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Legal conflicts of interest of the revolving door☆

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ABSTRACT

This paper analyzes the conflicts of interest arising from the “revolving door”. The revolving door is a common phenomenon, and it is unlikely that most of it can be explained by ‘regulatory capture’, a practice that is unlawful. Therefore, there is a need for a new framework.

This paper proposes a framework wherein conflicts of interest arising from the revolving door are not *unlawful*, as is in the case of regulatory capture, but still lead to economic distortions. The paper introduces a market for *bureaucratic capital*, which explains why in equilibrium, the government allows this unethical, yet not unlawful, conflict of interest to persist. Our first result is that the political elite finds it optimal to allow the existence of the revolving door, as well as the creation of *bureaucratic capital*. The second result is that in equilibrium, the revolving door leads to an excessive level of *bureaucratic capital*. As a consequence, the interconnection of elites and the existence of the revolving door actually lead to lower economic growth.

1. Introduction

State capture, and the various conflicts of interest arising from the “revolving door”, have lately become subjects of intensive economic research. These phenomena have become particularly relevant after the crisis of 2008; and the possibility of a link between state capture and the financial crisis has even been raised in the literature.[1]

The “revolving door” is a common phenomenon in the United States, and is defined as heads of state agencies, after completing their bureaucratic terms, entering the very sector they have regulated. This phenomenon is also common in many developed countries.[2] Over the years, three main empirical regularities have been identified vis-a-vis the revolving door.

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[1] See OECD (2009), and Carmen Segarra’s disclosure regarding Goldman Sachs. Previous financial crises were also traced to state capture (see Fisman, 2001).

[2] See Charle (1987) and OECD (2009). In France, it has been dubbed “pantouflage” [‘easing in’, as one does into their house slippers], and in Japan, it is called *amakudari* [‘descent from heaven’].

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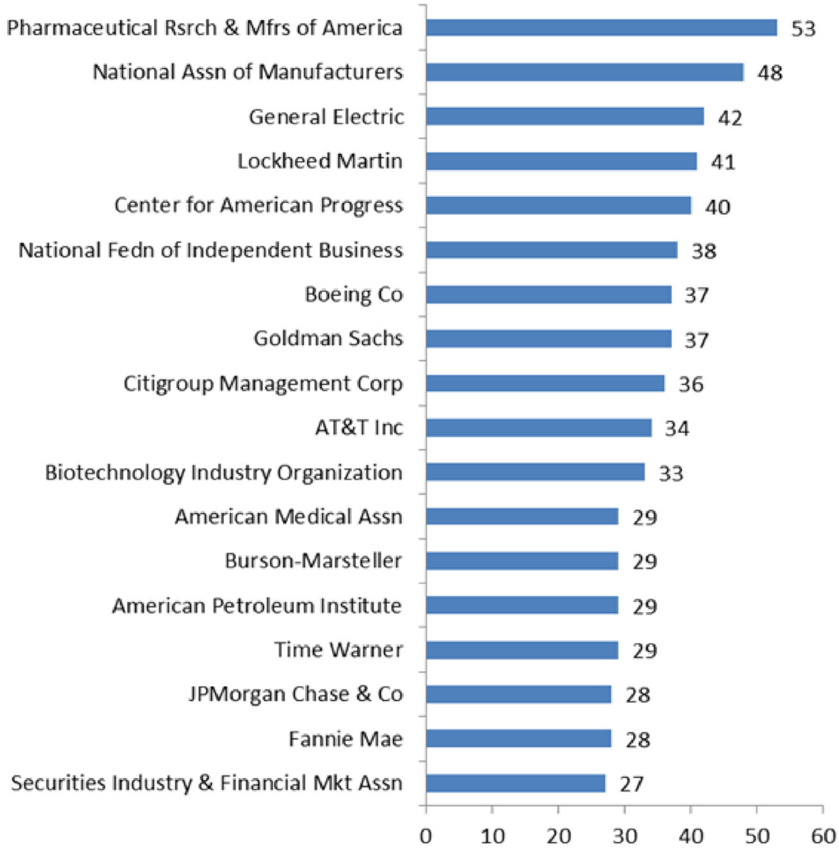

Fig. 1. Top revolving door employers in the US. *Source*: See website https://www.opensecrets.org/revolving/.

The first is that the waltz-like tempo, according to which prominent figures move from public-sector positions into the private sector, has become more intense over the last decade.[3] Moreover, the revolving door is not specific to the financial sector; it is widespread over many sectors of the economy, but not in a uniform way.[4]

Secondly, a firm's use of the revolving door affects its profits and stock share prices. Indeed, Luechinger and Moser (2014) showed that after the announcement of a former bureaucrat's appointment to a board of governors, there were positive abnormal returns to the firm. Goldman et al. (2009, 2013) found similar results.

Thirdly, over the last ten years, the revolving door phenomenon has been under scrutiny by organizations that combat conflicts of interest, and documentation of the interconnection between the various power elites has increased.[5] However, in most countries, the revolving door is not forbidden and is not declared unlawful, but rather is only mildly regulated via a "cooling-off" period.

The theoretical literature on the revolving door has mainly emphasized conflict of interest taking the form of *regulatory capture*, which focuses on fraud and unlawful behavior. *Regulatory capture* occurs when a former regulator is "captured" by one specific firm, and while strict with the others, she is lenient with this firm in order to be hired by it after leaving office. Note that this form of revolving door is unlawful in most Western countries and is perceived as pure corruption.[6] Nonetheless, it is difficult to believe that all the cases of revolving door as presented in Fig. 1 and Table 1 can be explained by fraud and unlawful behavior.

This paper proposes a framework wherein conflicts of interest arising from the revolving door are not *unlawful*, as is in the case of regulatory capture, but still lead to economic distortions. Broadly, this type of conflict of interest has been coined '*abuse of power*', and encompasses the creation of excessive regulation while in public office. As defined by

[3] See the list in *OpenSecrets* for the US and *Corporate-Europe* for the EU. The list of 'revolvers' cited in these websites is long, but to name just a few: Alan Greenspan, Glenn Hubbard, Robert Zoellick, Dick Cheney, Larry Summers, and Madeleine Albright.

[4] Figure 1 documents the strong inclination of US companies to hire large cohorts of revolving door personnel, especially in the financial sector, but also in the defense and pharmaceutical sectors. Moreover, Table 1 presents the data on the numbers of "revolvers" in Goldman Sachs, Citigroup, and Fannie Mae.

[5] See for instance *OpenSecrets, U4 Anti-Corruption Center, Transparency International*, and OECD (2009).

[6] Except for Kaufmann and Vicente (2011). Note that the wrongdoin arises while the worker is employed as a regulator, and any corruption might be difficult to prove in court. The literature on regulatory capture is presented in the next section.