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The Economics and Politics of Financial Modernization

The structure and regulation of a country's financial markets and institutions are the focus of considerable policy attention for a number of economic and political reasons. Banks and other financial institutions encourage and collect the savings that finance a country's economic growth. By allocating the savings to enterprises and monitoring the use of the funds, the institutions and the markets play an integral role in the corporate governance system that ultimately affects the productivity of resources throughout the economy. Banks and other financial institutions also play an integral role in transmitting the government's monetary and credit policies to the rest of the economy. Parts of the financial sector are effectively regulated as a means to provide subsidized credit or services to targeted groups (including the government itself) and to protect particular groups from such activities as competition, hostile takeovers, and expropriation.

Although the economics of financial regulation have been studied extensively (Herring and Santomero 1999 and Kroszner 1998a), the politics have received less—albeit increasing—attention. Rather than taking regulations as given, the political-economy approach attempts to provide a positive analysis of how and why regulations evolve as they do and what forces can lead to their durability as well as to their potential for change. This perspective offers an alternate lens through which one can analyze regulation, and it complements the traditional normative analysis undertaken by economists studying "optimal" regulation.

When the infamous American bank robber Willie Sutton was asked why he robbed banks, he replied, "That's where the money is." The same might be said for why there is such government involvement in the banking and financial system—that's where the money is. In the next section, I briefly outline a number of political-economy approaches to understanding government involvement in the economy and, in doing so, I examine why the banking and financial system appears to be particularly vulnerable to politicization.

Afterward, I apply these approaches to an investigation of why there has been such extensive deregulatory reform in banking and financial services during the past quarter-century. I focus on the breakdown of legal barriers that, until the Gramm-Leach-Bliley Financial Modernization Act of 1999, had separated banking, securities, and insurance activities. However, I also touch on other major reforms, such as the elimination of legal barriers to the geographic expansion of banks within states and across state lines. The political-economy approach helps to identify technological, legal, and economic shocks that disturbed the long-standing regulatory equilibrium in banking and financial markets. I conclude with a brief note on the role that traditional academic evaluations of regulation can still play in the policy-reform process of interest group competition filtered through government decision-making institutions.

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Approaches to the Political Economy of Regulatory Change

Economists, political scientists, and policy reformers have developed a variety of positive theories to explain how government intervention and regulation occur and how and when they change (Rodrik 1996). Five related approaches that have been used to analyze these phenomena fall under the classifications "public interest," "private interest," "ideology," "institutions," and "leviathan." Although these approaches are not mutually exclusive, they emphasize different aspects of the interaction between economics and politics, and each captures an important element in the process. I now discuss each approach briefly and apply them to an understanding of various aspects of banking and financial regulation and deregulation.[1]

Public Interest

This is the traditional "civics class" term that economists once used to explain regulation: banking and financial regulations exist to correct market failures and protect poorly informed consumers from harm.[2] From this perspective, regulatory intervention occurs primarily to maximize social welfare, so this approach is often called the public interest theory of regulation. Public interest rationales, for instance, are used to explain how government deposit insurance and capital regulation provide for a sound banking system, because the stability of the financial system can have spillover effects for general macroeconomic performance (Diamond and Dybvig 1983, King and Levine 1993, Jayaratne and Strahan 1996, and Kaufman and Kroszner 1997).

A key challenge facing the public interest view is that many forms of regulation have little or no redeeming social value. Entry restrictions that protect banks or other financial institutions from competition, portfolio restrictions that hinder diversification, and geographic restrictions that prevent expansion within a country or across national borders generally are difficult to rationalize on public interest grounds. Regulation that does not appear to serve a public interest is also common in other sectors (Stigler 1988).

Regardless of whether it may have a public interest rationale, regulation has significant distributional consequences. The parties affected by the regulation thus have an incentive to try to ensure that the government structures the regulation so as to benefit them. A public interest argument is often used to mask the private interests that the intervention serves. Indeed, private interests may try to confuse the public debate by providing false or misleading information that makes it difficult to discern which policy would improve social welfare (Kane 1996 and Dewatripont and Tirole 1999).

