Big Challenges for Big Business

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Big challenges for big business

The large corporations that connect much of the global economy are facing more than just a steep recession. They are also unpopular and under attack—especially in America, where public trust in its brand of capitalism has been battered and anti-business populism has risen. How will this shape the response to the crisis?

When they are doing well they create jobs, provide many of the goods and services that make modern life so comfortable, and harness savings to multiply people’s wealth. When they are struggling, the ordinary folks who work for them, sell to them and invest in them invariably share in the pain. Yet despite their importance to the economy, or perhaps in part because of it, big public corporations have never been all that popular—in good times or in bad.

As multinationals, they have long been accused of exploiting poor countries and turning their backs on rich ones. As employers, they are perennially blamed for squeezing wages and hurting ordinary workers. And as petitioners for tax breaks and legal loopholes, they are often viewed as natural opponents of democracy and the public good.

Lately, the hostility has gained intensity, most noticeably in the United States, where widely owned public corporations are especially important—both economically and symbolically. This anti-corporate sentiment has been building for years, but was cranked up further during the 2008 presidential race. The two main parties’ nomination battles were fought against the backdrop of a sharp rise in home-mortgage foreclosures and a troubled economy that began the year in recession and ended it in much more dismal shape (see exhibits 1 and 2).

When financial institutions began collapsing in the autumn of 2008, prompting a $700 billion bailout by American taxpayers, the explosive mix of politics and pain blew open the election. With share prices tumbling, the economy contracting and the budget deficit soaring, Senator John McCain, the Republican candidate, tried to head off attacks from the left by churning out populist rhetoric about greed on “Wall Street.” But the Democrats, led by then-Senator Barack Obama, had a more successful narrative, which linked such greed to international trade, deregulation and other perceived evils of capitalism. Mr Obama swung ahead of his rival in the opinion polls, and never looked back on his way to winning a decisive election.

There were other reasons, of course, why the financial and economic collapse helped Mr Obama. He was more articulate, and much more cool under fire, than the floundering Mr McCain. With George Bush, a Republican, in the White House, an economic shock was also bound to hurt the incumbent party’s candidate. Nevertheless, Mr Obama won a convincing victory after denouncing an entire “ideology” of deregulation and market-driven competition, which he said had led out-of-touch Republicans to drive America into such trouble. These are attitudes that the base of his Democratic Party, which now holds convincing majorities in both chambers of Congress, shares passionately.

This is the environment in which America’s decision-makers will now make crucial changes in wide-ranging aspects of economic policy. Besides shoring up the financial system and dealing with a deep recession, they will also want to make good on at least some of the Democrats’ most important campaign pledges. The effects—on everything from health care and home ownership to energy and entrepreneurship—could in some cases reverberate for decades. And America must attempt all of this while in the throes of a starkly anti-business mood.
A long time coming

The 2008 elections and the recent economic turmoil helped to stir up these passions, but the antipathy towards big business has been around for much longer. Consider the current decade, which began with a recession following a collapse in dot-com shares. Accounting scandals at giant companies such as Enron and WorldCom not only thrust clear villains into the spotlight, but also cast doubt on the financial numbers by which cheerleaders in the American business media had been keeping the economic score.

As the economy recovered, and those scandals began to fade from public view, critics of big business found it easy to stir up complaints in other ways. Hostility towards Wal-Mart, a retailing behemoth, continued to grow, with the help of coordinated attacks by labor unions and others.

Oil companies were also easy and obvious targets during Mr Bush’s presidency. Much of their supply comes from a region where America is fighting an unpopular war. Heavy use of their product is blamed for promoting climate change. American consumers want to gorge on the stuff anyway (complaints don’t have to be consistent to be effective), and resent paying more for it when demand rises elsewhere. Plus the government favors these companies get are easy to spot and hard to justify.

As the election campaigns of 2006 and 2008 heated up, an even wider range of corporate demons came under attack. Along with Big Oil, Democratic primary candidates added criticism of Big Pharma and big health insurance companies, which they blamed for denying cheap health care to tens of millions of Americans. Mr Obama went to Detroit during his campaign and excoriated executives of the Big Three car companies for failing to choose strategies that he said would have allowed them to keep creating lucrative jobs. Then, although many Democrats had previously urged big banks and other lenders to give loans to high-risk borrowers, their candidates turned and attacked those firms—once housing foreclosures spread rapidly—for making so many loans that cannot or will not be repaid.

These last two examples—cars and credit—highlight how complicated life is going to be for Democrats now that they are in control. The fear of being blamed for a full-blown financial panic, or for auto bankruptcies that would affect the union labor contracts of a diehard constituency, prompted them to espouse aggressive bailouts. Yet spending vast sums of taxpayer money in this way is especially awkward given the anti-business populism that helped to sweep them into power.

The attacks are not just coming from the left. As in the Populist and Progressive eras that followed the emergence of America’s first giant industrial corporations, and which preceded the Great Depression, some conservatives have also portrayed big business as an enemy of the public good. Mike Huckabee, who won the widely watched Iowa caucuses, frequently argued that voters want “someone who reminds them of the guy they work with, not the guy who laid them off.” Mr McCain was also sounding populist themes long before the financial collapse in the autumn.

Although the importance of this political trend has been overshadowed by America’s financial and economic crisis, such widespread complaints should not be taken lightly. They will surely play a large role in shaping the US government’s response to the steep recession, with long-lasting effects on the way the country does business. Apart from the family, however, it is hard to imagine a more important institution—especially in America—than the publicly traded company. In their 2003 book, The Company: a Short History of a Revolutionary Idea, John Micklethwait and Adrian Wooldridge argue that more depends on such organizations than on any others:

“Hegel predicted that the basic unit of modern society would be the state, Marx that it would be the commune, Lenin and Hitler that it would be the political party. Before that, a succession of saints and sages claimed the same for the parish church, the feudal manor, and the monarchy...they have all been proved wrong. The most important organization in the world is the company: the basis of prosperity of the West and the best hope for the future of the rest of the world.”

Clearly, an awful lot of Americans do not look at it that way right now. The recent crisis has provided unforgettable examples of corporations at their worst, just as many people have lost their jobs or a chunk of their savings and are worried about the future. Critics of big business are finding it easy to exploit their anger and fear.
It is possible, however—and tempting, for those who would rather reform corporate America than revile it—to argue that the rise in hostility is mostly just talk, and that new rules aimed at businesses will tend to be sensible. Indeed, three factors arguably could diminish the impact of the current populist wave, such that little harm, and perhaps some good, results from it.

One is that making policy is different from fighting elections, and involves much more compromise. Since thriving businesses are good for all Americans, this thinking goes, politicians are unlikely to get as carried away as they did during their campaigns. President Obama’s initial choices to fill advisory posts, many of whom have been widely described as centrists, may provide evidence of this.

Second, broadside attacks against corporations and other demons appeal to extremists, but much of the public might be unwilling to take fiercely anti-business measures if they risk doing more harm than good. Unsurprisingly, surveys by the Pew Research Center for the People & the Press do show that Americans’ opinions of big business have soured over the past decade or so. Those who held an “unfavorable” view of business corporations rose from 24% in 1994 to 45% in April 2008 (see exhibit 4). These negative views of business have no doubt risen further in the past ten months. A long-running survey by Gallup, however, helps to put these attitudes in context.

**Battle of the Bigs**

Every few years, the Gallup survey asks Americans whether they consider “big labor,” “big business” or “big government” to be the most serious threat. The last time the poll was taken, in December 2006 (see exhibit 4), only 25% of those surveyed said that big companies posed the biggest threat, compared with 61% who worried about big government (fears of big labor have fallen as union membership has shrunk, though that may change now that a new crop of Democrats have regained control of Congress and the White House).

That survey is over two years old, and distrust of big business may of course be much higher now. But it does suggest that many Americans held a better view of corporate America—at least until recently—than of the giant government that some politicians would like to use to rein in companies.

