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The Politics of Bank Bailouts

Raphael Reinke

Thesis submitted for assessment with a view to
obtaining the degree of Doctor of Political and Social Sciences
of the European University Institute

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Department of Political and Social Sciences

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To Heribert, Marianna and Sarah

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Crisis, banks and business power

1.1 Das Bailout

The failure of Lehman Brothers in the fall of 2008 started not only a financial crisis, but a crisis for capitalism. Banks, the epitome of the capitalist firm, hinged on the support of the state. No investor or insurance firm could stem the losses; only the state could restore confidence.

The failing banks also prompted a crisis for democracy. Faced with spreading turmoil in markets, politicians cobbled together rescues within a couple of weeks. This haste prevented journalists from penetrating the bailout options and explaining the difference to the public. It also curtailed deliberations in parliament. Government officials made policy decisions in closed rooms negotiating with bankers. Importantly, governments around the world channeled huge sums into their banking sectors. The rescue of banks amounted to a colossal nationalization of risks. Banks had incurred more and more risks in overheating markets, and when markets turned sour, the state picked up the bill. These bailouts bring to the fore the primacy of business power and cast ever greater doubt on the ability of democracy to produce equity. The issue is no longer whether Schattschneider's (1960) heavenly chorus sings with an upper class accent, but whether the act has turned into a business solo.

The rescue of banks created an unlikely alliance of censure across the political spectrum. Leftist critics decry the support for rich bankers. Critics from the

right condemn state activism as big government, *Atlas Shrugged* turned real.¹ The left and right demand different alternatives—state support for struggling homeowners and the nationalization of banks on the left, market discipline on the right (e.g. Lendman, 2011; Woods Jr, 2009; Melloan, 2009), but both ideological camps vilify state support for banks.

The use of the term “bailout” captures some of this widespread criticism. In American public debates, the suggested name by the government for the rescue, TARP, never really stuck. Instead, policymakers and pundits referred to the rescue as the bailout. The term featured prominently in the news; it was the most frequently looked-up word in Merriam Webster’s and was chosen by the American Dialect Society’s for the 2008 word of the year. Bailout is often used to evoke a negative image, as in titles like “Financing Failure: A Century of Bailouts” (McKinley, 2011) or “Das Bailout”² (to evoke Marx). The common dictionaries, however, define the term innocuously as “the act of rescuing something (such as a business) from money problems.”³ I use the term in this sense, as synonym for rescuing banks from money problems, and its politics are the topic of this thesis.

The pundits of the day lauded the British government for its decisive and well-designed rescue plan. At the same time, they criticized the American crisis management as catering to Wall Street. This verdict fits the partisan view that right-wing governments look out for their constituency in the financial sector. It also conforms to the interest explanation that Wall Street is well connected to the Treasury and to the offices on Capitol Hill. Moreover, it goes well with the account of inefficient policies due to the many constraints in the American political system. But time has flipped that assessment. The British government lost a substantial sum of money, and the two banks it saved are lingering rather than thriving. The American government carried away a net gain from the banking interventions, and this was not mere luck. The American government implemented a policy that broadened the risks and allowed the government to recover its costs by par-

1. Moore, Stephen. “‘Atlas Shrugged:’ From Fiction to Fact in 52 years.” *Wall Street Journal*, 9 January 2009.

2. James Pinkerton, “Das Bailout: A Conversation With Karl Marx” *Huffington Post*, 3 January 2009. Available at http://www.huffingtonpost.com/james-pinkerton/das-bailout-a-conversatio_b_155014.html [Accessed 1 July 2014].

3. Definitions of *bailout*: “An act of giving financial assistance to a failing business or economy to save it from collapse” (Oxford Dictionary), “the act of saving or rescuing something (such as a business) from money problems” (Merriam Webster), “A rescue from financial difficulties: a government bailout of a corporation” (American Heritage Dictionary).

icipating in the recovery of the banks, while the British government bought the shares of the weakest banks only.

The American crisis management performed well against the odds: the Wall Street-Treasury complex with a former Goldman-Sachs CEO as Treasury Secretary, a right-wing party, and a gridlocked political system. This outcome is puzzling and raises a series of questions: Why has the American government implemented a strict bailout? How does business power shape bailouts? Are leftist policymakers friendlier to banks? And do veto-players constrain crisis policymaking?

As many studies have shown, business tries to influence policymaking by lobbying, financing political campaigns and using their links to policymakers. And their trying—along with favorable outcomes—has often been taken as evidence for the power of business to shape public policy. My argument is that instrumental business power is overstated in the case of banking bailouts. Banks want government support, and for that they lobby, but banks are not alone in wanting government intervention. Financial crises threaten people's livelihoods and pensions, and this threat brings politicians to rescue banks. Because there is a broad electoral demand for interventions to restore financial stability, banks' instrumental power is immaterial. Governments rescue banks irrespective of their lobbying. And importantly, instrumental business power cannot explain the varying costs of bailouts across countries.

