, arguments and pretexts to say that This Time is Different for them, and they quote Alan Greenspan, Ben Bernanke, and others to show how knowledgeable policymakers believed that their situation excused them from the risks. This stance of denying vulnerability to crisis is human nature, and
not a phenomenon that is unique to democracy. As Reinhart and Rogoff point out, there are at least six ways in which “this-time-is-different” (TTID) was used by US officials and economists (2009, 214-5). But this pattern seems to be less democratic institutions than human nature. And the experience reminds us that democratic institutions do not always protect us against the foibles of human nature.

III Democratic institutions and processes and the policy reactions to the financial crisis

Reinhart and Rogoff show that the consequences of major financial crises are very great and very long lasting. In the context of history, the US may have recovered to positive (if not potential) growth remarkably fast. But its currently high public debt and high unemployment are not unusual for a country that has experienced a financial crisis. In any case, the costs of financial crisis are so great that one would hope that everything possible would be done to avoid a recurrence (2009, Reinhart and Reinhart, 2010). It is not clear that that is happening under the democratic institutions of the United States.

The Time Consistency Problem

The financial crisis of 2007 to 2009 is a good example of the time consistency problem, which was crystallized by Kydland and Prescott (1977). It is important to distinguish between best thing to do for all times and best thing to do at a specific time. There are two ways to evaluate the reaction to the financial crisis, and in particular the bailouts of Bear Stearns, Fannie Mae and Freddie Mac, AIG and Citigroup.

The Republican minority report of the Financial Crisis Inquiry Commission gives a good case for the thinking of the members of Congress who voted for the Emergency Economic Stabilization Act of 2008 (EESA), and that of Secretary of the Treasury Henry Paulson, Federal Reserve Chairman Ben Bernanke, and New York Federal Reserve President Timothy Geithner.

Policymakers were presented, for example, with the news that “AIG is about to fail” and counseled that a sudden and disorderly failure might trigger a chain reaction. Given the preceding failures of Fannie Mae and Freddie Mac, the Merrill Lynch merger, Lehman’s bankruptcy, …, market confidence was on a knife’s edge. A chain reaction could cause a run on the global financial system. They feared not just a run on a bank, but a generalized panic that might crash the entire system – that is, the risk of an event comparable to the Great Depression.

For a policymaker, the calculus is simple: if you bail out AIG and you’re wrong, you will have wasted taxpayer money and provoked public outrage. If you don’t bail out AIG and you’re wrong, the global financial system collapses. It should be easy to see why policymakers favored action – there was a chance of being wrong either way, and the costs of being wrong without action were far greater than the costs of being wrong with action (Report, 433).

Given the situation as described, this certainly makes sense. Under the circumstances, voting for EESA and approving the bailouts did provoke public outrage, and even looks courageous when one considers the risks of inaction. But this is not the whole story. This was perhaps doing the right thing at

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3 According to the NBER, this recession lasted from December 2007 to June 2009, a duration of 18 months, which was longer than any recession since the Great Depression, which lasted 43 months from August 1929 to March 1933. There were two 16 month recessions, from November 1973 to March 1975, and from July 1981 to November, 1982. Source: http://www.nber.org/cycles.html, accessed April 1, 2011.
a particular time, but it was not the best policy for all times. And previous comparable actions may have
made the situation worse.

The U.S. government had been bailing out major banks since Continental Illinois in 1984. In
hearings on the rescue of Continental Illinois, the Comptroller of the Currency actually said that the
government would not let the 11 largest “money center banks” fail. This led immediately to a new
phrase, “too big to fail” or TBTF. This and other actions created moral hazard in the banking system
(FCIC Report, 36-37. See also Report, 57-58, 431-432).

All of these rescues created the expectation that there would be future rescues. This
expectation encouraged risk taking that might not have occurred if it weren’t for the expectation of
bailout. This was a clear case of government causing moral hazard, and of the time consistency
problem. The best thing for all times would have been to allow failing banks to fail. The systemic risks
of contagion and TBTF were encouraged by previous rescues.

Another contributor to moral hazard was “the Greenspan put.” The Chairman of the Federal
Reserve had famously wondered in 1996 whether the stock market was reflecting “irrational
exuberance.” Not only did he not do anything to temper the exuberance, he later intimated that,
although the Fed would not intervene on the high side, the Fed would recognize a downturn when it
happened and “ease the transition to the next expansion.” In other words, the Fed would not limit gains
when traders took risks, but would limit adverse consequences when things went badly (Rajan 2010,

Now democracy does not have any monopoly on moral hazard or on the time consistency
problem. An authoritarian system could also be comparably vulnerable to these problems. But Mian,
Suffi and Trebbi (2010b) have shown how the Emergency Economic Stabilization Act got through
Congress. They say that “it was clear that the legislation represented a large wealth transfer from US
taxpayers to the financial services industry (2010b. 1973). They analyze differences between votes in the
House of Representatives on September 29, when the bill failed and October 3, when it passed.
Between the two dates was the largest one day drop in stock market value since the 1987 Black Monday
(2001b, 1991). The first vote was mainly influenced by campaign contributions from the financial
industry and by ideology. Among the 228 members who switched from no to yes, the causal patterns
differed between the parties. For the 95 switching Democrats, the main factors were the mortgage
default rate and the fraction of constituents with more than $200K in income. For the 133 Republicans,
the main factor was the fraction of constituents working in finance (2010b, 1991-2).

