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DANGERS FROM THE POLITICAL ALLOCATION OF CAPITAL

In many ways some of the ideas of [Friedich] Hayek and [Milton] Friedman about how markets best provide incentives, and best provide information, and best collect information may in a sense be even more true today, because of the changes that information technology is bringing, than they were at the time when they were propounded. If you think about it, it cannot be an accident that it is the same 15-year period when communism fell, when command-and-control corporations like General Motors and IBM had to be drastically restructured, when planning ministries throughout the developing world were closed down, and when the Japanese model of industrial policy proved to be a complete failure. There is something about this epoch in history that really puts a premium on incentives, on decentralization, on allowing small economic energy to bubble up rather than a more top-down, more directed approach, that may have been a more fruitful approach in earlier years.

Lawrence J. Summers
71st Secretary of the Treasury[1] and Adviser to President-Elect Barack Obama

Since the financial crisis began in August 2007, the federal government has become increasingly involved with U.S. banks and other financial institutions and U.S. financial markets. The Federal Reserve has greatly expanded the size, duration, and scope of its credit facilities (see Appendix). The Department of the Treasury has agreed to (1) inject up to $100 billion of taxpayer funds into Fannie Mae and another $100 billion into Freddie Mac, (2) purchase up to $250 billion of preferred shares in banks, and (3) purchase $40 billion of preferred shares in American International Group (AIG). Now, Chrysler, Ford, and General Motors along with the United Auto Workers (UAW) union are seeking emergency financing to help these automakers to avoid reorganizations under Chapter 11 of the federal bankruptcy code.

Although central governments play a large role in allocating capital in many Asian and European economies (1) through government-owned banks, government pension funds, and other government-owned financial institutions, or (2) through industrial policies that direct credit to and encourage investment in favored firms, industries, regions, or groups, a historical strength of the U.S. economy has been the relatively small role that the federal government has played in allocating credit and making investment decisions. The limited number and scope of government-owned financial institutions and the absence of an industrial policy in the United States has allowed private investors, private banks, and other private financial institutions to allocate credit and make investment decisions based on economic criteria without undue political interference. Subject only to general laws and regulations, private investors, banks, and other financial institutions may seek the highest returns consistent with their risk tolerance.

While recent federal interventions were designed to encourage banks and other financial institutions to replace government capital with private capital after market conditions improve, policymakers may nevertheless be tempted to use the leverage arising out of these federal interventions to affect credit and investment decisions. This raised an important question – how would the political allocation of capital affect the performance of the U.S. economy?

The political allocation of capital misdirects investment based on political criteria. Product innovation and process improvement in firms suffer. Over time, diminishing productivity gains slow real income growth and reduce real GDP well below its potential. Economists attribute the deterioration of economic performance under the political allocation of capital to several factors:

- Inability of policymakers or bureaucrats to incorporate all of the widely diffused and rapidly changing knowledge conveyed by prices into allocating credit and making investment decisions;
- Both legal and practical restraints on political decision-making in a constitutional republic that:
  - Reduce responsiveness to changing conditions and prospects, and
  - Produce biases
    - Against entrepreneurship and innovation, and
    - For existing constituencies;
- Division of firm resources away from managing the business toward lobbying policymakers and influencing the bureaucracy; and
- Potential for corruption.

Information problems. The knowledge necessary to allocate capital efficiently is widely diffused throughout the global economy and costly to obtain. It is impossible for any one person or organization to acquire and to update constantly all of the information necessary to allocate capital efficiently in a complex economy.

Prices reflect the collective judgment of global markets on all available information. Under the market allocation of capital, price signals from changes in interest rates and share prices allow households and firms to coordinate their investing and lending activities and rapidly adjust their behavior to reflect changing conditions or prospects.

Under the political allocation of capital, however, policymakers or government bureaucrats substitute their judgment for the collective judgment of global financial markets expressed through prices. Because of the high cost and extreme difficulty in obtaining and constantly updating information, this substitution necessarily ignores some of the information incorporated in market prices. With less than complete information, politically determined credit and investment decisions are less efficient than market-determined credit and investment decisions.

Unresponsiveness. A constitutional republic such as the United States places many restraints both legal and practical upon policymakers and bureaucrats. These restraints necessarily slow the response of policymakers or bureaucrats to changing conditions or prospects.

It takes time for policymakers to perceive funding needs. Congress must enact enabling legislation to allow a political allocation of capital. Normally, federal agencies must then devise implementing regulations before decisions can be made. While laws and regulations can be amended, change is often slow. In contrast, market participants have no such time constraints.