The third reason—which will be obvious to many centrist reformers—to avoid being too alarmed by current populism is that corporations really do deserve some of the criticism they get. They often look for ways to restrict competition, including from overseas rivals. They negotiate endlessly for tax breaks and subsidies, which not only cost taxpayers directly but also distort resources throughout the economy. They lobby relentlessly, and tend to make regulations worse than they would otherwise be. And far too often, although media coverage exaggerates the frequency, some of their managers pull unforgivable stunts that range from reckless to illegal, costing society huge sums of money and often leaving innocent workers and savers to bear the brunt of the pain.

Given big companies’ potential for causing trouble, therefore, a sharp drop in their popularity could arguably lead to a few new rules that improve matters. It could also drive at least some companies—and, just as importantly, independent watchdogs—to clean up their own act.

The benign interpretation, therefore, is that this latest wave of anti-corporate populism is a modest trend that should be watched closely but not overly feared. Some firms will have new regulations to deal with. There will likely be big changes in health care provision and energy markets to negotiate, along with a remaking of the financial sector. These will require tough adjustments, but American firms need to navigate political and regulatory shifts all the time, the optimistic argument goes. And if the past is a guide, some of these changes will be made in ways that limit some of the adjustment costs. In short—according to this view—the US economy faces severe risks to financial flows and confidence in the short term, and serious fiscal dangers in the medium term, but worries about longer-term threats to its dynamic brand of capitalism are likely to prove unfounded.

These are credible arguments, and this sort of scenario is indeed a real possibility. But this report will argue that the challenges posed by anti-business populism should be taken more seriously, for several reasons. One is that even though the American political system usually fosters messy compromises and slow change, it is still capable of producing bursts of aggressive legislation. These can be good, but if poorly conceived can easily do long-term damage instead.

The danger is that the wreckage left behind by misguided conservatives, by discrediting the system of competitive private enterprise that they claimed to represent, will now lead to a slew of bad rules by misguided progressives. Or, as Raghuram Rajan—a professor at the University of Chicago Booth School of Business and a former senior economist for the International Monetary Fund—recently put it in a speech to his school’s MBA students, the Republicans endorsed a simplistic view of markets, which “time and time again makes the extreme Right play into the hands of the extreme Left.”

A direct and overly aggressive reaction in favor of the state is hardly the only risk, however. Much of the harm done by anti-corporate sentiment occurs indirectly in subtler ways. A great deal of the country’s economic activity, for example, is already heavily distorted by an ugly tax code and senseless regulations that act as a drain on growth. Any new set of “compromises,” however much of a balance they represent between anti-corporate populists and other pressure groups, are likely to make these distortions bigger rather than smaller. Political deals that cater to these
Corporate governance

America’s political system has allowed its economy to thrive in many ways—and falter in others—by relying heavily on corporations that are widely owned by the public. But what happens if the public revolts?

Big business enterprises are common in many economies, but the way these firms are organized and regulated varies hugely across countries. America, Britain and a few others tend to have a large number of big, publicly traded companies, with widely dispersed investors holding small stakes. Many of the direct shareholders are institutional asset managers—such as mutual funds, pension funds and university endowments—often acting on behalf of millions of ordinary savers. But there are lots of them, and none tend to have much influence over the governance of any single firm.

In most other economies, by contrast, large business groups are much more narrowly owned and controlled, whether it is by banks, powerful families or the state. Wealthy families control much of the corporate sector not only in emerging economies such as Argentina and Mexico, but also in a diverse set of rich ones, such as Hong Kong, Israel and Sweden (see exhibit 5). In fact, this tendency was once much more pronounced in the United States as well.

From the Gilded Age of the late nineteenth century, into the early Progressive era of the twentieth, wealthy and powerful tycoons with names such as Carnegie, Rockefeller and Vanderbilt controlled giant industrial empires that held sway over oil, steel and other crucial sectors of the economy. Financial titans, epitomized by J Pierpont Morgan, also held big stakes in vast swathes of industry.

Such concentrated economic power was viewed not only as harmful to some interest groups’ livelihoods, but also as a threat to democracy itself, prompting widespread political movements for reform on both the left and right. Yet whereas the ownership of corporate America eventually shifted into the hands of those widely dispersed shareholders (the big family business groups that have survived in the US must now get by on good

interests also risk frustrating efforts to design policies that are aimed directly at putting the economy back in good health.

In laying out these dangers and trying to offer some guidelines, this report will examine the connections and similarities between flaws in America’s corporate governance model and those in its political economy. In doing so, it will focus more on the Democrats who now run the country than on the Republicans who used to. This is not because Democrats are inherently less well placed to handle these challenges. It is simply because they are now in charge. Besides, the failings and inconsistencies of the Republican Party’s economic approach in recent years have been well documented.

Section 2 of the report puts America’s approach to corporate governance in an international context, and explains the basic problem any good system needs to solve: managing corporations’ investment capital wisely on behalf of the millions of savers who ultimately supply it. Those who blame corporate America’s failures, implicitly or explicitly, on excessive “capitalism” tend to overlook an important point: that most corporate misdeeds occur when entrenched executives abuse the trust of their companies’ owners, the savers who provide them with their precious capital. If new rules do not empower these ultimate capitalists, by getting the companies they invest in to act in their interest more consistently and transparently, then those rules are unlikely to benefit the general public either.

Much of the formal system that tries to protect those investors dates from the 1930s, another period marked by widespread financial abuses and economic trauma. The structure that emerged was never perfect, but it worked pretty well for long enough. The question now is whether changes over time have exacerbated the system’s weaknesses. Section 3 describes one such set of changes—the evolution of financial markets and their effects on corporate governance—and looks at some principles that should govern modern reforms.

Reforming relations between managers and owners sensibly, however, requires good decisions by the politicians and regulators who will do much of the reforming. Section 4, therefore, looks at a second set of changes since the 1930s: the enormous growth of the state, and its interaction with the well-organized modern interest groups that it feeds. This trend has twisted political incentives and damaged government’s ability to do a good job of setting the rules intelligently.

Section 5 will then examine how the interest groups that team up to manipulate these two systems—corporate and political—can defy the simple stereotypes that are often associated with the left and right in American politics. For example, labor union leaders and corporate executives can hurt everyone else when they join forces to exploit the political system.

Section 6 asks why this kind of collusive behavior, if it is so harmful to the rest of the public, is so hard to stop. A large part of the answer lays in the role that information—and the difficulty of processing and conveying it credibly—plays in holding politicians accountable. If politicians choose bad approaches in their efforts to oversee corporate America, then why can’t the media and other watchdogs help to hold the politicians accountable for this failure? Questions such as this make research into the media and the nature of persuasion one of the most promising new branches of economics.

Finally, in section 7, the report concludes by asking where all of these forces might lead Mr Obama and his Democratic majority, as they grapple with the other problems they have inherited. What signs should observers look for, to gauge whether the new president and his team are on the right track? This concluding section will argue that the Obama administration’s attitudes towards economic competition, including in international markets, will be a good indicator of what is going on.

Start, however, by examining what makes US corporate capitalism different from that of other countries, and how it got that way.
management, rather than monopoly power or political clout), capitalism in other countries took different paths.

An excellent rundown of this international variety can be found in A History of Corporate Governance Around the World, edited by Randall Morck of the University of Alberta. It contains separate historical studies, by an impressive collection of researchers, which describe how patterns of corporate control have evolved in a range of developed countries, as well as in China and India. Some of their examples suggest that corporate America’s detractors might want to be careful what they wish for. Corporations in the United States could indeed be much more accountable in many ways—no system is perfect—but the alternative approaches used elsewhere deviate much further from American ideals of dispersed power. Moreover, corporate governance patterns are sensitive to a wide range of rules and regulations, and crude approaches based on simple political ideologies are unlikely to promote the best mix.

Consider Mr Morck’s Canada. Around a century ago its big companies were mostly family-controlled firms that showed little regard at the time for their minority shareholders. By the middle of the twentieth century that had changed dramatically, and corporate Canada had evolved into a collection of more transparent firms that were owned by widely dispersed public investors, much like the system that had also emerged in the US. Beginning in the late 1960s and early 1970s, however, Canadian corporate governance did yet another about-face as politically connected, family-controlled business pyramids reasserted themselves. Mr Morck and his coauthors conclude that an unfortunate combination of left- and right-leaning policies deserves much of the blame. Sharply lower inheritance taxes (cut by the right) made it easier for wealthy Canadians to keep huge business empires in the family; and a rise in activist government (beloved of the left) opened many more avenues for corruption, which made ties between politicians and prominent families more important.