Private Interest

The private interest theory of regulation, also called the economic theory of regulation, characterizes the regulatory process as one of interest group competition in which compact, well-organized groups are able to use the coercive power of the state to capture rents for themselves at the expense of more dispersed groups (Olson 1965, Stigler 1971, Peltzman 1976, 1989, and Becker 1983). Changes in the size, strength, and organization of interest groups thus provide the key to understanding policy changes. Regulated groups may be sufficiently powerful so as to influence the politicians and the regulatory bureaucracy to serve primarily the interests of those subject to the regulation. In other words, the regulated group "captures" the regulators; hence, this is sometimes called the capture theory of regulation.

The incentives for such regulatory behavior may be direct or indirect. Pressure may be exerted directly on politicians, through campaign contributions or votes. The politicians may then pass a new statute or pressure the regulators to act sympathetically toward the interest group. Indirect incentives may come through regulators understanding that cooperative behavior may be rewarded with lucrative employment opportunities in the industry after leaving the government, a practice so common in the past with Japanese Ministry of Finance officials that it is euphemistically called *amakudari*, the "descent from heaven."

The effectiveness of the interest groups depends on a number of factors. First, cohesive groups will find it easier to organize and overcome free-rider problems in lobbying for regulations that may benefit them. Producers of goods and services tend to be more compact and better organized than consumers, so there is a tendency for regulation, on net, to benefit producers more than consumers (Stigler 1971).[3] The ability of a group to organize is often inversely related to its size, but many labor unions and trade organizations have been able to develop effective lobbying bodies through carefully crafted incentives that provide a variety of information and support services in return for membership (Olson 1965). The Independent Community Bankers of America (formerly the Independent Bankers Association of America), for example, has been very effective at organizing and representing the interests of small banks.

Second, groups tend to be more effective not only when the benefits are concentrated among group members but also when the costs of the regulation are relatively diffuse.

A compact group of potential "losers," each of whom would experience high losses associated with the regulation, are likely to form a lobby that will try to counteract the original interest group's pressure. Interest groups most directly affected by the regulation may also attempt to build a broader coalition to lobby for or against the regulation.[4]

In the long legislative debate over the expansion of bank powers, banks, securities firms, and insurance companies organized powerful lobbying organizations that focused much of their energy on battling each other (Kroszner and Stratmann 1998). Until 1999, the numerous major legislative initiatives during the previous fifteen years were thwarted by strenuous lobbying efforts by the rival groups. In 1995, for example, even though the chairmen of both the House and Senate Banking Committees, the President, the chairmen of the Federal Reserve Board, and the Comptroller of the Currency supported expanded bank powers, a broad banking reform bill was again killed by interest group wrangling: "It was Wall Street securities firms and insurance companies that helped kill a bill to repeal the Glass-Steagall Act and allow banks to enter their markets" (*New York Times*, December 23, 1995, p. 19).

Third, in addition to the diffusion of costs across different groups, the level of the costs relative to the benefits obtained by the interest group plays an important role (Becker 1983). Deadweight loss is defined as precisely the difference between the "winner's" benefit minus the loser's cost from the change in output generated by the regulation. Factors affecting the "efficiency" of the regulatory or transfer mechanism thus may have an important impact on political outcomes. As the deadweight loss grows, for example, the losers are losing more for each dollar of the winner's gain. When this gap widens, losers have a greater incentive to fight each dollar of the winner's gain and the winners have less incentive to fight for each dollar of the loser's loss. In other words, when deadweight losses are high, an interest group faces greater opposition to its protective regulation on the margin and hence it is less likely to be successful.[5]

Similarly, politicians in electoral democracies are concerned about finding an optimal support coalition to promote their reelection chances, so they take into account the marginal costs and benefits to different groups. The rents generated by regulation in an electoral democracy thus are likely to be spread among different groups, even though one group may be the primary beneficiary (Peltzman 1976).[6] Regulation that protects financial institutions from competition and subsidized government deposit insurance to banks generate rents for this sector that are then partially shared through directed credit allocation.[7]

