

Chapter Four: Economic Analysis of Banking Regulation

The financial system is among the most heavily regulated sectors of the economy, and banks are among the most heavily regulated of financial institutions. In this chapter, we develop a framework to see why regulation of the financial system takes the form it does. Unfortunately, the regulatory process may not always work very well in many countries throughout the world. Here we also use our analysis of financial regulation to explain the worldwide crises in banking and to consider how the regulatory system can be reformed to prevent future disasters.

Asymmetric Information and Financial Regulation

Asymmetric information—the fact that different parties in a financial contract do not have the same information—leads to adverse selection and moral hazard problems that have an important impact on our financial system. The concepts of asymmetric information, adverse selection, and moral hazard are especially useful in understanding why governments choose the form of financial regulation we see in different countries. There are different categories of financial regulation: the government safety net, restrictions on asset holdings, capital requirements, prompt corrective action, chartering and examination, assessment of risk management, disclosure requirements, consumer protection, and restrictions on competition.

Government Safety Net

Financial intermediaries, like banks, are particularly well suited to solving adverse selection and moral hazard problems because they make private loans that help avoid the free-rider problem. However, this solution to the free-rider problem creates another asymmetric information problem, because depositors lack information about the quality of these private loans. This asymmetric information problem leads to several reasons why the financial system might not function well.

Bank Panics and the Need for Deposit Insurance A bank failure (in which a bank is unable to meet its obligations to pay its depositors and other creditors and so must go out of business) meant that depositors would have to wait to get their deposit funds until the bank was liquidated (until its assets had been turned into cash); at that time, they would be paid only a fraction of the value of their deposits. Unable to learn if bank managers were taking on

too much risk or were outright crooks, depositors would be reluctant to put money in the bank, thus making banking institutions less viable. Second, depositors' lack of information about the quality of bank assets can lead to bank panics, which can have serious harmful consequences for the economy.

To see this, consider the following situation. There is no deposit insurance, and an adverse shock hits the economy. As a result of the shock, 5% of the banks have such large losses on loans that they become insolvent (have a negative net worth and so are bankrupt). Because of asymmetric information, depositors are unable to tell whether their bank is a good bank or one of the 5% that are insolvent. Depositors at bad *and* good banks recognize that they may not get back 100 cents on the dollar for their deposits and will want to withdraw them. Indeed, because banks operate on a "sequential service constraint" (a first-come, first-served basis), depositors have a very strong incentive to show up at the bank first, because if they are last in line, the bank may run out of funds and they will get nothing. Uncertainty about the health of the banking system in general can lead to runs on banks both good and bad, and the failure of one bank can hasten the failure of others (referred to as the *contagion effect*). If nothing is done to restore the public's confidence, a bank panic can ensue.

A government safety net for depositors can short-circuit runs on banks and bank panics, and by providing protection for the depositor, it can overcome reluctance to put funds in the banking system.

Other Forms of the Government Safety Net Deposit insurance is not the only form of government safety net. In many countries, governments have often stood ready to provide support to domestic banks facing runs even in the absence of explicit deposit insurance. Furthermore, banks are not the only financial intermediaries that can pose a systemic threat to the financial system. When financial institutions are very large or highly interconnected with other financial institutions or markets, their failure has the potential to bring down the entire financial system.

One way governments provide support is through lending from the central bank to troubled institutions. This form of support is often referred to as the "lender of last resort" role of the central bank. In other cases, funds are provided directly to troubled institutions. Governments can also take over (nationalize) troubled institutions and guarantee that all creditors will be repaid their loans in full.

Moral Hazard and the Government Safety Net Although a government safety net can help protect depositors and other creditors and prevent, or ameliorate, financial crises, it is a mixed blessing. The most serious drawback of the government safety net stems from moral hazard, the incentives of one party to a transaction to engage in activities detrimental to the other party. Moral hazard is an important concern in insurance arrangements in general because the existence of insurance provides increased incentives for taking risks that might result in an insurance payoff. For example, some drivers with automobile collision insurance that has a low deductible might be more likely to drive recklessly, because if they get into an accident, the insurance company pays most of the costs for damage and repairs.

Moral hazard is a prominent concern in government arrangements to provide a safety net. With a safety net, depositors and creditors know that they will not suffer losses if a financial institution fails, so they do not impose the discipline of the marketplace on these institutions by withdrawing funds when they suspect that the financial institution is taking on too much risk. Consequently, financial institutions with a government safety net have an incentive to take on greater risks than they otherwise would, with taxpayers paying the bill if the bank subsequently goes belly up.