Canada is just one example. There, as elsewhere, it is hard to gauge how new rules will affect the way businesses are run without asking why corporations tend to organize themselves in certain ways, what the alternatives are, and which alternatives will become more attractive under any new rules.

A powerful tool for answering such questions is the notion of transaction costs. Ronald Coase, now a Nobel laureate in economics, advanced this concept in the 1930s to help explain what companies do best. He pointed out that some transactions—such as buying and selling commodities—tend to be more efficiently done at arm’s length using prices, whereas others—such as training workers to make specialized car parts and then telling them when, how, and which ones to produce—are better done inside companies, which can combine long-term contracts with hierarchical authority over many decisions.

Many transaction costs stem from information, incentive and enforcement problems that are expensive to solve. The trick is seeing not just how hard it is, and how daunting the scale and variety of transaction costs can be.

You, incorporated

Watching managers like a hawk, for example, is expensive for shareholders. Auditors and board directors can do it more efficiently, but don’t have the same motivation and may also have conflicting interests. For example, directors may come from other firms that do business with the company, or—if they are chief executives themselves—may be tempted to go easy on the company’s boss so that others in the clubby world of board directors go easy on them.

How might you try to correct this? For starters, you could try concentrating all of the shares in the hands of a few investors. If a small group of owners holds all of the firm’s equity, they will each have more of an incentive—and over time will gain more of the needed expertise as well—to act more like real proprietors by doing the watching and controlling themselves. This will
limit some of the managers’ mischief. Relying on only a few investors, however, places constraints on how much equity capital each firm can raise. By itself, therefore, concentrating ownership can stifle growth and investment.

So perhaps your imaginary firm could borrow a lot more as well. This would leave in place a small group of equity investors with incentives to watch managers closely, while still providing the company much more capital—through debt instead of equity—to grow. But all that leverage would be potentially disruptive, and therefore expensive in other ways, if overdone. You could try stock options for the managers as well. This might give them strong and direct incentives to create value for themselves and other shareholders, while limiting their downside risks so that they are less likely to make wacky decisions to protect their wealth. You would not have to skim many news articles, however, before you realized that these options come with their own nasty set of risks and costs.

Finally, with no way to eliminate this messy set of problems, you are likely to mix and match approaches to find the right balance. This might include expensive monitoring, imperfect incentives, and learning to live with decisions by the managers that diverge from what you would have done if you had known what they knew. The best combination will depend on the traits of your beloved firm: its size and growth potential, the riskiness of its investments, the transparency of its assets and business model, and so forth. In practice, of course, there is no benevolent decision maker balancing competing problems in this way. But strong forces push corporations to find the most efficient mix, especially when they face competition in product and capital markets.

Crucially, however, this equilibrium will also depend on a host of other factors—including the legal, social and political system—that naturally differ across countries. And when circumstances change, so can the balance that affects how corporations are run. In the United States, for example, a series of changes in the first half of the twentieth century radically altered the way corporations were governed.

The main result of all these changes—whether this was fully intended by policymakers remains subject to debate—was to lessen, dramatically, the role that large “block holders” play in the US. Block holders are big investors who hold large enough stakes in a company to have the incentive and clout to invest time and effort in influencing the firm’s management and strategy.

They can be financial institutions, wealthy business families, or others. In effect, they are like the imaginary concentrated owners who formed part of the solution in the hypothetical governance problem above. And their role in America’s modern economy is tiny by international standards—even compared with Britain, where the system is in many ways similar but in which institutional investors nevertheless exercise much more control over corporations and their managers.

Why is America so different? Changes in the first half of the twentieth century had much to do with it. Marco Becht (of Université Libre de Bruxelles ULB) and Bradford DeLong (of the University of California-Berkeley), have studied the evolution of ownership during this period and concluded that several factors combined to make the US so exceptional.

In part, they conclude, populist and progressive political movements made large financial institutions unpopular, leading to reforms that limited their ability to act as block holders. America’s transcontinental expansion and role in industrialization also contributed, by dictating that the most efficient companies would be gigantic by international standards—so anyone owning a large block of shares in such a firm would have had to put a dangerously high share of their wealth into one basket. Protections for small shareholders, along with the early popularity of widespread equity investing, also played a role, by making it more lucrative than in other countries for family business dynasties to cash out by tapping into deep and liquid capital markets.4

Whatever the relative importance of each of these factors, the result was a system that worked pretty well for a very long time. Thanks partly to market forces that helped to nudge imperial corporate executives in the right directions, America’s big public corporations, with their widely dispersed investors, were part of a broad and flexible economic system that delivered impressive innovation and growth.

Is it time for an overhaul? Maybe. For all its strengths, the American system of corporate governance was never perfect, and much has changed since the earlier burst of reform. Much depends on which shifts have been most important for corporate governance, what these mean for regulation, and whether whatever emerges from the political process—especially in the current environment—is likely to push the system in the right direction. With that in mind, the next two sections focus on the two most relevant big changes since the 1930s. ▲

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Savers, unite

A collapse of both economic output and trust in financial markets looks similar to the 1930s. But there are two big differences between then and now.

Although an awful lot has changed since the burst of reforms during the Progressive era and Franklin Roosevelt’s New Deal, two themes stand out. One is the size and scope of government, and of the collection of interest groups that both drive the state’s expansion and fight to cash in on it (these will be addressed in the next section). The other is a broad set of changes in finance, encompassing everything from portfolio theory and the evolution of mutual funds to corporate finance, investment banking and securities markets. This second trend has led to profound shifts in the way modern corporations are organized and held accountable.

The corporate conglomerate, for example, with business divisions operating in a diverse set of industries, has become much more rare over the past three decades, although giant firms such as GE still manage to pull it off. Changes in securities markets and corporate finance have been crucial to this shift. New debt instruments and other improvements in capital markets have fostered hostile corporate takeovers, as well as buyouts in which management teams and specialized private equity firms take corporations off listed stock markets so that they can be run differently.

This market for corporate control has imposed impressive discipline on modern businesses, steering them in productive directions for the most part. Venture capital for innovative startups has also become simpler to obtain (in normal times), making it easier for good entrepreneurs to succeed without ties to a big corporation or a narrow elite.

Financial innovations have not been the only forces driving these changes, of course. Information technology, for one, has also played a role, by
making it easier for firms to organize in new ways and still be monitored by investors and plugged into global commerce. But in the current political and regulatory environment, with an overhaul of the financial sector underway, it is especially worthwhile to compare modern finance to the system that emerged in the 1930s, which protected small investors by reining in big financial firms. That structure contributed to the paucity of powerful block holders that Becht and DeLong describe; and in the process it gave managers a lot of power.

In a recent paper on the future of securities regulation, Luigi Zingales, of the University of Chicago Booth School of Business, points out that the main threat to small investors seven decades ago was far different from the risks they face today. Then, the fear—backed by popular concerns about scandals and abuses—was that the investment banks that issued securities to the public would have incentives to fleece small investors because they also had other, conflicting, interests.

Since some of these investment-banking firms were also commercial lenders, for example, they had an incentive to ensure that loans would be repaid, even if that meant issuing equity capital to an unsuspecting public. If their securities arms gambled and went under, it might also put those firms’ commercial-bank depositors at risk. And since the investment banks also held stakes in the corporations whose securities they underwrote, there was plenty of scope to misuse inside information and abuse small investors in other ways.

People also worried about similar risks with other big financial institutions, such as insurers. So for various reasons—to prevent abuses and restore investors’ trust, to soothe populist outrage, to give politically powerful corporate managers some breathing room—the government separated commercial lending from investment banking and made it very hard for other financial firms to influence the direction of corporations in which they held equity stakes.

