

# When Main Street Deters Wall Street : Conflict, Inequality and Political Capture

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## 1. Introduction

The unfolding of the global economic and financial crisis is characterized by increasing risks of social unrest in many countries. Bailout plans of the financial system highlights conflicting interests between banks – Wall Street – and individual taxpayers and non-financial firms – Main Street. Financial executives and professionals' compensation have led to public outrage following bonuses announcements. Bankers have the sense that the crisis resolution is in hands of politicians. Therefore better understanding the political economy of the current policy-making dynamics can become crucial in the management of the crisis.

With decreasing monetary resources for lobbying, political capture by different groups in the society may rely more heavily on the production and transmission of information to policy-makers. Who is more likely to win the race for influence in the current circumstances? How should this impact policymaking and special interest groups' behavior? So far little attention has been paid to the new political interactions that may result from the current crisis.

In order to bring more insights on these issues, this short paper presents an analytical framework developed by the author (Ansón, 2006) and applies it to the current political and economic situation. Section 2 introduces the intuition of the model. Section 3 provides the interpretations that could be made in the current circumstances using the model.

## 2. The Model

Two groups, Wall Street on the one hand, and Main Street, on the other hand, compete for political influence. Assume they have conflicting interests and unequal stakes. They must decide:

i) whether to organize a lobby or not; ii) how much effort they put into this activity to produce information, before iii) the government decides to choose among a set of policies with unknown payoffs including the status quo, the worst policy for all, the best policy for the government, the best policy for Main Street, and the best policy for Wall Street. Without enough information available, all policies look alike except the status quo with zero payoffs for all the parties. The government picks the policy on the basis of its own independent information – if available – and the one forwarded to it by Main Street and Wall Street – if not. It has the final decision right (called formal authority), but may choose the policy using Main Street and Wall Street information when itself insufficiently informed, thereby giving the decision power (called real authority) to either Main Street or Wall Street. How does Wall Street react to Main Street's influence effort and vice versa? The figure 1 below describes it.

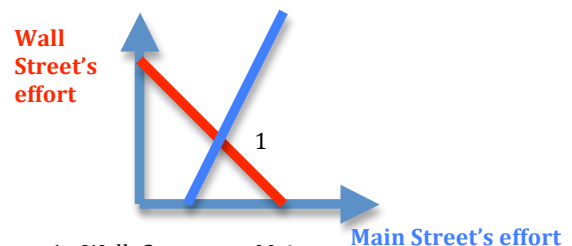


Figure 1: Wall Street vs. Main Street's influence efforts

The higher Wall Street's efforts are in recovering political influence through the production of information, the higher Main Street's response is in terms of efforts (the blue line) yet the higher Main Street's efforts the lower Wall Street's response (the red line).<sup>1</sup>

<sup>1</sup> An example of influence efforts can be found at: [www.opensecrets.org/lobby/top.php?showYear=2008&indexType=c](http://www.opensecrets.org/lobby/top.php?showYear=2008&indexType=c)

Why is this so? When Main Street knows what is the best policy among the possible ones, then Wall Street has less residual decision power should it also know its. The reason for is an insufficiently informed government will give a preference to Main Street should both groups know (Main Street votes while Wall Street doesn't, and is thus better aligned with the government). Hence the mobilization of efforts by Main Street reduces Wall Street's political response in terms of production of information to be conveyed to the government if bankers weigh the costs of influence efforts relative to the expected policy payoffs. Eventually this strategic interaction between Main Street and Wall Street results in influence equilibrium efforts at the point 1 of intersection between the blue and red lines in figure 1. This is true for any given level of conflicting interests between Main Street and Wall Street. What happens in terms of reactions if this conflict now worsens?

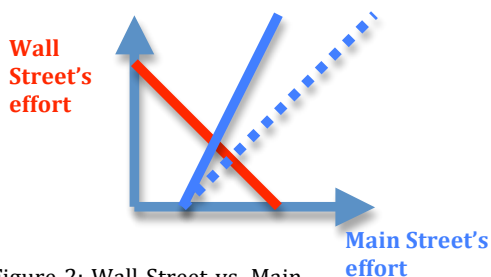


Figure 2: Wall Street vs. Main Street's influence efforts with higher conflict

When conflict worsens, Main Street's blue line moves to the right (the new dashed blue line in figure 2) resulting in a higher equilibrium influence effort by Main Street and a lower equilibrium influence effort by Wall Street (the equilibrium being the intersection of the dashed blue and red lines), that is in higher recovery of political decision for Main Street with respect to Wall Street. A very interesting first property of the model is that Main Street reacts relatively more than Wall Street to increased conflicting interests (a sort of motivation device).

