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AGENTS, INSTITUTIONS, AND THE POLITICAL ECONOMY OF PERFORMANCE

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>
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THIS BOOK introduces a new approach to the politics of money focused on the decisive role played by central bankers themselves. There is a surprisingly large gap between what we know about the behavior of ideal central bankers, and how *real* central bankers make crucial decisions about interest rates, inflation, unemployment, and economic growth. To understand how monetary policy really works, I offer practical means of measuring, explaining, and predicting central bankers' preferences and the effects of those preferences on economic outcomes.

I argue that patrons, or "shadow principals" in the financial sector and partisan governments, shape the beliefs and career incentives of bureaucratic agents otherwise legally insulated from outside pressure. This claim is simple but has important implications. Focusing on developed countries between the end of Bretton Woods and the birth of the euro, with sidetrips to developing countries and earlier periods, I show that career theories of central banker behavior explain substantial differences in interest rate decisions, inflation rates, and in some cases, real economic performance, especially in countries with independent central banks.

The concept of shadow principals lets us revisit the role of outside pressures on monetary policy. The political influence of banks is now a critical public issue in many industrial democracies. From the sober assessment of MIT economist Simon Johnson, who argues the six largest American banks are a dangerous "oligarchy" threatening public welfare, the economy, and democracy itself (Johnson and Kwak, 2010, 221), to Matt Taibbi's furious diatribes against Goldman Sachs, the "great vampire squid wrapped around the face of humanity," condemnation of the political activities of the financial sector has reached a pitch not heard in a century.[1] Populist fury against the combination of bank bailouts and public austerity has brought down governments in Iceland, Ireland, Spain, and Greece. Disapproval of state favoritism toward banks and bankers is perhaps the only thing the American left and right can publicly agree on. Arguably, no sector of the ecomomy is more responsible for the economic crisis that began in 2008, yet no other sector has emerged more profitably, or with greater leverage over policy in the United States and Europe.

Solving the problem of overpowered banks depends on understanding the origins of their political influence. Is financial sector influence on politics a new phenomenon dating back just to the deregulation of American banks in the 1990s? Is it the result of the massive increase in financial sector concentration over the last decade, likely to recede (as some argue) if the largest banks are broken up? Would new, legally independent regulatory agencies be sufficient to restore the balance of power between public regulators and banks? By focusing on the making of monetary policy, the central mission of supposedly autonomous central banks, I cast doubt on the idea that heavy financial sector influence on economic policy is new, operating through new channels, or solvable through institutional reform alone. We have only underestimated outside influence on policy because of the masking role of a supposedly perfect form of political independence, embodied by the modern central bank. Once we recognize the systematic ability of private banks to influence central bankers' future careers, the enduring basis of private banks' ability to shape the policies set by central banks – from interest rates to bailouts – becomes clear.

To gain a deeper understanding of the politics of central banking, I take a broadly comparative approach to monetary policy, centered on agents. Central bankers' ranks are much larger than the handful of celebrities – Greenspan, Volcker, Trichet, Bernanke – who make monthly rounds in the headlines. We can learn much more about monetary policy if we cast our nets wide enough to include the hundreds of monetary policy board members who have collectively set the interest rates of dozens of economies over the last half century. Though my focus is on individual decision makers, I do not tell a story of personalities.

1 Matt Taibbi, 2010, "The Great American Bubble Machine," *Rolling Stone*, April 5.

Instead, I trace the patterns and incentives underlying central bankers' policy preferences and behavior using the ideas and tools of modern political economy, and emphasizing the political and institutional context in which central bankers operate.

But the arguments I make about the policy preferences of central bankers have implications beyond monetary policy and should inform the wider debate on delegation and institutions in political economy. I offer not only a theory of how bureaucratic agents' preferences and behavior can be understood through career effects, but also tools of quantitative measurement and statistical analysis designed to efficiently catalog bureaucrats' career experiences and assess the effects of those careers in a wide variety of bureaucratic contexts. If models and measures of bureaucratic preference can shed new light even on monetary technocrats, there is little doubt the same techniques will reveal new insights about regulators and policy implementers in all corners of the state.