Clearly, other forms of conflicting interests have emerged or grown in importance since then, as some of the corporate managers themselves have become bigger threats to the public trust. With no large block holders to oversee them and hold them accountable, some executives—including those who until recently ran many big banks—have led one corporation after another into scandal or financial ruin.

Another change, however, is that a new form of financial institution has evolved to serve small investors: asset management companies selling
Reforming regulations so that corporate America functions better would be hard enough on the merits. But politics invariably increases the risk that new rules will do more harm than good. So as they grapple with the economic mess they’ve inherited, the wizards who will be advising President Obama and his Democratic majority should also ponder advice from one of their country’s most accomplished center-left economists: Alan Blinder.

In the 1980s, long before he served on Bill Clinton’s Council of Economic Advisers and as vice chairman of the Federal Reserve, Mr Blinder (who is now back at Princeton University) wrote one of the best modern books for a general audience on the interaction between politics and economics in America. The title—*Hard Heads, Soft Hearts: Tough-Minded Economics for a Just Society* (1987) —conveyed his appeal to inject both better analysis and more compassion into government policies. And although it was born of Mr Blinder’s disappointment with the policies of then-President Ronald Reagan, his observations on the way that economic reasoning gets mangled by the policymaking process, and on the poor state of public debate over economic issues, have been equally useful for understanding every presidential administration since.

So even if the new crop of policy advisers are too busy dealing with a steep recession to read Mr Blinder’s book, they should at least heed his dictum on the way the process is skewed against them: “When conflicting economic advice is offered, only the worst will be taken.”

Given how complex the current environment is, there will indeed be plenty of conflicting advice, even from within Mr Obama’s own party. The recent $787 billion stimulus package offered a hint of what is to come, producing a cacophony of opinions from economists across academia, and especially from those with policy roles or media pulpit.
Economists’ varied—and often clashing—views on fixing the banking system have also left the public puzzled.

This rambunctious policy bazaar could be taken as evidence that decision-makers have lots of good options to consider, just as variety and competing claims in consumer markets promote a healthy degree of choice. When politicians shop for advice, however, it is the voters rather than the buyers who had better beware.

“Politicians do not accept and reject economists’ advice at random,” argues Mr Blinder. “They choose solutions that they perceive to be politically correct. Unfortunately,” he laments, “there seems to be a systematic tendency for good economics to make bad politics.” Little seems to have changed since the 1980s, among politicians from either party.

On its face, this is profoundly odd. Since good economics would produce outcomes that made voters’ lives better, politicians should anticipate getting rewarded on election day, and fall over each other to enact better policies right away. Yet for reasons not all that different from the troubles that affect corporate governance, political governance is warped by unreliable scorekeeping and intractable incentive problems. Moreover, the enormous size and clout of the US public sector—and the role of popular pressure in driving it—makes matters worse.

Unlike when FDR was struggling with the Great Depression, the US government is now a colossus bestriding every thoroughfare of modern economic life. In a few specific ways, of course, it is still not imposing enough: it apparently lacked the capacity to watch over financial companies to prevent excessive risk and lending fraud that might jeopardize the entire economy…a rather obvious shortcoming, one would have thought. Overall, however, government’s ability to redirect resources—through tax breaks, subsidies and voluminous regulations—makes it a completely different beast from what existed three-quarters of a century ago (see exhibit 6).

This expansion is a focal point of modern ideological and partisan battles for all sorts of reasons. But set those broader arguments aside. Instead, to grasp the challenges involved in regulating corporate America in light of the current populist wave and to make sense of any parallels to the Great Depression and New Deal reforms, it helps to examine two specific aspects of the government’s growth: 1) why many Progressives who focused on business issues thought bigger government was necessary in the early twentieth century, and 2) how the growth of that government has changed the role of interest groups in affecting policy.

When the early Progressives looked out with alarm at America’s corporate landscape, one of the things they feared most was the sheer might that such heavily concentrated business ownership implied. Between their economic reach and their political connections, these business empires threatened to become so powerful that they could potentially overwhelm the ability of democratic institutions to keep them in check. This sparked a debate over whether it made more sense to cut big companies down to size, or instead to foster other giant institutions—namely labor unions and government—as counterweights.

Going back to a manufacturing base of artisans and small workshops seemed fanciful: even if it could have been achieved, politically or economically, the organizational and technological advantages of big corporations were obvious. The argument in favor of counterweights obviously fared better. Although the Progressive desire to create a bulwark against corporate power was not the only, or even the main, reason for the subsequent growth of the state, that expansion did give them part of what they wanted: the government of the United States, clearly, is now powerful enough to tell corporate America what to do—even if its injunctions so seldom seem to make any sense.

Yet instead of big government making the corporate sector more honest and accountable, as many Progressives had hoped, the perverse effect has been, in many ways, to entrench some forms of corruption and make the political system seem powerless. For at least a couple of decades, and across several presidential administrations, it has been unable to deal with obvious economic problems, from a low savings rate and runaway entitlements to schools that don’t educate and health insurance that doesn’t assure people.

At the core of this political-economy problem lie interest groups and their lobbyists. Special interests, of course, have been around far longer than the modern era of big government. But the growth of the state has transformed their nature.

One of the first serious scholars to pinpoint the role of special interests in skewing policy was Mancur Olson. In The Logic of Collective Action, which he wrote in 1965, Olson laid out the simple yet brutal arithmetic that allows small groups with coherent common interests to out-organize and out-muscle diffuse majorities—such as consumers, savers and taxpayers—in the political process, even if the total costs to the disorganized majority far outweigh what is gained by the special interests.

Jonathan Rauch, who is based at the Brookings Institution and writes regularly for the National Journal and The Atlantic, took these ideas a step further. In his 1994 book Demosclerosis (which he updated in 1999 and renamed Government’s End: Why Washington Stopped Working), Mr Rauch described how the forces identified by Olson have rendered the US political system so
glaringly ineffective at addressing commonly agreed problems, despite all of the resources it deploys in response to voters’ complaints.

Olson had pointed out that individual group members have incentives to enjoy the benefits of any collective goods their group can create, without bearing any of the costs necessary to create them. As a result, he argued, special interest groups could only be held together by the coercive use of force or by finding a way to tie substantial benefits could only be held together by the coercive use of force or by finding a way to tie substantial benefits. Much of his analysis implied that, other things being equal, it was easier to forge and hold together small interest groups than big ones.

Yet today, Washington seems overrun by interest groups that are in many cases enormous. The American Association of Retired Persons, which lobbies for the elderly, has more than 38 million members. Many trade associations and pro-corporate groups are also large, as are unions, trial lawyer groups, small business lobbies, and so forth. Mr Rauch documents the ways in which the growth of government subsidies and other benefits have nourished and fertilized these groups, and how technology such as the internet (and before that, fax machines) also made it easier for them to sprout and grow (exhibit 7).

This shift, according to Mr Rauch, radically altered America’s political landscape. For although special interests have indeed been around since the country’s beginnings, they were once called special for a reason: because they gave privileged access to a few. Nowadays, he argues, just as widespread mutual fund investors have replaced the concentrated owners of an earlier era, widespread participation in interest group politics has replaced the cozy lobbying practices that used to predominate. Indeed, these groups have become so ubiquitous, since Olson first analyzed them, that Mr Rauch has dropped the word “special” from the label when he refers to them.

The proliferation of interest groups is clearly an important change. “No society can reorganize itself into benefits-seeking groups,” says Mr Rauch, “and expect to function as it did before.” But why does the trend have to be a harmful one? After all, one of the depressing aspects of Olson’s analysis is that small groups that find it easier to organize can win out over large ones in a tyranny of the economic minority. If new methods for organizing have allowed more and bigger interest groups to draw more voters into the interest group game, shouldn’t this just lead to a better balance of power?

To see why this is not simply a healthy expansion of democratic access, it helps to consider what those groups need to do in order to stay organized: they must continually transfer benefits from the government to their members. This means that each group must pressure the state for benefits that are packaged so as to keep its members united and politically potent (which is not the same as policies that would benefit the group’s members the most). Each group must also lobby to prevent other groups from taking away the goodies it is trying to keep its own hands on.