The authors conclude that their “results are consistent with the hypothesis that politicians voted
in favor of the EESA in part because of special interest campaign contributions from the financial
services industry” (2010b, 1997). The policy that made bailouts possible was made in democratic
institutions as a result of democratic processes.

The fact that the crisis did happen and that the bailouts were necessary was itself a policy
failure, linked to previous bailouts. Banks and other financial institutions had gotten so large that their
failure would have huge adverse ramifications beyond their own creditors, stockholders and customers. The
fact that the major banks except Lehman were bailed out by the government reinforced the moral
hazard that already existed in the system. It was a violation of time consistency, the idea that doing the
right thing at any given time should be consistent with doing the right thing for all times.
Reactions in the Obama administration

One of the first acts of the newly inaugurated Obama administration was to pass in February of 2009 a massive 787 billion dollar fiscal stimulus package called the American Relief and Recovery Act. This act has become one of the most controversial pieces of legislation of the Obama administration, and seems to be a political liability, in part because of the way it was sold to the public. Making unrealistic promises for reduction of unemployment as a result makes it an easy target as an expensive, debt increasing bill that “has not worked.”

On the positive side, this is the first fiscal stimulus package in the postwar era to have passed before the recession was over (February passage and June official end of recession). Also, the widely used argument against it (that it has not worked because unemployment is still high) is simplistic. We do not know what would have happened without the stimulus, and we do not know whether less or more would have been better.

On the negative side, the stimulus was oversold with “recovery summer” and unfulfilled promises. There is no visible result of the fiscal stimulus, like the Blue Ridge Parkway or the post offices that were visible symbols of fiscal stimulus in the Great Depression. Systematic research on the relevant fiscal multipliers is mixed to negative in its implications. For example, Ilzetski et al. (2010) suggest that fiscal multipliers are smaller in countries that have floating exchange rates, open economies and high debt, all of which are true of the United States.

Until the early 2000s, active fiscal stabilization policy had fallen into disuse, but since then, several stimulative measures have been taken (Auerbach, Gale, and Harris, 2010). There is considerable disagreement about whether or not these measures work, or are worth the costs to long term debt. This I consider an honest debate where correct answers are not uncontestable. Democracy is meant to be a system of competition of ideas in which there is a free and open debate. Making the right choice is not assured by democracy.

Reforms that would minimize vulnerability to comparable crises in the future

In his dissent from the Financial Crisis Inquiry Commission Report, Peter Wallison says he is often asked why Congress bothered to authorize the Commission at all, since Congress passed the Restoring Financial Stability Act (the Dodd-Frank Act) in July of 2010, months before the Commission’s report came out (FCIC Report, 2011, 443). The Report does not give a single coherent explanation of why the crisis occurred and how to avoid it. The majority report is a lengthy history of what happened. The main minority report is much more analytical. And Wallison’s personal dissent blames the crisis entirely on government housing policies.

While I agree with those who argue that the full explanation will not be known for some time, I also think that there will never be a single widely accepted explanation. Surely some of the political pressure to pass “reform” legislation quickly can be attributed to the incentives of democratic politics to “do something now” and to act before public interest dissipated.

In the remainder of this section, I will compare two analyses. The first is The Squam Lake Report: Fixing the Financial System. It is a product of a meeting of fifteen top financial economists, who first met at a New Hampshire resort in the fall of 2008. It draws together their collective wisdom about the causes of the financial crisis, and makes numerous recommendations, which are reflections of two central principles. The first principle is that “when developing and enforcing regulations, government

See footnote 3.
officials must consider the implications not only for individual institutions but also for the financial system as a whole (French, et al. 2010, 135). The second principle is that “regulators must create conditions that minimize the likelihood of bailouts of financial firms by forcing them to internalize the costs of failure that they have been imposing on taxpayers and the broader economy” (Ibid., 137). A central substantive recommendation is that capital requirements should be larger for larger banks, banks with less liquidity, and with more short term debt (French et al. 2010, chapter 5). In spite of its distinguished collective authorship, this report seems to have received almost no public attention.\(^5\)

The second (Carpenter 2010) takes the Obama administration’s proposal for reform and analyzes what happened to it in Congress on the way to becoming the Restoring Financial Stability (Dodd-Frank) Act that passed in July 2010. Carpenter focuses on five features of the original proposal: minimal capital requirements, regulation of derivatives, unification of systemic financial regulation in a new agency, a consumer financial protection agency, and fees for the regulation of large banks (2010, 827). Although Carpenter does not explain or directly defend the desirability of these proposals, the article implicitly endorses them, and makes the case that they were watered down or cast aside on the way to the passage of the Dodd-Frank law.