Interests and Institutions in Comparative Political Economy

Comparative political economy is the study of what happens when political and economic actors with different interests interact within different institutional contexts.[2] The political economy of performance, an important subfield within comparative political economy, is interested in how the interactions of institutions and preferences shape economic outcomes. But the balance between these two variables has tilted firmly to institutions, with scholars paying less attention to individuals' preferences, some attention to large groups such as political parties, industrial sectors, or economic classes, and a great deal of attention to the rules of the political games that individuals and groups play.

By focusing on long-overlooked organizing features of the social world, the institutionalist turn in comparative political economy has yielded impressive advances. Earlier economic and sociological analyses glossed over variation in

2 The actors of interest are individuals and organizations (formally constituted groups) of individuals. *Institutions* are formal and informal rules defining permitted interactions among individuals and organizations (North, 1990). Recursively, these include the rules that constrain the interaction of individuals within organizations. *Interests* are the preferences of actors over policies, induced by their underlying preferences over economic and political outcomes and their *ideas* about the causal relationships among them (Hall, 1989; Blythe, 2002). If we can take for granted that actors with the same preferences share the same economic ideas, descriptions of interest can even subsume ideas, at least within a shared context. For the most part, I talk only of interests and institutions, leaving economic ideas in the background.

institutional context and its effects on incentives and behavior. These perspectives struggled to explain differences in political economic outcomes across cases with congruent economic conditions, societal demands, and endowments of technology and capital. In contrast, institutional theories offered powerful new explanations of diverse long-standing problems.[3] If the new institutionalism has opened up new ways of seeing politics, it has also – unintentionally and unnecessarily – created new blindspots. Most often lamented is the weakness of institutional explanations of change, but the most important may be the tendency to under-study the agency and interests of actors operating within the constraints of rules. Human actors working within institutions play an indispensable role, and their preferences and strategies are inextricably linked with the outcomes institutional scholars study. Their interests shape the content of policy from everyday decisions on budgets and regulations to the extraordinary questions raised by social revolutions and institutional design. But the role of agents is often submerged, especially in empirical tests of institutional theories.

Agent preferences can flow *from* institutions, a phenomenon contemporary institutionalists are well prepared to study (North, 1990; Knight, 1992; Zysman, 1994; Acemoglu, Johnson, and Robinson, 2004). But the relationship between interests and institutions is not always so one-sided. At other times, preferences shape institutions – either suddenly, when institutions are made from scratch, or gradually, through the layering of changes on top of existing institutions.[4] Most often, however, preferences and institutions persist independently, jointly determining policy outcomes. To comprehend cases in which

3 Institutional theories help explain why, despite similar natural endowments, some nations develop and others do not (North, 1990; Acemoglu, Johnson, and Robinson, 2004); why different economies have "failed" to converge on the neoliberal model (Hall and Soskice, 2001; Hollingsworth and Boyer, 1997); why public policy changes rapidly in some polities, and remains frozen in others (Tsebelis, 2002); why some governments exercise more oversight than others (Huber and Shipan, 2002); why labor market systems evolved differently across the industrialized world (Swenson, 1991; Thelen, 2004); whether and how governments manipulate the economy for electoral gain (Clark and Hallerberg, 2000); and on and on. Casting our net beyond political economy, institutionalism has helped explain why social unrest only rarely culminates in social revolution (Skocpol, 1979); how the modern state develops from the legacies of past institutions (Skowronek, 1982; Ertman, 1997); and how legislatures resolve the fundamental ambiguities of majority rule (Shepsle and Weingast, 1981; Laver and Shepsle, 1996), among many other examples.

4 Thelen (2004) calls this layering process "conversion." An example can be found in the development of the Federal Reserve from its birth in 1913 to its divorce from the

agent preferences are at least partially exogenous, we need to shine a spotlight on the agents themselves.