Another kind of business power, however, does matter. What came out of the negotiations between the government and banks depended on banks' structural power. Large and financially healthy banks that have much business abroad can invoke their impunity to regulatory sanctions and block unfavorable proposals. The presence of these structurally powerful banks precludes a distribution of risks and shifts the bailout costs to the government and, ultimately, to the taxpayer. The large difference in the costs of bailouts across countries thus depends on this strategic structural power of banks. The British bank HSBC was large, healthy and highly international. It could resist taking part in the government's program. In the United States, all major banks depended on the domestic market and were susceptible to regulatory sanctions. No bank could afford to object to the government's plan. In the next section, I elaborate this argument and place it within the wider debates.

1.2 Selling out to cronies

The banking rescues were not merely bailouts; they were sellouts. Politicians sold out democracy to bankers; they saved the bankers of Wall Street, not the people on Main Street. That, at least, is the widely shared view among various scholars, regulators and observers. There are a number of reasons for politicians to privilege banks over voters: Banks donate heavily to political parties. By crossing banks, politicians jeopardize an important source of revenues to finance their campaigns for reelection. Banks have also excellent political connections. Many banking CEOs personally know the finance minister and even the president or prime minister. Thus, bankers can bring their issues to the government's attention and promote their preferred solutions. And the revolving door brings bankers into government and provides lucrative jobs after public office. Banks have thus their lieutenants inside the finance ministry, and future jobs give policymakers the incentive to keep banks happy. These connections between government and business via personnel and money evoke a label usually reserved for Asian and African countries—crony capitalism—and bailouts are often seen as politicians helping their cronies at taxpayers' expense.

Governments have been bailing out banks before the recent crisis. Especially in developing countries, governments responded to banking crises with large rescue programs for banks (Honohan and Klingebiel, 2003; Laeven and Valencia, 2008). Scholars have argued that these interventions resulted from *crony capitalism*. A crony is a close friend,⁴ and crony capitalism refers to friendships between public officials and business executives. It alludes to political favoritism which distorts government decisions to allocate resources in favor of friends (Johnson and Mitton, 2003; Wei, 2001). In crony capitalist systems, politically connected firms do better than their peers (Johnson and Mitton, 2003; Faccio, Masulis and McConnell, 2006). Crony capitalism does not necessarily imply corruption, but many authors see a strong positive relation between the two (Wei, 2001; Rosas, 2006). It is usually associated with developing countries, and some scholars have found that its political favoritism hurts economic development (Braun and Radatz, 2010). This mirrors the results of development research more broadly which

4. The Oxford dictionary defines crony as “close friend or companion,” and Merriam Webster as “close friend especially of long standing.”

found that democratic institutions curtail corruption and promote development and growth (e.g. Acemoglu, Johnson and Robinson, 2002).

The first political-economy scholars of bailouts, Sylvia Maxfield (2003), Guillermo Rosas (2006) and Philip Keefer (2007), study banking bailouts against the background of these studies. They view bailouts as politicians' favors to cronies and argue that democratic accountability curbs these favors. Where policymakers face little accountability, they can embezzle public money to rescue their friends' banks. The first quantitative study on bailouts supported this view of bailouts. Honohan and Klingebiel (2003) found that accommodating crisis policies strained public finances and inhibited economic growth. The optimal policy is, in their view, not to bail out banks, but to intervene quickly, avoid forbearance and shut down struggling banks. Maxfield, Rosas and Keefer differ merely on which mechanisms make politicians accountable. Sylvia Maxfield (2003) analyzes bank bailouts in Latin American countries, and she argues that future voter mobilization enhances politicians' accountability and prevents them from wasting money on bank rescues. Keefer (2007) and Rosas (2006, 2009) emphasize the importance of elections. If elections are competitive, people will throw out politicians who hand out favors to bankers. In this view, electoral threat disciplines politicians and inhibits banking bailouts.

These studies focus on the crises before 2008, but scholars on the recent bailouts strike the same tone. They find political favoritism due to the revolving door, banks' campaign contributions and bankers' access to policymakers. Duchin and Sosyura (2012) analyze the banking recapitalizations in the American TARP program, and they observe the same effect of political connections that Faccio, Masulis and McConnell (2006) had found for bailouts in other industries: Politically connected banks are more likely to get government funds, and government investments in connected banks yield less than those in other banks. Johnson and Kwak (2010) emphasize Wall Street's access to policymakers. They write that "not only did key policymakers have long-standing ties to Wall Street, but during the crisis they gave tremendous access to their Wall Street contacts" (Johnson and Kwak, 2010, 187). Even former supervisors argue in this vein, like Sheila Bair. She suggests that Citi's political connections helped the bank to get a better bailout deal (Bair, 2012). Not only scholars of the American bailout find political connections to be important. Studying the banking rescues on the other side of the Atlantic, in France, Jabko and Massoc (2012, 562) conclude that the French "bank support

plan should be viewed as a gift that members of the same elite group extended to each other in exchange for future, albeit still indeterminate, counter-gifts.” Thus, Jabko and Massoc join most scholars and argue that bankers get sweetheart deals because of their connections to politicians.