The overall outcome may reflect the best that each group can do, given what the other interest groups are doing. But it is far inferior to what other, much better, policies could do for many taxpayers—even those who belong to some big interest groups—if the government were not spending so much money fueling the interest-group wars and skewing politicians’ incentives.

Consider the US federal tax code. It is famously riddled with holes, the result of countless tax breaks that appeal to different interest groups. Most complaints about this focus on its unfairness, on the complexity and high cost of compliance, or on the distortions that arise because some activities (drilling for oil, borrowing to buy a home) are favored over others. What gets far less attention is the damage that this tax structure does to investment and economic growth through high marginal tax rates—the amount the government takes from each extra dollar of salary or investment income.

The government must hike marginal tax rates to offset the lost revenue from the gap-ridden base. Most economists agree that it is these marginal rates that determine overall incentives to work and invest; and that a tax code with many holes and high rates thus leads to much lower investment and productivity growth than one with few holes and low rates. Yet from a politician’s point of view, the loopholes are better. They reward lots of interest groups in ways that let each group see its own benefit clearly; but they hide the full costs from voters, because many of these costs occur through distortions and lost growth that are hard to measure.

As with many other interest-group-driven distortions, the overall losses to the economy far exceed the gains to those who receive the tax breaks. Yet politicians routinely do it anyway, despite being supposedly accountable to the public. This problem is in many ways similar to that of getting the managers of a corporation to act as good stewards for the savings of all those small investors. Asymmetric information, skewed incentives, and the difficulties of preventing or punishing opportunism make it hard for politicians to cut the right deals with the electorate.

These forces drive a costly wedge between powerful officeholders (whether chief executives or politicians) and the dispersed principals (small investors or voters) who entrust them with their resources and then try to get them to behave well. Avinash Dixit, of Princeton University, described this problem clearly in a 1996 book on economic policy-making. Mr Dixit laid out the parallels between transaction cost economics and “transaction cost politics,” and argued that, for each type of friction that creates transaction costs in the business world, an equivalent problem bedevils the political sphere.

To hold elected officials and bureaucrats fully accountable, even in a world of complete transparency, voters would need to be able to process enormous amounts of information, then figure out which actions were really in their interest when compared with alternatives that were not pursued. That is not a remotely good use of any normal person’s time. The same is true of large corporations, of course. How much credit should Jack Welch get for the impressive performance of GE during his tenure, and how could shareholders tell which of his countless decisions were truly in their best interest?

In one sense, however, the transaction cost problem appears worse in politics. That is because the giant organization Mr Welch ran faced competition. Investors could look at what other big firms did in similar sectors, and gain information about how well GE was performing. Indeed, the
main way that US voters know how badly the Big Three carmakers have done is by comparing them to the foreign firms that have built plants in America. The federal government, by contrast, is a monopoly. So whatever rules its politicians and bureaucrats enact, it is harder for the voters to see directly whether an alternative would have been better.

The twisted incentives of politicians, in short, make them unlikely candidates right now to set new rules that steer corporate America in a better direction. That would require setting the narrow concerns of interest groups aside for a while, and pushing for rules that make the economy as a whole function better. Instead, with economic turmoil leading (justifiably, in some ways) to a rise in government activity, many politicians are understandably eager to use the increase in spending and rulemaking as a way to boost their winnings from the interest group game. The next section looks more closely at how corporate transgressions and political ones so often seem to go hand in hand.

Interest groups

When seemingly opposed interest groups set aside their differences, peace is not so much the absence of tension as the presence of subsidies. 14

Interest groups that seem mutually antagonistic from a distance—such as corporate executives and organized labor—often have more in common than popular debates take into account. If they cooperate in ways that make a company more efficient, for example, the two groups can share the gains and both will benefit. Creating more wealth that they can share, however, is hardly the only way in which collaborating benefits both sides.

Instead of joining forces to produce more themselves, interest groups can also team up to take money from other people, such as taxpayers or consumers. This is especially true when the government is big and active. The more goodies the state is doling out, the more sense it makes for a corporation’s executives and its workers to take adjoining seats on the gravy train and share in the feast.

Consider car firms, for example. In the 1980s, as the Big Three carmakers in the US faced tougher competition from Japanese rivals and others, their executives and workers lobbied the government for protection. The Reagan administration obliged, by negotiating “voluntary” Japanese restrictions on its car exports to the United States. Consumers suffered, but the two better-organized interest groups won out (as did some Japanese carmakers, since the restrictions helped them to act like a cartel, exporting fewer, bigger cars at higher prices). Eventually, foreign carmakers became more immune to protectionist stunts, after they built more of their own car plants right in America (perhaps because they could not rely as much on the US government’s largesse, these also tend to be better run and more profitable than those of the Big Three).

Directly shutting out competition, however, was hardly the only lobbying tool available to the car executives and their workers. In recent years they have also tried to please environmental interests by pressing for rules that elevate some approaches to building fuel-saving cars over others. The hope was that this arrangement would prompt enough politicians to keep doing the Big Three favors, since the firms and their workers had lined up a broader political coalition behind their approach. And in the past few months, as the sliding economy threatened to land them in bankruptcy court—in which their labor contracts and management strategy would come under scrutiny—they have teamed up again to lobby for a bailout by taxpayers, even as they fight publicly over which group would benefit most from the handout.

Such cozy arrangements between firms and their workers are hardly limited to cars. Consider, for example, some recent research on lobbying by Matilde Bombardini (of the University of British Columbia) and Francesco Trebbi (of the University of Chicago Booth School of Business). 15 The patterns that they find within America’s congressional districts suggest that the interaction between blocs of voters and wads of corporate campaign cash is more complex than the populist narrative of “the people versus the powerful” would imply.

The researchers looked, for example, at companies that operate across many different congressional districts, and that also give money to candidates’ campaigns. When one economic sector—such as insurance, nursing care, steel or tobacco—has lots of workers in a district,
Bombardini and Trebbi find, its companies also tend to contribute less money to candidates in that district.16

Why might corporate campaign donors behave this way? Because when they are lobbying for rules or subsidies that will help their sector at the expense of other sectors—or of consumers or taxpayers broadly—the firms’ managers and workers are on the same side of the political battle. To succeed, they divide and conquer the political map.

Bombardini and Trebbi find that in districts where a sector has lots of employees, it conserves its corporate campaign cash and instead relies on workers to influence policy by showing their electoral clout. The sector then concentrates much of its campaign money on candidates who sit on committees that are important to it, but who also come from districts in which the industry does not have lots of workers. Since they cannot sway such powerful members of Congress with a show of strength at the ballot box, they do it by dropping more in the cash box.

The substitutability of votes for campaign cash is not unique to companies and their workers. Bombardini and Trebbi point out that the American Association of Retired Persons, which gives zero money in campaign contributions, has exploited the narrow common interests of its elderly voters to become one of the most powerful interest groups in Washington. The AARP’s supporters are so well-organized, and such a credible threat to vote against candidates who will not help divert taxpayers’ money towards their interests, that they do not need campaign contributions to get their way. What Bombardini and Trebbi show, using their data on campaign contributions and employment across districts, is that the substitutability of votes for money can also make companies and their workers into political bedfellows.

Given how this game works, it shouldn’t be hard for Democrats in Congress to please many of the corporate donors who have switched sides to support them, now that they are in charge. In some cases—such as making it easier for labor unions to expand—the corporate donors fiercely oppose policies that other Democratic constituencies support. However, just as Republicans who lauded “free markets” teamed up with corporate lobbyists in previous years to cut interventionist deals, Democrats will find plenty of chances—from subsidies to protectionism to bailouts—to marry their corporate donors’ interests with those of their other backers.

Describing all the ways in which such policies might distort incentives and lower growth is beyond the scope of this report. One aspect that clearly seems underappreciated by much of the public, however, is the cost of propping up big established businesses, which makes it harder for newer, smaller and more productive ones to grow.