Carpenter’s explanation of this is not simply in terms of the well-known constitutional veto points in the American political system. His article expresses an interpretation of “institutional strangulation” that is presented as more insidious than it would be if simply based on the classical ideas of checks and balances. He points out that many of the institutional veto points, such as the filibuster, were not part of the original institutional design of checks and balances. He also observes that new ideas and proposals may be discounted because they come from people outside of privileged professional networks. Carpenter also observes that a “culture of partisanship and vituperation” has emerged in a way that worked against financial reform. And finally, he identifies bureaucratic politics and struggle over turf as an obstacle to the Obama proposals. Clearly Carpenter does not like what happened to the Obama administration proposals. And he makes a strong case that important parts of them were watered down and cast aside by a process of negation that went beyond the original intents of the framers.

Carpenter’s analysis has a somewhat stronger political valence than the articles of Igan et al. (2009) or Mian et al. (2010a, 2010b), but they all call attention to features of the legislative process that make it responsive to the preferences of “special” interests who are established or powerful or have a substantial financial stake in a policy that involves moral hazard, time consistency or both. This is to say that the legislative process in a democracy can be used to create these generic problems as well as to resolve them.

Conclusions
Democratic institutions in the fundamental sense of regular elections of public officials and limitations on government do not necessarily cause any particular type of policy. In terms of Plott’s Fundamental Equation \([\text{preferences (x)} \rightarrow \text{outcomes}]\), it depends on the preferences that are processed by the institutions. These preferences can be shortsighted or not, and highly polarized or not.

In terms of long term budgetary sustainability, there have been “regimes” in which the democratic institutions of the United States have performed better than they have in recent years. This

\(^5\) But see Goodhart (2011) and Hoshi (2011).
is due to informal practices that must be inferred econometrically, as in the Hoover articles on the causality of taxing and spending. And it is due to the presence or absence of formal rules of budgeting.

The United States first drifted into an unsustainable fiscal situation, basically due to political leaders pandering to voters with policies that brought short term benefits with long term costs. These were appealing enough to the public to have been rewarding to the politicians who proposed them. This is a fairly simple story of promising lower taxes and more benefits with the costs shifted to future generations through borrowing. The corrective would be a return to fiscal discipline, whether through political will or formal rules like those reviewed in Auerbach (2008). One hopeful sign is that there are several commissions and an increasing number of scholars and public figures calling for reform. But the case for pessimism seems strong, given the lack of attention to the long term problems even after the November 2010 election that seemed to hinge on deficits and debt.

The financial crisis of 2007 to 2009 is more complicated. To the extent that it was rooted in U.S. housing policy, it is a leading example of adverse unintended consequences of efforts to do good things by extending the benefits of home ownership to more and more people. These policies were efforts to please constituencies that are directly linkable to the incentives of democratic politics. Unfortunately they have lessons for how good intentions can have bad consequences.

To the extent that even members of the Federal Reserve thought that “this time is different,” the financial crisis was caused by human nature discounting danger signs for prudent behavior. But the financial crisis was in part facilitated by democratic institutions and processes that exacerbated the dangers. Mian et al (2010a) document that special interests representing the mortgage industry and subprime borrowers influenced housing legislation in the period leading up to the subprime crisis in ways that made the country more vulnerable to the crisis that resulted. They also show in Mian et al (2020b) that the bailouts were a response to lobbying by the financial industry.

We still do not know the full impact of the Dodd-Frank law, but we do know that the banking industry successfully blocked higher capital requirements for banks, and also requirements that banks reduce their size so as not to be too big to fail. It is not at all clear that, had Dodd-Frank been in effect before the recent financial crisis, that the crisis would have been avoided.

Democratic institutions are compatible with just about any pattern of policy. It is not just regular elections or limitations on government that lead to the good economic performance that is often associated with democratic politics. It is the ancillary institutions and practices, such as the unwritten rules of the budgetary process, that guide behavior and policymaking in democracies.

Systematic models of routine politics as developed in the political economy literature have contributed enormous insight into the ways in which politicians and voters interact with each other and among themselves. Yet they for the most part overlook some more serious problems that may be less routine and more like one-time developments and path dependent processes. Public choice and political economy models of democratic politics should consider more seriously ways in which formal and informal democratic institutions relate to generic problems like moral hazard and time consistency.

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