The private interest theory thus helps to explain why the banking and financial system is particularly susceptible to political influence. The banking system provides an effective but off-balance-sheet way for the government to redistribute resources (Kroszner 1999a). Few, if any, other sectors provide the same degree of flexibility to redistribute resources, whether implicitly through Bank of Japan "window guidance" or explicitly through statutes such as the Community Reinvestment Act. Credit allocation through financial institutions can be an important implicit or explicit part of a government's industrial policy.[8] Banks and financial institutions may be induced to act, at least in part, as implicit fiscal arms of the state, but they must be compensated through protective regulation.

Since the government is so heavily involved in banking, it may be very difficult to have effective government regulation of the domestic banking and financial sectors. In these circumstances, simply hiring more and better trained supervisors and adopting good regulatory principles are not sufficient strategies because the government may have little incentive to enforce rules of sound banking, either on state-owned banks or privately owned ones. The codependence of the banks on the government and of the politicians on the banking industry allows problems to grow unchecked, as shown by the depth of banking troubles in the Asian countries experiencing currency crises.

This linkage may also help to explain why governments cannot seem to avoid bailouts of the financial sector, even as officials acknowledge and decry the moral hazard problems of the bailouts themselves. These perverse incentives are not unique to developing countries, as illustrated by the long delays in responding to the savings and loan crisis in the United States and the banking problems in Japan.

Ideology

Although the private interest theory has had much success in explaining a wide variety of regulatory interventions that are difficult to rationalize on public interest grounds, it has been less effective in explaining the widespread economic deregulation that has taken place in many countries during the past two decades (see Peltzman [1989] and Noll [1989], but also see Kroszner and Strahan [1999]). Many political scientists and some economists emphasize the importance of the beliefs and "ideology" of voters and politicians to explain regulation and deregulation (Kalt and Zupan 1984 and Poole and Rosenthal 1997). Differences over time across countries or among citizens in their general beliefs about government's appropriate role in economic affairs might affect the extent of intervention. Roe (1994), for example, argues that populist

fears of excessive concentration of power in the hands of the financial elite were a driving force behind many banking and financial regulations in the early part of this century, using the 1933 Glass-Steagall Act's restriction of commercial bank powers as an example (Hellwig [1999], however, offers an alternative interpretation).

Poole and Rosenthal (1997) have developed a useful measure of ideology based on roll-call voting that rates legislators on a simple left-right scale. This ideology measure has had much success in accounting for a wide variety of economic regulation and deregulation not well explained by private interest group variables or party politics. Berglof and Rosenthal (1999), for example, analyze bankruptcy law in the United States and find that this measure of ideology is a key element in understanding the voting patterns on bankruptcy legislation during the past two centuries. Poole and Rosenthal (1993) also find an important role for ideology in the battles over the origins of the economic legislator in the United States during the nineteenth century.

Identifying the driving forces behind changes in ideology over time, however, has been difficult. Margaret Thatcher and Ronald Reagan are said to have embodied a shift toward a pro-market ideology, but an exogenous change in ideology is an unsatisfying explanation for a sustained move toward deregulation and privatization. This is particularly true when one recalls that the first major deregulatory action of the 1970s concerning airlines was initiated by a liberal Democrat from the northeast, Edward M. Kennedy. Also, airline and trucking deregulation and the first phase of federal banking deregulation—the 1980 Depository Institutions Deregulation and Monetary Control Act—were passed by Democrat-controlled Congresses and signed by a President who was a Democrat. What constitutes ideology and whether it can be measured independent of economic interests is the subject of an extensive and ongoing controversy (see Peltzman [1984] and overviews by Bender and Lott [1996] and Poole and Rosenthal [1996]).