For a concrete example of the successes and limitations of current institutionalist practice, I consider one of the most famous, accepted, and influential topics of institutionalist scholarship, the independent central bank. After the Great Inflation of the 1970s, economists on the hunt for general explanations and solutions for this persistent problem found an attractive explanation in the concept of time inconsistency. Elected governments, even if they understand that easy money is no free lunch, are tempted to occasionally stimulate the economy through unexpected jolts to the money supply. Unless this temptation is banished, inflation will be permanently higher (Kydland and Prescott, 1977). Later authors suggested the problem could be resolved by passing on responsibility for monetary policy to an agent with credible anti-inflation preferences, so long as that agent's independence from the elected government was legally guaranteed (Barro and Gordon, 1983; Rogoff, 1985). When still more studies found that central bank independence (CBI) was correlated with low inflation, countries the world over jumped on the CBI bandwagon (Grilli, Masciandaro, and Tabellini, 1991; Cukierman, Webb, and Neyapti, 1992; Alesina and Summers, 1993; Maxfield, 1997). Although it remains an open question whether the low inflation of the 1990s was a result of higher CBI, the appearance of success was enough to convince twelve members of the European Union to create the über-independent European Central Bank (McNamara, 1998). But institutional independence is not the the whole story of monetary policy, and central bank independence brought not the "end of history" for central banks, but a new set of questions.

The CBI literature exemplifies the popular principal–agent model of delegation.[5] Many problems in politics are intrinsically dilemmas of delegation, in which a political executive (the principal) must choose a bureaucrat (the agent) to carry out her agenda. Granting discretion to an agent entails two dangers for the principal, both of which hinge on the agent's informational advantages over her. First, there is the *moral hazard* that an agent might secretly benefit at the expense of the principal. Second, there is the possibility that by *adverse selection*, the principal has unwittingly chosen an agent with dissonant policy preferences

Treasury in 1951; Meltzer (2003) claims the cumulative change rendered the institution unrecognizable to its founders.

5 For reviews of the application of principal–agent models to bureaucratic delegation, see Bendor, Glazer, and Hammond (2001) and Meier and Krause (2003*b*). For a rigorous introduction to the logic of these models, see Laffont and Martimort (2002).

who will implement a policy at odds with the principal's agenda. The principal–agent framework highlights the importance of the interests of principal and agent, on one hand, and of the institutions of agent selection, monitoring, and enforcement on the other. Elegant theoretical and empirical work tackles the question of how political principals monitor, discipline, constrain, oversee, or otherwise control the bureaucracy (McCubbins, Noll, and Weingast, 1987; Epstein and O'Halloran, 1999; Huber and Shipan, 2002).

But there is something missing from this literature. Regarding principal–agent relationships, and especially monetary delegation, James March (1997) hits the bullseye when he laments that "[w]e know more about abstract agents dealing with abstract principals than we do about real bureaucrats dealing with real politicians." The modern approach to the bureaucracy devotes the lion's share of attention to legislatures and executives, often treating the bureaucracy and its preferences as a "black box," and in the case of central banks, a *deus ex machina*.[6] Studies of principal–agent relationships usually focus on what principals want and the enforcement mechanisms they use to discipline agents, but spend little time finding out what agents desire. Yet how can we understand what constraints achieve if we do not know what they are constraining?

Agents, Institutions, and Change

Treating the bureaucracy as a black box fosters dangerous habits. If we never peek in the box, we might assume its contents never change. Static thinking impoverishes the stock of explanations for change, limiting political agency to rare "critical junctures," crises when the rules of the game can be rewritten. During those periods, actors design new institutions to systematically advantage themselves in the future (Knight, 1992; Katznelson, 2003; Thelen, 2004). But if agents can pack their preferences into institutions, the temptation arises to treat institutions as sufficient statistics of the political system. We end up with punctuated equilibrium theories that overwork the few available explanations and

6 Meier and Krause (2003*a*) identify inattention to bureaucrats as the key failing of the bureaucracy literature. They applaud the growing "theoretical and empirical understanding of the motivation, incentives, and tactics employed by political institutions to mold bureaucracy," but warn that in failing to "reserve a place for the bureaucracy at the table … we get a portrait of bureaucracy that is neither bureaucracy centered nor institutionally balanced."

overlook gradual changes during periods of apparent equilibrium.[7] In particular, people seem simply redundant to explanations of outcomes during settled times.