Adverse Selection and the Government Safety Net A further problem with a government safety net, like deposit insurance arises because of adverse selection, the fact that the people who are most likely to produce the adverse outcome insured against (bank failure) are those who most want to take advantage of the insurance. For example, bad drivers are more likely than good drivers to take out automobile collision insurance with a low deductible. Because depositors and creditors protected by a government safety net have little reason to impose discipline on financial institutions, risk-loving entrepreneurs might find the financial industry a particularly attractive one to enter—they know that they will be able to engage in highly risky activities. Even worse, because protected depositors and creditors have so little reason to monitor the financial institution's activities, without government intervention outright crooks might also find finance an attractive industry for their activities because it is easy for them to get away with fraud and embezzlement.

"Too Big to Fail" The moral hazard created by a government safety net and the desire to prevent financial institution failures have presented financial regulators with a particular quandary. Because the failure of a very large financial institution makes it more likely that a major financial

disruption will occur, financial regulators are naturally reluctant to allow a big institution to fail and cause losses to its depositors and creditors.

However, once large depositors know that a bank is too big to fail, they have no incentive to monitor the bank and pull out their deposits when it takes on too much risk: No matter what the bank does, large depositors will not suffer any losses. The result of the too-big to-fail policy is that big banks might take on even greater risks, thereby making bank failures more likely.

Similarly, the too-big-to-fail policy increases the moral hazard incentives for nonbank financial institutions that are extended a government safety net. Knowing that the financial institution will get bailed out, creditors have little incentive to monitor the institution and pull their money out when the institution is taking on excessive risk. As a result, large or interconnected financial institutions will be more likely to engage in highly risky activities, making it more likely that a financial crisis will occur.

Financial Consolidation and the Government Safety Net Financial consolidation poses two challenges to financial regulation because of the existence of the government safety net. First, the increased size of financial institutions as a result of financial consolidation increases the too-big-to-fail problem, because there will now be larger institutions whose failure would expose the financial system to systemic (system wide) risk. Thus more financial institutions are likely to be treated as too big to fail, and the increased moral hazard incentives for these large institutions to take on greater risk can then increase the fragility of the financial system.

Restrictions on Asset Holdings

As we have seen, the moral hazard associated with a government safety net encourages too much risk taking on the part of financial institutions. Bank regulations that restrict asset holdings are directed at minimizing this moral hazard, which can cost the taxpayers dearly. Even in the absence of a government safety net, financial institutions still have the incentive to take on too much risk. Risky assets may provide the financial institution with higher earnings when they pay off, but if they do not pay off and the institution fails, depositors and creditors are left holding the bag. If depositors and creditors were able to monitor the bank easily by acquiring information on its risk-taking activities, they would immediately withdraw their funds if the institution was taking on

too much risk. To prevent such a loss of funds, the institution would be more likely to reduce its risk-taking activities. Unfortunately, acquiring information on an institution's activities to learn how much risk it is taking can be a difficult task. Hence most depositors and many creditors are incapable of imposing discipline that might prevent financial institutions from engaging in risky activities.

Capital Requirements

Government-imposed capital requirements are another way of minimizing moral hazard at financial institutions. When a financial institution is forced to hold a large amount of equity capital, the institution has more to lose if it fails and is thus more likely to pursue less risky activities. In addition, capital functions as a cushion when bad shocks occur, making it less likely that the financial institution will fail, thereby directly adding to the safety and soundness of financial institutions.

Capital requirements for banks and investment banks take two forms. The first type is based on the **leverage ratio**, the amount of capital divided by the bank's total assets. To be classified as well capitalized, a bank's leverage ratio must exceed 5%; a lower leverage ratio, especially one below 3%, triggers increased regulatory restrictions on the bank.

Prompt Corrective Action

If the amount of a financial institution's capital falls to low levels, there are two serious problems. First, the bank is more likely to fail because it has a smaller capital cushion if it suffers loan losses or other asset write-downs. Second, with less capital, a financial institution has less "skin in the game" and is therefore more likely to take on excessive risks. In other words, the moral hazard problem becomes more severe, making it more likely that the institution will fail and the taxpayer will be left holding the bag.