What happens if, instead of an increasing conflict of interests, Main Street and Wall Street's stakes become more unequal? With higher inequality, Wall Street's red line moves to the right (the new dashed red line in figure 3) ensuring a new equilibrium with both an increased influence effort for Wall Street and Main Street (i.e. the intersection of the dashed red and blue lines). Another very interesting property of the model is that Wall Street's reaction in terms of lobbying effort is more sensitive to inequality than Main Street's. This is so because increasing stakes for Wall Street also increase its potential losses when Main Street succeeds in recovering political decision power through its information efforts.

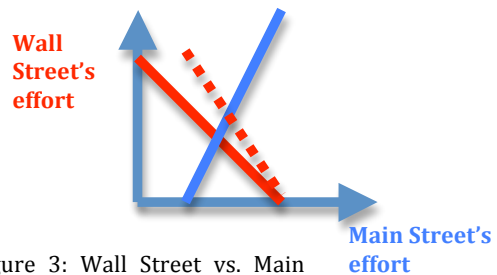


Figure 3: Wall Street vs. Main Street's influence efforts with higher inequality

The results described so far have supposed that both Main Street and Wall Street will always lobby the government for influence – stages ii) and iii) of the model as stated above. But could Wall Street decide – stage i) – to save its lobbying efforts and not lobby at all in some circumstances? This will ultimately depend on whether it makes it better off or not. If one considers the decision to form a lobby – stage i) – the model shows that Wall Street could indeed interrupt its lobbying for high enough levels of conflicting interests and prefer giving up a chance to capture more political decision power. This could be reinforced by higher inequality as well; and a less self-informed government could further increase the likelihood of such an outcome. Main Street could indeed deter Wall Street from participating in the political process and influence become one-sided. The reason

for is Main Street's efforts mobilization could make Wall Street's influence efforts useless in pursuing its own interests due to its extremely low probability of eventually capturing political decision power – and thus benefiting from some rents. In these circumstances, what lessons could be learnt regarding the current crisis?

### 3. Lessons from the model for the management of the current crisis

The model highlights three key elements that will determine whether a policy issue is influenced by both sides, or only one: the level of conflicting interests, the level of stake inequality between the different parties involved, and the level of government's own information. What do we observe in the present crisis? The level of conflicting interests becomes increasingly higher between Main Street – including taxpayers and non-financial firms – and Wall Street. The level of stake inequality has reached record levels during the last two decades and encouraged high holding of debt by individuals – as a substitute to higher wages. The same is generally true regarding the monetary rewards of financial vs. non-financial firms. The current level of government's own information on so-called toxic assets – related to bad loans and subprime mortgages – is low. According to the model's predictions, the combination of these elements makes the one-sided influence by Main Street more likely than ever before on an increasing number of policy issues related to the crisis. Now, in these circumstances, was it strategically sound for Wall Street to maintain important bonuses? The model's answer is unambiguous: it wasn't. It was indeed a move in the wrong direction. By so doing, it increased – through the strategic interaction between Main Street and Wall Street in terms of influence – the likelihood of an equilibrium switch from two-sided to one-sided influence by Main Street due to the aforementioned combined impact of high inequality,

higher conflict of interest, and high level of government's ignorance on the right policy choices. Yet the current scarcity of information in hands of the government asks for more information from Main Street and Wall Street rather than less.

Another interesting property of the model is that – provided high enough conflicting interests as this is the case in the current global economic and financial crisis – decreases in inequality needed to achieve again more two-sided influence are likely to be very large when the respective stakes are initially highly unequal – and this is today's case between Main Street and Wall Street. On the contrary, when departing from a situation with moderate levels of inequality, a small increase of the latter may also quickly lead to one-sided influence by “la Grand-Rue” (the Main Street in French language).

One-sided lobbying creates two major risks in the current circumstances: populism on the one hand, and a jeopardized democratic process on the other hand. Populism may lead to a temporary control of bonuses and executive pay in the financial sector while doing very little to achieve real sustainable decreases in inequality in the medium and long run – and the conflicting interests between Wall Street and Main Street's taxpayers and non-financial firms are in the medium and long term horizon. Another undesired consequence of one-sided lobbying by Main Street could be a government circumventing the democratic process for a number of decisions. Fixing the financial system is paramount to the crisis resolution yet the model also suggests that it could be very difficult to achieve this highly desirable outcome without two-sided influence; and this ultimately depends on a massive decrease in the current level of inequality between Main Street and Wall Street or – in the other polar case – avoiding any slight increase in inequality when its initial level is moderate. For Wall Street's sake (and stake), this is the price to be paid for better business prospects tomorrow, thereby prevent-

ing Main Street from succumbing to dangerous populist temptations or being increasingly discarded by the government in an undemocratic way (as shown by increasing bureaucratic cognitive capture). Only Wall Street is to rescue Main Street now.

#### Reference

Ansón, José (2006). Conflict, Stake Asymmetry and Capture of Real Political Authority. PhD Dissertation, University of Lausanne (Switzerland).

#### Important disclaimer:

This paper expresses the sole views of the author; all possible remaining errors are his. The terms Wall Street and Main Street are not specific to any particular country but generic with the sole purpose of modeling.