But agents, groups, and even social forces come and go. Pierson (2004) takes punctuated equilibrium theories to task for assuming an impossible degree of actor continuity. Even if the rules governing a specific bureaucracy were put in place to serve a particular policy goal held by a particular faction, many years and shocks to the political system later, new actors inhabiting or interacting with the bureaucracy may employ the same institutions to unanticipated ends (Pierson, 2004; Thelen, 2004).[8] As the agents of a bureaucratic organization change over time – because of elections, retirement, recruitment, and career shuffling – the original purpose of an agency can be buried or even subverted without any alteration of its governing charter.

Political economists are beginning to recognize that the actors inside bureaucracy are neither timeless nor inert. At the same time, institutionalists are breaking free of the punctuated equilibrium setup to consider ways in which actors – including principals, agents, and outsiders – chafe at institutional constraints. As Streeck and Thelen (2005) put it,

> Political institutions are not only periodically contested; they are also the object of ongoing skirmishes as actors try to achieve advantage by interpreting or redirecting institutions in pursuit of their goals, or by subverting or circumventing rules that clash with their interests.... [T]he aim must be to understand ... the way actors cultivate change from within the context of existing opportunities and constraints – working around elements they cannot change while attempting to harness and utilize others in novel ways.

As an effort to re-evaluate the interplay of structure and preference in policy making, this book falls neatly within Streeck and Thelen's agenda. In particular, I discuss various ways in which the *interaction* of institutions and successive generations of agents influences policy outcomes. Doing so uncovers an underappreciated answer to a commonly perceived limitation of institutional theories

7 The punctuated equilibrium metaphor originates in evolutionary biology (Eldredge and Gould, 1972), and is subject to similar critiques there (Dawkins, 1986).

8 An American example: the laborers and farmers who fought for the 1890 Sherman Act – a policy change allowing the courts to restrain industrial monopolists – were doubtless chagrined when conservative judges later used the same law to curtail union activities (Letwin, 1981).

	Country A		Country B	
	Period 1	Period 2	Period 1	Period 2
Institution	○	○	□	□
Agent	+	−	+	−
Outcome	⊕	⊖	■	■

Figure 1.1. *How static institutions cause change through agent replacement.* In some cases, an institution (○) gives agents the autonomy to affect outcomes, such that the final outcome is a synthesis of agent preferences (+ or −) and institutional effects (yielding ⊕ or ⊖). Other institutions (□) constrain agents to produce the same outcome (■) regardless of agent preferences.

of policy, the difficulty of explaining change. Whereas institutions often provide explanations – even too many explanations – of cross-sectional variation, it seems at first impossible that static institutions could "explain" variation in outcomes over time. But if actors and their preferences are changing over time, and interacting with static institutions, those institutions can matter. In fact, studying interactions can add a necessary dose of gradualism to the punctuated equilibrium models so common in comparative political economy.

Figure 1.1 provides a simple representation. Two countries (A and B) studied over two periods (1 and 2) have different time-invariant policy making institutions (○ and □, respectively). In period 1, type + agents set policy under each country's institutional rule, and in period 2, type − agents take over. The figure illustrates an example where the effects of institutions are felt through the change in agents over time: institution ○ allows agents to change the policy outcome, whereas institution □ does not. From a comparative perspective, it would be misleading to say that either agents or institutions alone caused the outcomes to differ. What matters is their joint effect, which can be discerned even though the institutions are static.[9] In Chapter 6, I exploit this logic to im-

9 One methodological upshot is that the interaction of agent preferences and static institutions offers political economists working with panel data the chance to escape the dilemma posed by fixed effects specifications. Including fixed effects in a panel data model protects estimates of the effects of time-varying covariates from confounding by omitted time-invariant variables. However, the same protection does not extend to any time invariant institutions for which we might want parameter estimates. Even if these parameters are backed out of the model, our estimates of them will still be subject to confounding by any of the myriad omitted static features of the units stud-

prove our understanding of the effects of mostly static institutions when run by different agents.