To prevent this, government may adopt prompt corrective action provisions that require it to intervene earlier and more vigorously when a bank gets into trouble.

Financial Supervision: Chartering and Examination

Overseeing who operates financial institutions and how they are operated, referred to as **financial supervision** or **prudential supervision**, is an important method for reducing adverse selection and

moral hazard in the financial industry. Because financial institutions can be used by crooks or overambitious entrepreneurs to engage in highly speculative activities, such undesirable people would be eager to run a financial institution. Chartering financial institutions is one method for preventing this adverse selection problem; through chartering, proposals for new institutions are screened to prevent undesirable people from controlling them.

Regular on-site examinations, which allow regulators to monitor whether the institution is complying with capital requirements and restrictions on asset holdings, also function to limit moral hazard. Bank examiners give banks a *CAMELS rating*. The acronym is based on the six areas assessed: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. With this information about a bank's activities, regulators can enforce regulations by taking such formal actions as *cease and desist orders* to alter the bank's behavior or even close a bank if its CAMELS rating is sufficiently low.

Actions taken to reduce moral hazard by restricting banks from taking on too much risk help reduce the adverse selection problem further, because with less opportunity for risk taking, risk-loving entrepreneurs will be less likely to be attracted to the banking industry. Note that the methods regulators use to cope with adverse selection and moral hazard have their counterparts in private financial markets. Chartering is similar to the screening of potential borrowers, regulations restricting risky asset holdings are similar to restrictive covenants that prevent borrowing firms from engaging in risky investment activities, capital requirements act like restrictive covenants that require minimum amounts of net worth for borrowing firms, and regular examinations are similar to the monitoring of borrowers by lending institutions.

A commercial bank obtains a charter either from national bank. To obtain a charter, the people planning to organize the bank must submit an application that shows how they plan to operate the bank. In evaluating the application, the regulatory authority looks at whether the bank is likely to be sound by examining the quality of the bank's intended management, the likely earnings of the bank, and the amount of the bank's initial capital.

Once a bank has been chartered, it is required to file periodic (usually quarterly) *call reports* that reveal the bank's assets and liabilities, income and dividends, ownership, foreign exchange operations, and other details. The bank is also subject to examination by the bank regulatory agencies to ascertain its financial condition at least once a year.

Bank examinations are conducted by bank examiners, who sometimes make unannounced visits to the bank (so that nothing can be “swept under the rug” in anticipation of their examination). The examiners study a bank’s books to see whether it is complying with the rules and regulations that apply to its holdings of assets. If a bank is holding securities or loans that are too risky, the bank examiner can force the bank to get rid of them. If a bank examiner decides that a loan is unlikely to be repaid, the examiner can force the bank to declare the loan worthless (to write off the loan, which reduces the bank’s capital). If, after examining the bank, the examiner feels that it does not have sufficient capital or has engaged in dishonest practices, the bank can be declared a “problem bank” and will be subject to more frequent examinations.

Assessment of Risk Management

Traditionally, on-site examinations have focused primarily on assessment of the quality of a financial institution’s balance sheet at a point in time and whether it complies with capital requirements and restrictions on asset holdings. Although the traditional focus is important for reducing excessive risk taking by financial institutions, it is no longer felt to be adequate in today’s world, in which financial innovation has produced new markets and instruments that make it easy for financial institutions and their employees to make huge bets easily and quickly. In this new financial environment, a financial institution that is healthy at a particular point in time can be driven into insolvency extremely rapidly from trading losses. Thus an examination that focuses only on a financial institution’s position at a point in time may not be effective in indicating whether it will, in fact, be taking on excessive risk in the near future.

This change in the environment for financial institutions has resulted in a major shift in thinking about the prudential supervisory process throughout the world. Bank examiners, for example, are now placing far greater emphasis on evaluating the soundness of a bank’s management processes with regard to controlling risk. The focus is to provide bank examiners with tools to evaluate risk management systems.

Now bank examiners give a separate risk management rating from 1 to 5 that feeds into the overall management rating as part of the CAMELS system. Four elements of sound risk management are assessed to come

up with the risk management rating: (1) the quality of oversight provided by the board of directors and senior management, (2) the adequacy of policies and limits for all activities that present significant risks, (3) the quality of the risk measurement and monitoring systems, and (4) the adequacy of internal controls to prevent fraud or unauthorized activities on the part of employees.