Institutions

The new institutional economics approach emphasizes transaction costs and institutional arrangements for decision making as key factors influencing the outcome of the policy process (McCubbins, Noll, and Weingast 1988, North 1990, Williamson 1996, Alston, Eggertsson, and North 1996, Dixit 1996, and Irwin and Kroszner 1999). This approach examines how alternative policymaking structures (such as delegation to an independent agency versus a parliamentary vote versus an executive order) influence the incentives of both special interests and governmental actions to shape policy. Opportunities for vote trading and issue linkages, for example, may differ under alternative structures and can confer advantages (like agenda control) to particular players. These institutional and transaction cost features in turn can affect the incentives for interest groups to organize as well as the efficiency of their lobbying efforts. Interest group size and strength, therefore, is not given, but may be endogenous (Irwin and Kroszner 1999).

The regulation of bank powers illustrates the endogeneity of interests with respect to the regulatory framework (Kroszner 1996). In 1933, the United States adopted the Glass-Steagall Act, which fragmented the U.S. financial system by strictly limiting the powers of commercial banks. In particular, commercial banks could not engage in securities underwriting, much in contrast with the classic German universal banks and banks in many parts of Europe. While there does not appear to be an economic justification for such a separation (Kroszner and Rajan 1994, 1997, and Kroszner 2000b), there may be a redeeming feature in terms of the political economy of financial regulation.

The silver lining to the cloud of Glass-Steagall is that a rich variety of alternate financial services providers has developed in the United States and they compete in both the financial market and the market for financial regulation. In Germany, for example, the early implicit state fostering of strong, universal banks allowed the banks to capture the regulatory system and thwart the development of alternate institutions and markets. In the United States, well-organized groups have helped to establish competing regulatory bodies that are likely to keep the market for financial regulation far from being a monopoly, even after the Financial Modernization Act of 1999. As I describe in the section on the leviathan approach, competition among regulators plays an important role, parallel to that of competition among the interest groups.

Before turning to the leviathan approach, however, I want to emphasize another aspect of the institutional structure of policy decision making—namely, the committee structure of Congress—to clarify another aspect of interest group activities—namely, the strategies that the groups use in competing with each other for influence over policy outcomes. The committee structure of Congress, in which standing committees have specialized jurisdiction over particular policy issues, creates opportunities for vote trading and issue linkages that may affect coalition formation and policy outcomes (Shepsle and Weingast 1987 and Weingast and Marshall 1988). Committee members, by virtue of their gatekeeping control over legislation in their ambit, may have a disproportionate impact on outcomes (Shepsle 1978 and Shepsle and Weingast

1995). Committees may consist of either preference "outliers," who have intense views not representative of the rest of the legislature, or policy experts, who gather and process information in order to make well-informed decisions, perhaps as part of the execution of the major party's agenda (Hall and Grofman 1990, Krehbiel 1991, Kiewiet and McCubbins 1991, and Cox and McCubbins 1993).

Each standing committee operates as a forum in which the legislators and the interest groups repeatedly interact, and repeated dealing allows legislators to develop credible policy positions among the rival interests (Kroszner and Stratmann 1998). The special interests lobby and provide campaign contributions through their political action committees (PACs) to the committee members and determine who their supporters are by observing the actions that the legislators take. They then continue to reward their supporters with contributions, and this process then helps the legislators to maximize special interest contributions (Kroszner and Stratmann 1998, 2000).

The financial services sector is the largest source of PAC campaign contributions in the United States, accounting for roughly 20 percent of total contributions, but most of these funds have been spent on battles among rival banking, insurance, and securities interests rather than on battling the consumer (Kroszner and Stratmann 1998). During the long struggle over financial services modernization legislation, these competing groups focused their contributions on members of the Banking Committees, relative to the rest of Congress, but not on the same Banking Committee members. In our analysis of financial services PAC contribution patterns (Kroszner and Stratmann 1998), we show that House Banking Committee members who received more contributions from commercial banks tended to receive fewer contributions from insurance companies and securities houses, and vice versa. The committee members appeared to be building consistent reputations for supporting one of the rival groups, rather than playing on both sides of the fence.