Consider some recent research on big business stability, by Kathy Fogel (at the University of Arkansas), Bernard Yeung (of the National University of Singapore and NYU’s Stern School of Business) and Mr Morck (who edited the comparative corporate governance book mentioned earlier). In a pair of studies,17 they examine the performance of 43 countries from 1975 to 1996. They relate each country’s economic growth to whether the same big firms tended to dominate its economy over the course of those two decades.

The researchers tried several measures of stability: whether the same companies stay in the
top ten over the course of their study; whether they account for a large share of the workforce at the beginning and end; and so forth. Whichever way they slice the data, countries with big firms that are stable over time tend to be those that grow most slowly.

Nor does this poor performance seem to reflect any tradeoff between broad economic growth and more specific social goals, such as higher employment, income equality, or the provision of health care or other public goods. Fogel and her coauthors find no evidence that big business stability provides any of these benefits to society. Once they control for the level of income, they find that countries with more stable big businesses tend to have both slower economic growth and worse health care. They also find that big business stability is associated with more income inequality rather than less, and is “utterly uncorrelated” with the rate of unemployment.

These results should not surprise any careful student of industrial policy. When governments direct resources, such as investment capital, towards propping up entrenched firms, then those resources are not available for other businesses that want to invest in productive new activities. If General Motors were to go bankrupt, for example, the courts would reorganize its activities in an effort to wring the most value out of its assets and salvageable business units. This might include selling some of its assets to bidders who can make more productive use of them than GM’s executives have. Although judges, too, can be unreliable, this would be better than bailing out the firm. Besides the inefficiency inherent in letting the firm be run in a similar failed way, it would also be a waste to use capital propping up GM that could be deployed better elsewhere in the economy.

Mortgages
Deals that satisfy both corporate executives and their workers are not the only examples of how adding more interest groups to a compromise can make it worse for the general interest. Corporate pressures can also combine with demands from other interest groups to warp economic policy. The recent meltdown in mortgage markets is a good example. America’s misguided tax deductions for home-mortgage borrowers have long distorted its economy. But in the years leading up to the crisis, many other interest groups put pressure on the system, leading to a conflicting and irrational set of rules that kept each of these groups satisfied while leaving the entire financial system at risk.

There were the financial institutions themselves, who were chasing high-return investments and discovered that buying securitized mortgages and related instruments was a good way to do it. These firms’ executives got the lavish bonuses as profits rose, but did not have to bear their share of the risks, which were shouldered by shareholders, creditors and (in the event of a bailout) taxpayers. Then there were advocacy groups lobbying on behalf of borrowers with low income or high credit risk. The best way to get more credit to promising borrowers in this group—in an efficient and sustainable way—is a complicated question. But the political system simplified the issue by reducing it to a contest between the poor and the powerful, and lenders were encouraged to send more loans their way.

To ensure that the mortgage market was skewed in favor of politically important interest groups, Congress also provided implicit backing for two huge government-backed mortgage-lending agencies: Fannie Mae and Freddie Mac. These agencies helped to buy many of the securitized loans that were being created, including subprime loans to higher-risk borrowers. Politicians liked this, because they wanted to show that they were doing something visible for the poor. The executives running Fannie and Freddie gladly obliged: pleasing the politicians made sense, since the government was implicitly guaranteeing hundreds of billions of dollars of their debt, even as they took risks and pocketed profits as if they were private corporations.

The mechanism by which financial firms deleveraged and sold assets as everything turned sour, and the reason why attempts to stem the downward spiral failed, is obviously a complex story involving many subtleties. But the interest group alignments above helped to create the problem in the first place. And some of the biggest eventual losers—such as taxpayers, or the business owners who are now struggling to get loans in a wrecked financial system—were not really part of this lobbying. These bystanders failed to grasp the risks to which the political games were exposing them, and even now have only a vague idea of what exactly happened.

They do know that there is at least one group of people who deserve blame: those who work on “Wall Street.” Yet in reality the disaster had pluralist, even populist, roots: each group gained narrowly from a different set of politically driven distortions, but when these were all tallied up everyone lost.

Voters’ apparent failure to grasp this reality is disheartening. For if there is any truth in Mr Obama’s famous exhortation to his supporters—that “we are the ones we have been waiting for”—it is because we are also the ones we have been complaining about. But we still don’t seem to realize it yet.

So, short of a collective epiphany, how should sensible business leaders, politicians and pundits respond to the backlash against “Wall Street” and private enterprise? Won’t a refusal to appease populists prompt even more outrage?

Mark Roe, of Harvard Law School, has argued that changing the rules to accommodate strong public sentiments is not just democratic, but also economically efficient. In The Political Determinants of Corporate Governance, which he wrote in 2003, long before the current crisis, Mr Roe began with the premise that “before a nation can produce, it must achieve social peace,” and that “the forces that stabilize a society inevitably affect the corporation, sometimes directly, sometimes indirectly.” He argues, therefore, that some politically motivated business constraints “may enhance a system’s political stability, preserving the core efficiency tendencies of capitalism, private property and competitive markets, by conceding a few economically dubious but politically astute regulations here and there.”

Suppose that Mr Roe’s analysis is broadly right. Does this mean that catering to America’s angry populists—by steering bailout funds or economic stimulus money towards programs that do not make the most sense economically, but which sound good to the public—is the wisest route in the current environment? One could apply Mr Roe’s analysis and conclude that it might be,
since it would reinforce a message that America’s system is mostly in favor of private enterprise but is also responsive to the broad wishes of voters.

This kind of thinking, however, overlooks an important risk: that appealing populists by pursuing bad economic policies is actually politically inefficient as well as economically reckless, since it reinforces a false distinction in voters’ minds between policies that are good for the economy and policies that are good for ordinary people. Many populist policies are ultimately bad for both.

So again, what should influential people be saying to the angry mob when it is not really listening? To shed more light on this sort of dilemma, it helps to look at a growing and exciting branch of economics, which deals squarely with the rules of persuasion. ▲

Persuasion

In a battle of ideas, it is tricky when each side has its own referee.

Compromise is often a good idea. So it might make sense for America’s decision makers to strike some sort of bargain between angry critics of big business, who mostly want to attack the current system, and those who—because they think that corporations do good as well as harm—would prefer carefully targeted reforms. After all, if populist pressures keep rising during a period of widespread economic pain, failing to compromise will likely infuriate some voters even more, and risk making matters worse. And compromising is consistent with the notion—often assumed—that a two-party system with lots of checks and balances tends to foster the best kind of stability, by playing to the center while allowing healthy leeway in either direction when things get out of whack.

This raises the question, however, of what drives two-party politics in the first place. It is clear that at least along some dimensions, such as their approach to religion and culture, America’s two main parties do not converge towards the center. So what prevents them from lurching off in even more radically different directions with respect to economics as well, thus making policy more risky and volatile?

It is hard to answer such questions without asking what conditions motivate politicians and their supporters to adopt more extremist positions. This no doubt depends partly on what voters believe, both about how the economy works and about the likely effects of alternative policies. But how these beliefs get formed and sustained over time, in the face of evidence, can be hard to untangle. It depends on what actually constitutes evidence in voters’ eyes, and on how they receive and process information—as well as on whether all voters get roughly the same information as each other.

In recent years, there has been a promising burst of economics research that tries to pin down more precisely the way that voters, politicians and information brokers interact in the political marketplace. These efforts are still somewhat new, but are starting to generate good insights into the role that persuasion and extremism play in politics, both in America and in other democracies.

In a 2004 essay, Kevin M. Murphy (of the University of Chicago Booth School of Business) and Andrei Shleifer (of Harvard University) laid out a short but powerful model of how “Persuasion in Politics” can, in different circumstances, drive parties either to the center or the extremes.26 Their approach pays close attention to the role that “social networks”—which could include organized groups such as trade unions and religious coalitions, or media consumers such as talk-radio listeners and blog readers—play in the political process.

Specifically, Murphy and Shleifer try to model how these and other groups of like-minded folk interact with politicians, and the role that well-informed power brokers can potentially play in skewing the beliefs of those who know less than they do. They focus on strong social networks, whose members are influenced more by people inside the group than by outsiders.