Disclosure Requirements

The free-rider problem indicates that individual depositors and creditors will not have enough incentive to produce private information about the quality of a financial institution's assets. To ensure that there is better information in the marketplace, regulators can require that financial institutions adhere to certain standard accounting principles and disclose a wide range of information that helps the market assess the quality of an institution's portfolio and the amount of its exposure to risk. More public information about the risks incurred by financial institutions and the quality of their portfolios can better enable stockholders, creditors, and depositors to evaluate and monitor financial institutions and so act as a deterrent to excessive risk taking.

Disclosure requirements are a key element of financial regulation, as they focus on increasing market discipline by mandating increased disclosure by banking institutions of their credit exposure, amount of reserves, and capital.

Regulation to increase disclosure is needed to limit incentives to take on excessive risk and to improve the quality of information in the marketplace so that investors can make informed decisions, thereby improving the ability of financial markets to allocate capital to its most productive uses. The efficiency of markets is assisted by the government's disclosure requirements, as well as its regulation of brokerage firms, mutual funds, exchanges, and credit-rating agencies to ensure that they produce reliable information and protect investors.

Restrictions on Competition

Increased competition can also increase moral hazard incentives for financial institutions to take on more risk. Declining profitability as a result of increased competition could tip the incentives of financial institutions toward assuming greater risk in an effort to maintain former profit levels. Thus governments in many countries have instituted regulations to protect financial institutions from competition.

Although restricting competition propped up the health of banks, restrictions on competition also had serious disadvantages: They led to higher charges to consumers and decreased the efficiency of banking institutions, which did not have to compete as vigorously. Thus, although the existence of asymmetric information provided a rationale for anticompetitive regulations, it did not mean that they would be beneficial. Indeed, in recent years, the impulse of governments in industrialized countries to restrict competition has been waning. Electronic banking has raised a new set of concerns for regulators to deal with.

The Savings and Loan Crisis and Its Aftermath

The savings and loan and banking crisis: why?

To better understand the savings and loan and banking crisis of the 1980s, let's break up our discussion into two stages.

1. Early Stage of the Crisis

The story starts with the burst of financial innovation in the 1960s, 1970s, and early 1980s. Financial innovation decreased the profitability of certain traditional lines of business for commercial banks. Banks now faced increased competition for their sources of funds from new financial institutions such as money market mutual funds even as they were losing commercial lending business to the commercial paper market and securitization.

With the decreasing profitability of their traditional business, by the mid-1980s commercial banks were forced to seek out new and potentially risky business to keep their profits up, by placing a greater percentage of their total loans in real estate and in credit extended to assist corporate takeovers and leveraged buyouts (called *highly leveraged transaction loans*).

The existence of deposit insurance increased moral hazard for banks because insured depositors had little incentive to keep the banks from taking on too much risk. Regardless of how much risk banks were taking, deposit insurance guaranteed that depositors would not suffer any losses.

Adding fuel to the fire, financial innovation produced new financial instruments that widened the scope for risk taking. New markets in financial futures, junk bonds, swaps, and other instruments made it easier for banks to take on extra risk—making the moral hazard problem more severe. New legislation that deregulated the banking industry in USA in the early 1980s, the Depository Institutions Deregulation and

Monetary Control Act (DIDMCA) of 1980 and the Depository Institutions (Garn-St. Germain) Act of 1982, gave expanded powers to the S&Ls and mutual savings banks to engage in new risky activities. These thrift institutions, which had been restricted almost entirely to making loans for home mortgages, now were allowed to have up to 40% of their assets in commercial real estate loans, up to 30% in consumer lending, and up to 10% in commercial loans and leases. In the wake of this legislation, S&L regulators allowed up to 10% of assets to be in junk bonds or in direct investments (common stocks, real estate, service corporations, and operating subsidiaries).

In addition, DIDMCA increased the mandated amount of federal deposit insurance from \$40,000 per account to \$100,000 and phased out Regulation Q deposit-rate ceilings. Banks and S&Ls that wanted to pursue rapid growth and take on risky projects could now attract the necessary funds by issuing larger-denomination insured certificates of deposit with interest rates much higher than those being offered by their competitors. Without deposit insurance, high interest rates would not have induced depositors to provide the high-rolling banks with funds because of the realistic expectation that they might not get the funds back. But with deposit insurance and the widespread use of the FDIC'S purchase and assumption method to handle failed banks, the government was guaranteeing that the deposits were safe, so depositors were more than happy to make deposits in banks with the highest interest rates.