We also find that the longer a legislator stays on the House Banking Committee, the more his sources of PAC contributions become concentrated in one of the three rival financial services groups. This pattern of how PAC contributions from the rival groups evolve over a legislator's career again suggests that through repeated actions on the Banking Committee (such as introducing legislation, offering amendments, holding hearings, talking to the media, and voting), the legislator builds a clear and consistent reputation on these policy issues. The competing banking, insurance, and securities PACs learn the reliability of each Banking Committee member with respect to their own interests and reward their own supporters. Those legislators who have a high proportion of PACs that repeatedly contribute to them, which could be considered a rough measure of the reputational consistency of a legislator on a set of policy issues, tend to receive higher levels of PAC contributions than those who have few PACs that repeatedly give to them (Kroszner and Stratmann 2000). Long-term relationships develop between the rival interest groups and the House Banking Committee members, and thus it is an important feature of the strategies that the rival interests pursue in trying to influence financial services modernization legislation.

Leviathan

Politicians and bureaucrats may be considered a distinct interest group concerned about expanding its size and influence over the economy. Niskanen (1971) and Brennan and Buchanan (1977) suggest that an objective of the government may be to maximize or, on the margin, increase its size and expenditures. This view has been characterized as the leviathan approach.

The fiscal demands of the government help to explain part of the close relationship between politics and the banking and financial sectors and the origins of numerous regulations. Geographic restrictions on banks in the United States, for example, arose in the early nineteenth century as a way for state governments to maximize revenues from the sale of bank charters by providing a series of local monopolies (Kroszner 1997a). These initial restrictions created a constituency of small banks that then organized to protect their vested interest to maintain branching restrictions.[9] The federal government began to grant national bank charters during the U.S. Civil War to create a new class of banks that would hold federal debt and thereby facilitate the financing of the war effort. The Bank of England was founded as a way to aid in the financing of the Crown in England. More recently, as governments have come to rely more heavily on deficit financing through the issuance of sovereign debt, reforms of the government securities markets around the world can be understood from this perspective (Kroszner 1997b).[10] Debt moratoria, debt abrogation, and changes to bankruptcy law can also be seen in this light (Berglof and Rosenthal 1999, Bolton and Rosenthal 1999, and Kroszner 1999b).

In the financial services modernization debate, as noted in the previous section, competition among regulators has played an important role. Both the Federal Reserve and the Treasury wished to be the main supervisor of banks with expanded powers. The Federal Reserve had been the main regulator of bank holding companies, and the Treasury, through the Office

of the Comptroller of the Currency (OCC), had been the main regulator of nationally chartered banks. If new financial powers were permitted to take place within the bank or a subsidiary of the bank itself, then the responsibility to regulate the new activities could fall to the OCC. In contrast, if the new powers were permitted only within separate subsidiaries of a bank holding company—not the bank—then the Federal Reserve would be the main regulator.

While there are a number of interesting and important issues concerning the role of the legal corporate structure of full-service financial services firms (Kroszner and Rajan 1997), the debate between the regulators was primarily over which one would be the dominant regulator in the future. The outcome would affect the size and influence of the regulatory staffs of the agencies. The controversy between the two over the appropriate structure for what eventually became financial holding companies was parallel to the rivalry among the banking, insurance, and securities interests described above. After much lobbying by both sides, the resolution of the difference largely has been in the Federal Reserve's favor, for it has "umbrella" supervisory and regulatory control over the financial holding companies.

Political-Economy Factors Driving the Recent Trend toward Financial Regulatory Reform

To understand why there has been so much recent regulatory reform in banking after little change for more than three decades following World War II (see table), we must try to identify the factors that would have disturbed the long-standing political-economy equilibrium. The approaches to the political economy of regulatory change discussed above suggest that one look for technological, legal, and/or economic shocks that altered the relative strengths and effectiveness of competing interest groups.