Many institutionalists concede their theories explain continuity far better than change (DiMaggio and Powell, 1991; Orren and Skowronek, 1994). As Thelen (1999) emphasizes, change in an institutionalized world must come from exogenous shocks – shocks which either so disorder politics that real institutional reconfiguration is possible, or which institutions withstand and mediate in unique ways. Exogenous shocks might include technological change or (in North's (1990) deceptively modest phrase) changes in relative prices. Orren and Skowronek (1994) add the insight that exogenous shocks can also come from the collision of different institutional streams.[10]

I emphasize a different kind of shock – the turnover of agents within institutions. New agents transform institutions and policies from the inside out. Change can happen suddenly, when a new regime installs its own elite civil servants, or it can also occur gradually, when the training, socialization, and career interests of bureaucrats shifts over years and generations. Therefore, even the routine replacement of personnel provides insights into the process of change between critical institutional events.

Bringing Bureaucrats Back In

Ironically, just as some political economists were relegating the study of real actors to the backseat in favor of institutions and ideal representations of actors, strands of research in other fields of political science, notably the study of legislatures and courts, moved in the opposite direction. Understanding the motivations and preferences of political actors is now a core component of the American politics research agenda, as the large literature surrounding ideal point estimation shows. Extending its reach into the study of courts and Supreme Court

ied. Agent-institution interaction terms, on the other hand, can be estimated without omitted variable bias in a fixed effects panel model. The analyst can simply control for both the time-varying agent preferences and their interaction with institutions, which is always time varying. Note that if fixed effects are used, the institution itself must be omitted from the specification, as this base term is already incorporated in the fixed effect.

10 Acemoglu, Johnson, and Robinson's (2002) "reversal of fortune" is a world-shaping example.

Justices, this literature resists the puzzling tendency to assume some political actors are different: not economically rational beings but selfless wise men.[11]

Central bankers are the most important political actors still veiled by the myth of bureaucratic impartiality. The myth has many sources, including fawning accounts of central bankers as oracles (Woodward, 2000), but it draws sustenance from economists' eagerness to treat monetary policy as a purely technical problem with an optimal solution, downplaying or dismissing its distributive consequences. Not least, the myth of neutrality persists because central bankers have every reason to feed it – it is always easier to be considered above politics, whether or not one has a political agenda (Kettl, 1986).

Like legislators, executives, judges, and other bureaucrats, central bankers are political agents with their own interests and plans. As with any question of bureaucratic decision-making, to comprehend monetary policy choices we must know the goals of the central bankers themselves. Of course, we also need to know something about the institutions central bankers inhabit, the constraints they operate under, and the governments that appoint them. But it is not sufficient to know these things: an understanding of policy delegation that ignores agents' preferences will be flawed, with rare exceptions.

What do bureaucrats want? A simple typology of motivations helps work through the myriad answers political scientists, sociologists, and economists have offered to this question.[12] The catalog is incomplete, but it helps fix the reasons bureaucrats might work or shirk, and the ends to which they direct their efforts.

Table 1.1 classifies eight material and non-material bureaucratic motives. Perhaps the oldest view of state officials supposes the rewards of office come from the power of office to set policy. On this view, bureaucratic agents can be political players. Recognizing that battles over regulation and distribution have winners and losers, these bureacratic agents gain ego-rents from picking the winners.[13] A second, rarer politicized bureaucrat seeks power itself. Their num-

11 The seminal work on Congress is Poole and Rosenthal (1997). For the study of judges' preferences, see Segal and Cover (1989); Segal and Spaeth (1993, 2002); Martin and Quinn (2002); and Epstein and Knight (1998). Although most central banks provide no record of their members' voting behavior, the Federal Reserve does, and several attempts have been made to tease preference information out of these data (Chang, 2003; Chappell, McGregor, and Vermilyea, 2004*a*); see Chapter 4.

12 See also Downs (1967), Wilson (1991), Brehm and Gates (1999), and Golden (2000) for overviews.

13 Examples of models that assume bureaucrats are policy seekers are too numerous to name. It should be said that many of these studies use "policy" as an implied short-hand