Financial innovation and deregulation in the permissive atmosphere of the Reagan administration led to expanded powers for the S&L industry, which in turn led to several problems. First, many S&L managers did not have the required expertise to manage risk appropriately in these new lines of business. Second, the new expanded powers meant that there was a rapid growth in new lending, particularly to the real estate sector. Even if the required expertise was available initially, rapid credit growth may outstrip the available information resources of the banking institution, resulting in excessive risk taking. Third, these new powers of the S&Ls and the lending boom meant that their activities were expanding in scope and were becoming more complicated, requiring an expansion of regulatory resources to monitor these activities appropriately. Unfortunately, regulators of the S&Ls at the Federal Savings and Loan Insurance Corporation (FSLIC) had neither the expertise nor the resources that would have enabled them to monitor these new activities sufficiently. Given the lack of expertise in both the S&L industry and the FSLIC, the weakening of the regulatory apparatus, and the moral hazard incentives provided by deposit insurance, it is no

surprise that S&Ls took on excessive risks, which led to huge losses on bad loans.

In addition, the incentives of moral hazard were increased dramatically by a historical accident: the combination of sharp increases in interest rates from late 1979 until 1981 and a severe recession in 1981–1982, both of which were engineered by the Federal Reserve to bring down inflation. The sharp rises in interest rates produced rapidly rising costs of funds for the savings and loans that were not matched by higher earnings on the S&Ls' principal asset, long-term residential mortgages (whose rates had been fixed at a time when interest rates were far lower). The 1981–1982 recession and a collapse in the prices of energy and farm products hit the economies of certain parts of the country, such as Texas, very hard. As a result, there were defaults on many S&L loans. Losses for savings and loan institutions mounted to \$10 billion in 1981–1982, and by some estimates more than half of the S&Ls in the United States had a negative net worth and were thus insolvent by the end of 1982.

2. Later Stage of the Crisis: Regulatory Forbearance

At this point, a logical step might have been for the S&L regulators—the Federal Home Loan Bank Board and its deposit insurance subsidiary, the Federal Savings and Loan Insurance Fund (FSLIC), both now abolished—to close the insolvent S&Ls. Instead, these regulators adopted a stance of **regulatory forbearance**: They refrained from exercising their regulatory right to put the insolvent S&Ls out of business. To sidestep their responsibility to close ailing S&Ls, they adopted irregular regulatory accounting principles that in effect substantially lowered capital requirements. For example, they allowed S&Ls to include in their capital calculations a high value for intangible capital, called **goodwill** (an accounting entry to reflect value to the firm of its having special expertise or a particularly profitable business line).

There were three main reasons why the Federal Home Loan Bank Board and FSLIC opted for regulatory forbearance. First, the FSLIC did not have sufficient funds in its insurance fund to close the insolvent S&Ls and pay off their deposits. Second, the Federal Home Loan Bank Board was established to encourage the growth of the savings and loan industry, so the regulators were probably too close to the people they were supposed to be regulating. Third, because bureaucrats do not like to admit that their own agency is in trouble, the Federal Home Loan Bank Board and the FSLIC preferred to sweep their problems under the rug in the hope that they would go away.

Regulatory forbearance increases moral hazard dramatically because an operating but insolvent S&L (nicknamed a “zombie S&L” by economist Edward Kane because it is the “living dead”) has almost nothing to lose by taking on great risk and “betting the bank”: If it gets lucky and its risky investments pay off, it gets out of insolvency. Unfortunately, if, as is likely, the risky investments don’t pay off, the zombie S&L’s losses will mount, and the deposit insurance agency will be left holding the bag.

This strategy is similar to the “long bomb” strategy in football. When a football team is almost hopelessly behind and time is running out, it often resorts to a high-risk play: the throwing of a long pass to try to score a touchdown. Of course, the long bomb is unlikely to be successful, but there is always a small chance that it will work. If it doesn’t, the team has lost nothing, since it would have lost the game anyway. Given the sequence of events we have discussed here, it should be no surprise that savings and loans began to take huge risks: They built shopping centers in the desert, bought manufacturing plants to convert manure to methane, and purchased billions of dollars of high-risk, high-yield junk bonds. The S&L industry was no longer the staid industry that once operated on the *3-6-3 rule*: You took in money at 3%, lent it at 6%, and played golf at 3 p.m. Although many savings and loans were making money, losses at other S&Ls were colossal.