Technological change is often cited as a key force behind the innovations in financial markets and institutions during the past two decades. In the political-economy framework, technological improvement does more than simply shift the production possibility frontier for an industry. Technological change can have significant distributional consequences, completely independent of its effects on the costs and efficiency of production—that is, such change is rarely "distributionally neutral." New products and markets bring forth new constituencies. Innovations affect the preexisting markets and institutions and cause shifts in interests and alliances. Changing the relative strength of competing interests can then lead to regulatory reform.

A number of shocks, for example, have increased the supply elasticity of investors' and depositors' funds. As such, they have increased the competition that banks face from nonbanks and have eroded the value of regulation protecting geographic monopolies through branching regulation (Kroszner 1997a and Kroszner and Strahan 1999, forthcoming). As elasticities increase, there are fewer rents to share among competing groups, so regulation becomes less likely (Peltzman 1989). First, the introduction of the automated teller machine (ATM) in the early 1970s reduced the value of geographic protections to local banks. The small banks argued that ATMs should be considered bank branches, and they sued to prevent the spread of interstate ATM networks. The courts did not agree, and ATM networks grew rapidly both nationally and internationally.

Second, consumer-oriented money market mutual funds and "cash management accounts" offered by investment banks arose in the early 1970s. In the high-inflation environment of the 1970s, Regulation Q interest rate ceilings prevented banks from responding to these innovations by offering market rates on deposits. The Glass-Steagall and Bank Holding Company Acts prevented banks from offering the convenience of integrated investment and checking accounts.

Third, on the lending side, the increasing sophistication of credit-scoring techniques—following innovations in information-processing technology, financial theory, and the development of large credit databases—began to change the relationship characteristics of bank lending toward less personal and more standardized evaluation. As a result of these innovations, for example, securitization of mortgages, loans, and consumer credit has become commonplace. Commercial paper and junk bonds also provided competitive alternatives to traditional bank lending. Since technological change has diminished the value of specialized local knowledge that long-established local bankers might have about the risks of borrowers in the community, foreign banks could enter and succeed in domestic markets more easily than in the past, and foreign bank lending increased sharply in the United States during the 1980s.

These factors combined to reduce the strength of the small banks, which had long fought to maintain both branching and activity restrictions that would strengthen the large banks relative to them as well as increase the large banks' desire to have these restrictions lifted. This combination was important for making financial modernization legislation a reality. Also, the Gramm-Leach-Bliley Act contains a major provision that will provide below-market-rate financing to "small" banks (with less than $500 million in assets) through the Federal

Home Loan Bank System. Although the small banks are weaker than they once were, they are still able to obtain a valuable source of low-cost liquidity to soften their traditional opposition to the expansion of bank powers.

In addition to the technological shocks that altered the balance within the banking industry, a number of court decisions eroded the long-standing opposition by the insurance industry to the expansion of bank powers and the elimination of branching restrictions (Kroszner 1997a and Kroszner and Strahan forthcoming). The National Banking Act of 1864 and subsequent related legislation appeared to strictly limit bank involvement in insurance to selling insurance only in towns with less than 5,000 people. The extent of the restrictions and the precise definition of insurance products are ambiguous, and they are the subject of ongoing legal dispute between the banks and insurance companies.