Crucially, this is not just a matter of people joining the same social group or reading the same blogs, because they already start out with similar beliefs. Murphy and Shleifer also care about how people adjust those beliefs in the face of evidence—and on what happens when these adjustments depend on whom they are talking to.

The two economists focus much of their attention on what they call the “distance” between members of different social groups. Distance captures two separate ideas. One is the gap in what two different voters believe, before any fresh exchange of information has a chance to alter their views; the other recognizes that it can be hard for voters with disparate views to communicate at all in ways that sound credible to each other.

The distinction between these two notions of distance can shed light on Mr Obama’s promises to transcend partisan divisions that may have previously kept some reforms off limits. Some critics have argued that the new president cannot pull this off, partly because American liberals and conservatives disagree about so many things that any coalition spanning both is bound to be shallow and short-lived. But Mr Obama’s argument—although he does not put it in these terms—could be construed as tackling the other aspect of Murphy and Shleifer’s “distance”: a widespread sense that many on the left and right, however disparate their beliefs, drive themselves much further apart than they need to be by refusing even to listen to one another or debate each other seriously.

Murphy and Shleifer, based on their model, argue that whether these communication gaps lead to centrisim or extremism depends partly on how wide they are: the narrower the gaps between them, the easier it is for new information to lead two groups to common ground. The two economists
reckon that this helps to explain why extremists, be they politicians, pundits or preachers, try so hard to discourage open-mindedness among supporters: "Organizers of extremist networks do not want mainstream opinion to come close to their views: by infecting the beliefs of their members, such convergence can destroy the network altogether."

Their model is simple and insightful, but fails to deal with another important political reality: that some people are more likely to vote than others. Clearly, this is another reason why extreme messages often work: because extremists can drive up voting rates among supporters of their own party, without inducing too much rival turnout for the other party.

Edward Glaeser and Giacomo Ponzetto (of Harvard University), and Jesse Shapiro (of the University of Chicago Booth School of Business), try to model explicitly how these turnout dynamics work, and under what conditions they lead to extremism.21 Like Murphy and Shleifer, they find that the amount of extremism depends not only on what different groups of voters start out believing, but also on the disparate ways in which those factions get information. Among other things, their model sheds light on the importance of religious and cultural issues, as opposed to economic ones, in driving parties towards the center or the extremes.

Glaeser, Ponzetto and Shapiro point out that if information travels differently in some social settings than in others, then "extremism is also more likely along the issues that determine informational groups." To test this theory, they look at two dominant social networks that clearly play a big role in politics in many countries: religious groups and labor unions.

For several dozen countries, the researchers look at the share of the population who attend religious services regularly, and at how closely people who do attend are affiliated with the political right. The idea is that people are more likely to choose a party based on how religious they are in countries where religious intensity distinguishes one big group of citizens from another. In Scandinavian countries, where few people attend church, it might make little sense to choose a party on religious grounds; the same goes in countries like the Philippines, where nearly everyone attends religious services regularly.

Sure enough, Glaeser, Ponzetto and Shapiro find that people are more likely to choose parties based on religious beliefs when the share of the population that worships regularly is close to half. In the United States, around 60% of people go to some sort of religious service at least monthly; and the link in America between this attendance and voting for the conservative party is slightly higher than the cross-country average. The international pattern suggests that church organizations really can give some voters targeted messages that increase turnout, without being overheard by lots of other voters who might disagree.

Glaeser, Ponzetto and Shapiro suspect that labor unions have a similar ability to affect turnout based on economic issues. They argue that one reason why religious battles have become so much more important than class warfare, as a predictor of how Americans vote (at least until recently), is because the share of the workforce in labor unions fell from 35% to 15% from the 1970s to the 1990s.

They were unable to test their propositions about labor unions with the sort of international data that they used to examine religious attendance. But there is plenty of informal evidence in their favor. For example, Democrats who want to make income redistribution a bigger political issue, along with activists on the left who support them, invariably put lots of effort into reversing the decline in union membership.

One of the Democratic Party’s most powerful supporters, the Service Employees International Union, is especially keen to organize health care workers. This is a growing workforce in a sector that is little understood by the public, and is thus perfectly tailored for political promises which would motivate the beneficiaries but be dimly understood by the general voters who would end up paying the costs. Many Democratic politicians also support a law that would eliminate secret ballots when workplaces decide whether to unionize. This would make it easier for labor organizers to coerce workers, and would no doubt boost union membership over time.

Moreover, Glaeser, Ponzetto and Shapiro probably pay too much attention to actual union membership, rather than to the information networks that labor unions inhabit. What drives their theory, after all, is the ability of some groups to transmit messages that boost turnout for one party without triggering counter-turnout from the other party’s supporters. Increasingly, labor unions are teaming up with non-union networks on the left that favor policies to redistribute income.

All of this suggests that America’s two political parties remain quite capable of diverging even further from each other on economic issues, and that voters’ information channels will play a crucial role in deciding the influence of extremists. The easier it is for different sets of voters to receive and accept divergent streams of information and evidence about economic policy, the easier it will be for political operators to divide the country along these lines. If you doubt whether this sort of disparity is possible in the information age, consider an impressive study of the American news media that was published in 2007.

Mr Shapiro and Matthew Gentzkow (also at Chicago Booth) came up with a clever way to measure the interaction between politicians’ efforts to divide people and the news media’s reporting of “facts.”22 Members of Congress tend to use different phrases for the same things, depending on their party. Whereas Democrats often refer to the “estate tax,” for example, which they tend to support, Republicans prefer to call it a “death tax” and argue against it (see exhibit 8 for some examples). By using a computer program to comb through the Congressional Record, Gentzkow and Shapiro catalogued these tendencies and then compared them to the preferred phrases of different newspapers. They did this by building an objective partisan index, which captured how closely each newspaper’s language patterns resemble those of Democrats or Republicans.

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**Democratic vs. Republican Language in the Congressional Record**

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<thead>
<tr>
<th>Phrases used often by Democrats</th>
<th>Phrases used often by Republicans</th>
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<tr>
<td>• Estate Tax</td>
<td>• Death Tax</td>
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<tr>
<td>• Private Accounts*</td>
<td>• Personal Accounts*</td>
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<td>• Tax Breaks</td>
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<tr>
<td>• Budget Cuts</td>
<td>• Tax Increase</td>
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* in reference to Social Security changes proposed by George Bush

They then looked at several features of the newspaper industry to see what causes this partisan “slant” to vary across publications. They found that newspapers tend to slant their coverage towards the ideology of the readers in their local markets. This battle to match their customers’ tastes matters much more than other factors, such as the political leanings of a particular newspaper’s owner.

This suggests that there are mechanisms by which different groups of readers start out with different beliefs, and then have those beliefs reinforced as they get information slanted in their direction. If this can happen with something as supposedly “informative” as the daily paper, it is surely going on in all sorts of other media as well.

This is a worrying tendency. Because even if extremists only have limited success at locking in the policies they care about, they do not have to “win” in this way to do harm. The collateral damage they inflict on the political process hurts economic policy. If their efforts to divide the electorate muddle up the debate and skew voters’ choices, the policies that result are inconsistent and grossly inefficient. Moreover when politicians are clamoring for new rules to change the behavior and investment decisions of businessmen, it is harder to hold either group accountable if the referees are interested in a different game altogether.

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**Trade and transparency**

Competition is not just a great way to boost efficiency and living standards; it also helps to ensure that battles over business regulation and other economic policies are refereed fairly.

Flaws in America’s business model, and in the political system’s approach to shaping that model, present different challenges to different groups. Business leaders themselves have a hard time knowing what they should argue for in the public arena these days. Savers need the system to harness their wealth reliably, but have little influence individually on how firms operate. The same goes for taxpayers, who would benefit from a saner tax code that treated all business activity equally and encouraged investment, but are left clamoring for breaks instead. Finally, voters in general would gain from policies that led corporate America to spend more effort producing wealth instead of trying to extract it from the state.

All of these are problems of collective action, the sort that Mancur Olson identified as especially hard for broad, generic groups—businessmen, savers, taxpayers, voters—to solve. So what should these groups do? In most cases, there is little they can do in the foreseeable future to revolutionize policy or overhaul the system. But members of each group could do more to ensure that the decisions and arguments they make are at least headed in the right direction. It is not much, but it would be a good beginning.