Another outcome of regulatory forbearance was that with little to lose, zombie S&Ls attracted deposits away from healthy S&Ls by offering higher interest rates. Because there were so many zombie S&Ls in Texas pursuing this strategy, above-market interest rates on deposits at Texas S&Ls were said to have a “Texas premium.” Potentially healthy S&Ls now found that to compete for deposits, they had to pay higher interest rates, which made their operations less profitable and frequently pushed them into the zombie category.

Similarly, zombie S&Ls in pursuit of asset growth made loans at below-market interest rates, thereby lowering loan interest rates for healthy S&Ls, and again made them less profitable. The zombie S&Ls had actually taken on attributes of vampires—their willingness to pay above-market rates for deposits and take below market interest rates on loans was sucking the lifeblood (profits) out of healthy S&Ls.

Political Economy of the Savings and Loan Crisis

Although we now have a grasp of the regulatory and economic forces that created the S&L crisis, we still need to understand the political forces that produced the regulatory structure and activities that led to it. The key to understanding the political economy of the S&L crisis is to recognize that the relationship between voter-taxpayers and the regulators and politicians creates a particular type of moral hazard problem: the *principal-agent problem*, which occurs when representatives (agents) such as managers have incentives that differ from those of their employer (the principal) and so act in their own interest rather than in the interest of the employer.

The Principal-Agent Problem for Regulators and Politicians

Regulators and politicians are ultimately agents for voter-taxpayers (principals), because in the final analysis, taxpayers bear the cost of any losses by the deposit insurance agency. The principal-agent problem occurs because the agent (a politician or regulator) does not have the same incentives to minimize costs to the economy as the principal (the taxpayer).

To act in the taxpayers' interest and lower costs to the deposit insurance agency, regulators have several tasks, as we have seen. They must set tight restrictions on holding assets that are too risky, must impose high capital requirements, and must not adopt a stance of regulatory forbearance, which allows insolvent institutions to continue to operate. However, because of the principal-agent problem, regulators have incentives to do the opposite. Indeed, as our sad saga of the S&L debacle indicates, they have at times loosened capital requirements and restrictions on risky asset holdings and pursued regulatory forbearance. One important incentive for regulators that explains this phenomenon is their desire to escape blame for poor performance by their agency. By loosening capital requirements and pursuing regulatory forbearance, regulators can hide the problem of an insolvent bank and hope that the situation will improve. Edward Kane characterizes such behavior on the part of regulators as "bureaucratic gambling."

Another important incentive for regulators is that they want to protect their careers by acceding to pressures from the people who most influence their careers. These people are not the taxpayers but the politicians who try to keep regulators from imposing tough regulations on institutions that are major campaign contributors. Members of Congress have often lobbied regulators to ease up on a particular S&L that contributed large sums to their campaigns. Regulatory agencies that have little independence from the political process are more vulnerable to these pressures. In addition, both Congress and the presidential administration promoted banking legislation in 1980 and 1982 that made it easier for savings and loans to engage in risk-taking activities. After the

legislation passed, the need for monitoring the S&L industry increased because of the expansion of permissible activities.

The S&L regulatory agencies needed more resources to carry out their monitoring activities properly, but Congress (successfully lobbied by the S&L industry) was unwilling to allocate the necessary funds. As a result, the S&L regulatory agencies became so short-staffed that they actually had to cut back on their on-site examinations just when these were needed most. In the period from January 1984 to July 1986, for example, several hundred S&Ls were not examined even once. Even worse, spurred on by the intense lobbying efforts of the S&L industry, Congress passed the Competitive Equality in Banking Act of 1987, which, as we have seen, provided inadequate funding to close down the insolvent S&Ls and also hampered the S&L regulators from doing their job properly by including provisions encouraging regulatory forbearance.

As these examples indicate, the structure of our political system has created a serious principal-agent problem; politicians have strong incentives to act in their own interests rather than in the interests of taxpayers. Because of the high cost of running campaigns, American politicians must raise substantial contributions. This situation may provide lobbyists and other campaign contributors with the opportunity to influence politicians to act against the public interest, as we see in the FYI box on the previous page.