Bias against entrepreneurship and innovation. Extending credit and making investments involves risk. Loans may not be repaid, and the value of equity investments may dwindle. To reward lenders for assuming risk, riskier loans bear higher interest rates. Likewise, riskier equity investments require higher expected rates of return.

Entrepreneurs experience a high rate of failure. While only a small number of new firms grow into large prosperous multinational corporations, the rewards for investors in these few are enormous. Under the market allocation of capital, venture capital firms can provide funds to promising new firms with innovative products or breakthrough technologies because the vast returns from investing in the next Microsoft or Starbucks can offset many failed investments.

Under the political allocation of capital, neither policymakers nor bureaucrats receive large returns from successful investments in new firms. Instead, policymakers and bureaucrats that extend credit to or make investments in new firms that ultimately prove unsuccessful may suffer from press derision and public ridicule. As a result, policymakers and bureaucrats may lose their positions.

The differences in the balance between risk and returns in private firms and in government bias the political allocation of capital against funding entrepreneurship in emerging industries producing new goods and services using innovative technologies, and toward funding existing firms in established industries producing known goods and services using conventional technologies. Thus, the political allocation of capital discourages entrepreneurship, slows product and process innovation, and retards the development of new technologies.

Bias for constituents. Under the separation of powers system with legislatures whose members are elected by separate constituencies, the public expects individual lawmakers to respond to special needs of their constituents, while the public expects the chief executive to defend general interests. Under the political allocation of capital, the natural tendency of legislative policymakers to serve the special interests of their constituents may cause such policymakers to direct or at least to influence the flow of credit and investment to their constituencies.

Struggling firms that have trouble raising funds in capital markets often seek funding from government. Because of constituency bias, many policymakers may support extending credit or investing funds to struggling firms that employ the constituents of policymakers to avoid layoffs or facility closures.

Layoffs and facility closures are never popular, but such restructuring is often necessary for struggling firms to recover. To secure governmental funding, however, firms may make popular commitments that are often not in the long-term interests of the firm or its shareholders. For example, firms may commit to maintain their current level of employment, to keep inefficient facilities open, or continue to produce unprofitable products.

Resource diversion. The political allocation of capital encourages firms to devote management time and firm resources to lobbying activities to secure funding from policymakers or bureaucrats. At a minimum, this distracts entrepreneurs and firm managers from their business. Firms may redirect resources from product innovation and process improvement toward lobbying activities. As dependence on government funding increases, the diversion of attention and resources may become severe. Such diversions retard product innovations and process improvements. Over time, diminishing productivity gains slow real income growth and reduce real GDP below its potential.

Corruption and crony capitalism. Finally, the political allocation of capital may foster corruption. When policymakers and bureaucrats make credit and investment decisions, entrepreneurs and firm managers may be tempted to bribe policymakers and bureaucrats to secure funding for their firms or to prevent their rivals from securing funding. Both policymakers and bureaucrats may seek to exploit the considerable economic power that they are exercising when they allocate capital. Thus, policymakers and bureaucrats may seek bribes from entrepreneurs and firm managers.

In a number of countries, the political allocation of capital has led to crony capitalism, in which politically connected firms receive favors from the central government in exchange for various types of bribes to policymakers and bureaucrats. Under crony capitalism, politically favored firms are largely immune from competition with less well connected firms. This discourages both domestic entrepreneurship and foreign direct investment. By diminishing the incentive to innovate, productivity gains lag, reducing real GDP growth over time.

Conclusion. While the severity of the financial crisis may justify some of the recent federal interventions, these interventions, if not reversed once the crisis has dissipated, may retard the efficient allocation of capital in the United States and thus diminish its long-term growth prospects. Private firms and households make their credit and investment decisions based on economic criteria. While federal policymakers may incorporate economic criteria, federal policymakers must necessarily incorporate political criteria into their decision-making. This fundamental difference between decision-making in private financial institutions and markets and decision-making in government inevitably fosters certain biases in the political allocation of capital and creates the opportunity for corruption that reduces long-term economic growth.

Appendix: Federal Reserve Actions

On August 17, 2007, the Federal Reserve established the Term Discount Window Facility (TDWF) to allow banks and other depository institutions to borrow at the discount window for a term of up to 90 days instead of overnight.

On December 12, 2007, the Federal Reserve established the Term Auction Facility (TAF) to allow banks and other depository institutions to bid for funds for 28 or 84 days. The size of these auctions has been increased several times.