Major Legislative Changes in Bank Regulation during the 1980s and 1990s

Legislation	Year	Major Provisions
Depository Institutions Deregulation and Monetary Control Act (DIDMCA)	1980	Raised deposit insurance from $40,000 to $100,000. Phased out interest rate ceilings. Allowed depositories to offer NOW accounts nationwide. Eliminated usury ceilings. Imposed uniform reserve requirements on all depository institutions and gave them access to Federal Reserve services.
Garn-St Germain Act	1982	Permitted money market deposit accounts. Permitted banks to purchase failing banks and thrifts across state lines. Expanded thrift lending powers.
Competitive Equality in Banking Act (CEBA)	1987	Allocated $10.8 billion in additional funding to the FSLIC. Authorized forbearance program for farm banks. Reaffirmed that the “full faith and credit” of the Treasury stood behind deposit insurance.
Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)	1989	Provided $50 billion of taxpayer funds to resolve failed thrifts. Replaced Federal Home Loan Bank Board with the Office of Thrift Supervision to regulate and supervise thrifts. Restructured thrift deposit insurance and raised premiums. Reimposed restrictions on thrift lending activities. Directed the Treasury to study deposit insurance reform.
Federal Deposit Insurance Corporation Improvement Act (FDICIA)	1991	Imposed risk-based deposit insurance pricing. Required “prompt corrective action” of poorly capitalized banks and thrifts and restricted “too big to fail.” Directed the FDIC to resolve failed banks and thrifts in the least costly way to the deposit insurance fund.
Riegle-Neal Interstate Banking and Branching Efficiency Act	1994	Permitted banks and bank holding companies to purchase banks or establish subsidiary banks in any state nationwide. Permitted national banks to open branches or convert subsidiary banks into branches across state lines.
Gramm-Leach-Bliley Financial Modernization Act	1999	Authorized financial holding companies (FHCs) to engage in a full range of financial services such as commercial banking, insurance, securities, and merchant banking. Gave the Federal Reserve and the Treasury discretion to authorize new financial activities or complementary activities for FHCs. Established the Federal Reserve as the “umbrella” regulator for FHCs. Provided low-cost credit to community banks. Reformed the Community Reinvestment Act. Eliminated unitary thrift holding companies.

In 1986, the Comptroller of the Currency decided to allow national banks to sell any type of insurance product from small towns. This authority was later upheld in 1993 by the U.S. Fifth Circuit Court of Appeals in *Independent Insurance Agents of America v. Ludwig*. In 1995, the U.S. Supreme Court allowed banks to sell annuities nationwide (*Valic v. Clarke*), and in 1996 the Court again expanded banks' insurance powers by ruling in the *Barnett Banks v. Nelson* case that states could not bar national banks from selling insurance products from small towns (Seiberg 1996). The Court also implied that it would likely grant banks the right to sell additional types of insurance products if such cases were to come before it in the future.

Given its losses in the courts, the insurance industry realized that it would be unlikely to prevent bank involvement in insurance through continued litigation. In addition, the phase-out of bank branching restrictions following the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act helped to improve the ability of banks to distribute insurance products. Given the increasing competition from sellers of low-cost insurance on-line and over the telephone, the Independent Insurance Agents of America was in a weakened position to maintain its traditional opposition to the combination of banking and insurance. Technological and legal shocks again tipped the balance in favor of major deregulatory reform.

Kane (1996) argues that a major economic shock that generated support for bank regulatory reform was the high costs of the savings and loan crisis and the sharp rise in bank failures in the late 1980s. Prior to these events, the public and, perhaps, some policymakers had not been aware of the high costs of having government-insured institutions that were not well diversified. The large taxpayer-financed bailout of the savings and loans increased general public support for eliminating antiquated regulations and strengthening the financial system.[11]

In sum, technological, economic, and legal changes disturbed the old political-economy equilibrium. Moreover, these changes had important distributional consequences that typically are ignored in economists' emphasis on efficiency issues but are central to a positive explanation of regulatory change.

Conclusions

The thrust of the aforementioned arguments is that interest group competition, filtered through the institutions of government decision making, plays a key role in determining when and how regulatory change occurs. For the expansion of bank powers and "financial modernization" legislation to take place, various shocks were necessary to alter the balance among the interests during the past quarter-century. These changes undermined the long-standing political economy supporting the Depression-era regulations that balkanized the U.S. financial system. The technological and financial innovations responsible for the changes are continuing to create conditions that are likely to lead to further reductions in regulatory barriers both domestically and internationally (Kroszner 1997a and Kroszner and Strahan 1999).