Start with business leaders. Big business is unpopular, even in better times, partly because much of the public views its members as a powerful and monopolistic force. Yet the reality is that, when they lobby the government to influence policy, they are usually divided, petty and weak. Each sector lobbies against the others, and within sectors each firm tries to tilt the rules to its own advantage. In the meantime, on the issues that affect all of them—such as education—businesses perennially find themselves unheeded and ineffective as a group.

The children coming out of America’s schools, for example, will form the workforce of corporate America before long. If they stuck together, business leaders could form a powerful counterweight to other groups, such as teachers unions, who resist useful reforms.

For savers, the gap between reality and potential is even more frustrating. If each saver only owned shares in a couple of airlines, banks, or energy firms, then those firms might have an excuse for pursuing special favors from Congress and regulators on shareholders’ behalf. But thanks to modern finance, most sensible savers hold mutual funds, and thus own stakes in all of corporate America. So corporate political pressure on behalf of specific industries or firms hurts those savers unequivocally, since the lobbying merry-go-round is manifestly a negative sum game. It may be hard for investors to get this across to the corporate managers who claim to act on their behalf, but they could start by being more aware of the problem themselves.

But what about the public at large, what should it look for? This report has argued that many of the forces that drive weak corporate governance and bad business policies stem from powerful incentive issues, such as transaction costs and the collective action problem. Moreover, the media and other watchdogs do not always have incentives to report information in ways that help to lessen this problem. As a result, calls for transparency—which Mr Obama is the latest president to champion—tend to focus on only half the problem. The information that comes out of boardrooms, news rooms and congressional hearing rooms—even if there is plenty of it and each detail is accurate in isolation—is hard for voters and other watchdogs to process and interpret, especially given the size and complexity of America’s economy and government.

Embracing international trade and other forms of economic competition, however, is one of the best ways for any government to promote real transparency—by letting voters see the true cost and benefits of its policies. That is because competitive markets do not merely allocate resources efficiently and spur innovation. One of the supreme, yet underappreciated, advantages of markets is that they also reveal alternative ways of doing things.

Sometimes, the alternatives are better. And there is nothing more feared by a proud officeholder—whether an entrenched corporate executive or an incumbent politician—than clear evidence that their way might not have been the best one.

Normally, in politics, such evidence can be hard to come by. The government feeds policies into the system at one end, and results come out at the other. But it is often hard, in real time, for any referee to say clearly whether another policy would have performed better or worse. And given the scope for different conclusions, the media and other information brokers can be counted upon to give slanted interpretations that suit their constituencies.

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**Trade and transparency**

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Consider the $787 billion stimulus bill recently passed by Mr Obama and the Democratic Congress. After the economy receives this fiscal jolt, it may start to grow convincingly and sustainably again within the next couple of years. If the government had not tried such a large stimulus package, the outcome may have been the same: that, after all, is what happens with most recessions anyway. The credit driven nature of this crisis may make it different from other downturns, such that it might respond better than usually to extraordinary fiscal measures, as well as financial ones.

There is no way to prove the case either way, however, in the short term. And with much of the electorate and their media divided, only a few voters are likely to be persuaded by whatever firm evidence does come along over time.

Given this, and the huge political advantages of strengthening Democratic constituencies through the stimulus bill, it is entirely understandable for Mr Obama to have taken the path he did. His party believes in government’s power to solve problems, and plenty of credible people agreed that a stimulus was necessary.

The question now facing the public, however, is how to evaluate the package as they watch what happens next. How will people know whether the money was worth spending, or well spent? Fairly or unfairly, Mr Obama will be judged largely on how soon and how sharply the overall economy turns around. Another crucial question to ask, however, is whether the money was worth spending, or well spent?

Mr Obama has so far tried to have it both ways on trade—claiming to support it generally, but working in lots of caveats to please his protectionist base. Whether he genuinely stands up for free trade will have a huge effect on whether his presidency really does end up promoting competition and real transparency. For international competition, even more than other varieties, has a powerful ability to promote good governance, in both the corporate and political spheres. “Sunlight”, as Supreme Court Justice Louis Brandeis once said, “is the best disinfectant.” But it would be even better if moonlight were strong enough to compete.

As an excellent example, consider, once again, Randall Morck’s powerful Canadian business families. He points out that Canada’s entry into the North American Free Trade Agreement prompted the share prices of these family business groups to fall sharply compared with those of other firms. The reason, he reckons, is because international competition made it harder for clubby conglomerates to use the political process to stick it to consumers and investors—a practice that was much easier when the competition was mostly domestic and they could use political connections to stiff-arm Canadian rivals.

Despite the obvious advantages of international competition, however, and the blatant contradictions that beset protectionist arguments, policies that restrain international trade remain extremely hard to fend off in America and most other democracies. Trade politics thus provides an excellent example of how the forces highlighted in previous sections—interest group dynamics and the economics of [mis]-information—can combine to skew policy in strange directions. It is no coincidence that many researchers who look at the contribution of warped political incentives to poor economic policy—such as Mancur Olson, Jonathan Rauch, Avinash Dixit and Alan Blinder—end up choosing trade as one of their best examples.

Many Democratic constituencies seem especially hostile to trade and other forms of competition right now. But that unyielding position is at odds with the Progressive legacy that many of them claim. As much as modern progressives would like to draw parallels to an earlier era—since that is viewed as another time when Big Government tackled Big Problems—they are entirely overlooking the attitudes that many sensible early Progressives held towards competition. Many of them considered collusive business practices and restraints on competition to be among the strongest reasons why reform was needed.

Modern progressives, by contrast, appear to have lost touch with these pro-competitive roots. Too often, it seems as though healthy suspicion of corporate power has evolved into an obstinate dislike of big businesses and all that they do. The perverse result is an endorsement of any policy that crudely favors the expansion of government over the growth of profits.

That is a shame. For although America’s large corporations do not inspire citizens the way that an idealized view of government can—by leading dramatic national initiatives that give everyone a common sense of purpose—they do allow people to cooperate everyday in countless mundane ways, which boosts productivity and wealth relentlessly over time. During the past quarter century alone, the global investments that big corporations manage have helped to lift hundreds of millions above subsistence-level poverty. Driven by competition with international rivals and each other, America’s businesses have also fostered impressive growth and innovation at home. This sort of progress is never smooth, rarely exciting, often flawed, and perennially taken for granted. But based on the overall track record, it is the sort of change that more people ought to believe in.

Brian Barry is Clinical Associate Professor of Economics and executive director of the Initiative on Global Markets at the University of Chicago Booth School of Business. Prior to joining the Chicago Booth faculty, he was a staff correspondent for The Economist from 1994 to 2007, with postings in Asia, Europe and the United States.
Endnotes

1 Recent research by Christian Leuz at the University of Chicago Booth School of Business and Catherine Schrand at the University of Pennsylvania suggests that the Enron scandal may have prompted better behavior along some dimensions, as firms that posed similar risks took positive steps to reassure investors. The current challenge to corporate reputations is obviously much greater, but so may be the response. See Leuz and Schrand, “Disclosure and the Cost of Capital: Evidence from Firms’ Response to the Enron Shock,” IGM (Chicago Booth) working paper series, number 28, December 2008.


8 Zingales’ proposal also includes a call for regulators to close the gap between the way that publicly-listed and privately-placed securities are regulated and offered to investors.


11 For a good readable overview on marginal rates and dead-weight losses from taxes, see Martin Feldstein, “The Effect of Taxes on Efficiency and Growth,” NBER working paper number 12201, May 2006.


14 With respect to the Reverend Martin Luther King, who famously said: “True peace is not the absence of tension, but the presence of justice.”


16 To be more precise, Bombardini and Trebbi find that donations to political action committees (PACs) follow an inverted-U shape, first rising, then falling, as the share of a sector’s workers in a district rises.


19 Mark J. Roe, The Political Determinants of Corporate Governance, Oxford University Press, 2003, (quotes are from pages 12, 23 and 121).


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