On March 11, 2008, the Federal Reserve established the Term Securities Lending Facility (TSLF). Through the TSLF, the Federal Reserve lends up to $200 billion of Treasury securities held by the Federal Reserve to primary dealers secured for a term of 28 days (rather than overnight) by a pledge of other securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS. On September 14, 2008, the Federal Reserve expanded the eligible collateral for the TSLF to include all investment grade securities.

On March 16, 2008, the Federal Reserve established the Primary Dealer Credit Facility (PDCF) to allow primary dealers to borrow funds overnight. Collateral may include tri-party repurchase agreements (repos) and investment grade securities.

On May 2, 2008, the Federal Reserve established temporary currency swap lines of $50 billion with the European Central Bank and $12 billion with Swiss National Bank. On July 30, 2008, the Federal Reserve increased its temporary currency swap line from $50 billion to $55 billion with the European Central Bank. On September 18, 2008, the Federal Reserve increased its temporary currency swap lines with the European Central Bank from $55 billion to $110 billion and with the Swiss National Bank from $12 billion to $27 billion. The Federal Reserve established new lines with the Bank of Canada ($10 billion), the Bank of England ($40 billion), and the Bank of Japan ($60 billion). On September 24, 2008, the Federal Reserve established temporary currency swap lines with the Reserve Bank of Australia ($10 billion), the Sveriges Riksbank ($15 billion), the Danmarks Nationalbank ($5 billion), and the Norges Bank ($5 billion). On September 29, 2008, the Federal Reserve increased its temporary currency swap with the Bank of Canada from $10 billion to $30 billion, with the Bank of England from $40 billion to $80 billion, and with the Bank of Japan from $60 billion to $120 billion, for the Bank of Japan, with the Danmarks Nationalbank from $5 billion to $15 billion, with Norges Bank from $5 billion to $15 billion, with the Reserve Bank of Australia from $10 billion to $15 billion, and with the Sveriges Riksbank from $15 billion to $30 billion, and with the Swiss National Bank from $27 billion to $60 billion. On October 13 and 14, 2008, the Federal Reserve announced that it had increased its temporary currency swap lines with the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank to whatever is requested. On October 28, 2008, the Federal Reserve announced that it had established a temporary currency swap line with the Reserve Bank of New Zealand ($15 billion). On October 29, 2008, the Federal Reserve announced that it had established temporary currency swap lines with the Banco Central do Brasil ($30 billion), the Banco de Mexico ($30 billion), the Bank of Korea ($30 billion), and the Monetary Authority of Singapore ($30 billion).

On September 19, 2008, the Federal Reserve established the asset-backed commercial paper (ABCP) money market mutual fund facility to lend to banks and other depository institutions on a non-recourse basis to purchase ABCP from money market mutual funds.

On September 21, 2008, the Federal Reserve approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

On October 6, 2008, the Federal Reserve announced that it would begin paying interest on both required and excess reserve balances of banks and other financial institutions held at Federal Reserve Banks.

On October 7, 2008, the Federal Reserve established the commercial paper funding facility (CPFF). Through the CPFF, the Federal Reserve finances the purchase short-term unsecured commercial paper and asset-backed commercial paper that is rated at least A-1/P-1/F1 by a special purpose vehicle (SPV).

On October 21, 2008, the Federal Reserve established Money Market Investor Funding Facility (MMIFF) to finance of up to 90 percent of the purchase of up to $600 billion of U.S. dollar-denominated certificates of deposit, bank notes and commercial paper issued by highly rated financial institutions from money market mutual funds (MMMFs) by a series of private sector special purpose vehicles (PSPVs). The PSPVs will finance the remaining 10 percent of their purchases by issuing asset-backed commercial paper (ABCP).

On November 25, 2008, the Federal Reserve established the Term Asset-Backed Securities Loan Facility (TALF) through which the Federal Reserve will extend up to $200 billion of non-recourse loans to the holders of recently issued AAA-rated asset-backed securities collateralized by student loans, auto loans, credit card loans, and small business loans guaranteed by the Small Business Administration (SBA).

On November 25, 2008, the Federal Reserve announced that it would purchase up to $100 billion of Fannie Mae and Freddie Mac debt securities and up to $600 billion of residential mortgage-backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac.

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[1] Interview with Lawrence Summers, *Commanding Heights on PBS* (conducted on April 24, 2001). Found at: http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int_lawrencesummers.html#1.