In conclusion, I offer a final note on academics' role in the process of regulatory change. If interest group rivalry is a primary determinant of regulatory outcomes, is there any role for careful scholarly analyses of regulations and proposals for reform? In other words, does the political-economy approach imply that academics should just stay in their "ivory towers," since their work is of little relevance to policymaking in the real world? Although having an organized interest group and money may be necessary for a view to prevail in the political marketplace, they are not sufficient, due to the rivalry among interest groups. Theory and facts, not only money and power, are relevant to the debates. Without an interest group to champion a position, however, an argument may have little effect. As Michael Mussa quipped, "In Washington, truth is just another special interest, and one that is not particularly well financed."

A logical and empirically supported argument, however, affects the productivity of an interest group's lobbying efforts, much like a technological shock can increase the productivity of an investment. Although rival interests will always have an incentive to generate "studies" that support their positions, a well-executed systematic analysis can be of great help to a particular group by making its lobbying more effective. Careful analyses can also inform rival groups about the size of the costs associated with specific policy alternatives. The education of the public and policymakers in terms of the actual and potential costs of regulation thus can play a useful and important role in the political economy of the policy reform process.

Endnotes

1. This section builds on Kroszner (2000a, 2000b) and Kroszner and Strahan (forthcoming).

2. Joskow and Noll (1981) call this explanation "normative analysis as positive theory."

3. Hellwig (1999) has developed political-economy arguments to explain various practices and regulations in corporate finance based on the contrasting interests and organization costs facing insiders versus outsiders. For example, he interprets corporate financial structure choices, such as the "pecking order" preference for internal over external sources of funds, in terms of protection of incumbent management against outsiders. Also see Fischel (1997).

4. In addition, groups with completely unconnected interests may form "support trading" or "log-rolling" coalitions. Here, two groups may agree to support each other even if the members of one group are not affected by the regulations that the other group wants. Tariffs are a classic case of log rolling, in which, say, lumber and glass producers support each other's call for higher protection, thereby providing greater support for higher tariffs than would otherwise be the case (Irwin and Kroszner 1996).

5. Becker (1983) argues that competition among lobbying groups thus will lead to the most efficient (lowest deadweight cost) regulations being chosen, so there is a tendency for regulation to be "efficient" in this sense. Wittman (1995) takes this argument further to conclude that both democratic institutions and outcomes are efficient. For studies on obstacles to optimal reforms, see Kroszner (1999a), Kroszner and Strahan (forthcoming), Rajan and Zingales (forthcoming), and Rodrik (1996).

6. When the constraint of future elections is less binding on politicians, they may engage in less rent sharing and provide windfalls to targeted groups. McGuire and Olson (1996), however, argue that less democratic regimes may be better able to insulate themselves from rent seeking and may find it in their own interest to pursue economic policies in the public interest.

7. An example is the Community Reinvestment Act. Also, flat rate deposit insurance tends to subsidize the smaller and riskier banks at the expense of the larger, better diversified, and safer banks. Lobbying for flat rate deposit insurance historically has been consistent with this pattern of relative benefits (Calomiris and White 1994 and Economides, Hubbard, and Palia 1996).

8. Gershenkron (1962), for example, argues that the German government fostered the development of strong universal banks in Germany, at the expense of financial market development, to promote rapid economic development in the nineteenth century.

9. This provides another example of the endogeneity of the interests with respect to the regulatory structure.

10. The government also raises revenues thorough seigniorage, and the ability to tax through inflation is another reason for the government's long involvement with monetary and banking affairs.

11. Kane (1996) argues that bank regulators and beneficiaries of restrictions on the geographic expansion of banks purposefully misinformed the public and legislators about the costs of the regulations. Only a combination of large failures and costly bailouts (with academic studies explaining why the bailouts were so costly) was able to change the perception of the social welfare effects of the regulations. Jensen (1991) argues that much popular support for corporate governance regulation protecting incumbent management arises primarily from ignorance, rather than from intentional misinformation; thus, more policy-relevant research is important to effect reform.

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