There are exceptions to this view on bank bailouts. Hindmoor and McGeechan (2012) argue that governments bailed out banks because of their structural power, but that this came from earlier instrumental power. That is, banks get a bailout because they lobbied successfully before the crisis. And Cornelia Woll and Emiliano Grossman explain differences in bailouts across countries by the organization of banks (Grossman and Woll, 2014; Woll, 2014). Woll (2014) likens financial crisis management to a game of chicken, in which two drivers race their cars towards each other until one of them yields—or until they crash. In her metaphor, governments and banks risk the crash by waiting for the other party to act. She captures this idea—in reference to Olson (1965)—as the power of collective *inaction*. If banks are unwilling or incapable to act, they prompt the government to give in, rescue the financial system and bear the bailout costs. I agree that non-cooperation of banks shifts the costs of bailouts onto the government, but I argue that this is the result of banks’ deliberate *action*, and whether banks can intentionally obstruct the government’s crisis management depends not on the lack of organizational ties, but on their structural power (see Chapter 4). I return to these arguments in the context of the American government’s ability to wrench a tough rescue from banks. Before that, I address the more common view which emphasizes lobbying of banks and their connections to policymakers.

Despite the widespread notion of bailouts as a product of connected bankers, the way governments responded to the recent financial crisis conforms poorly to the view that politicians sold out to banks. American banks spent large amounts on the financing of both parties; they had access to policymakers, and even the Secretary of the Treasury was a former investment banker. In other words, American banks had substantial instrumental power. And if instrumental power is important, we would expect a particularly generous bailout for American banks. But American banks paid dearly. Unlike the British or German government, the American government got its money back from the bailed out banks. Comparative evidence from the crisis thus fails to support the importance of instrumental power. And explanations based on crony capitalism are similarly insufficient. If competitive elections curb bailouts (Keefer, 2007; Rosas, 2006), bailouts should be small

in advanced democracies. But governments in advanced democracies spent the most. And within the groups of advanced democracies, the size and the costs of bailouts varied considerably. This is a variation that electoral accountability cannot explain. The recent interventions, thus, stand at odds with crony capitalism and politicians selling out.

Why do these theories fail to explain the bailouts? They fail because they mistakenly assume that bailouts only harm voters and stand against the interest of the general public. Bailouts do require the government to take on large risks, and these can turn into a huge burden for the state and the taxpayer. But financial turmoil, failing banks and an ensuing recession hurt the general public as well. Bailouts aim to restore financial stability and to that extent, they are in the interest of voters. The sellout view neglects this aspect of bailouts. For instance, Rosas (2006, pp. 179, 185) and Keefer (2007, p. 618) consider, but dismiss the idea that bailouts work in the public interest. They characterize bailouts as zero sum games between banks and taxpayers. Undoubtedly, there are aspects of bailouts which pitch the interests of banks against those of voters. But to the extent that bailouts restore financial stability, they benefit both banks and the general public. And this alignment of interests reverses the effect of electoral accountability. For this reason, it is important to distinguish the instances when voters' and banks' interests tally and when they collide. In the next section, I outline my argument for when their interests coincide.

1.3 The argument

Beyond private interests

Banking crises devastate the economy. Banks fail, stock markets plummet, credit freezes, and firms stop investing (Reinhart and Rogoff, 2009). For people, banking crises create two sources of risks. One source is the contracting economy. People suffer income cuts or even job loss. The second source of risks is people's investments. In most countries, large parts of people's savings accounts are insured by a deposit insurance system, but other savings and investments have no such protection. Financial turmoil creates especially large risks for people who

rely on pensions invested in financial markets.⁵ It threatens their income during their retirement. And these risks prompt people to demand government action. In other policy areas, the connection between risks and demand for state intervention has been well documented. For instance, Rehm, Hacker and Schlesinger (2012) have shown that people who face higher income risks demand more social insurance. In the same way, financial risks during the crisis change people's preferences towards more state intervention.

The insight that banking bailouts correspond to people's preferences turns Keefer's (2007) and Rosas' (2006) argument upside down. They argue that politicians implement smaller bailouts if they are held accountable through competitive elections. But if people prefer the government to restore financial stability, competitive elections should prompt banking bailouts. Accountability makes politicians consider voters' preferences to mitigate financial market risks. And this reasoning is not limited to electoral accountability, but also applies to salience. Based on the literature on interest groups and salience (Culpepper, 2011), one could expect that governments spend little on bank rescues because public scrutiny is high. But since bailouts satisfy public demand to restore financial stability, salience has no such effect. Faced with a financial crisis, politicians will spend billions to save banks regardless of public scrutiny.

What does this argument imply for analyzing banking bailouts across countries? First, governments should spend more on bailouts the larger the size of the crisis impact. With banking bailouts, policymakers respond to financial turmoil and the risks it creates for voters. Bailouts are a problem solving policy, and their size depends on how big the problem is. Where banks suffer severely, policymakers respond with larger interventions than in countries where banks experience a mere hick-up. This comes as no surprise, but some studies have omitted to control for crisis impact (Rosas, 2006; Keefer, 2007). A trivial case of this argument is the absence of crisis. No one expects bailouts when there is no banking crisis.

Second, bailouts increase with holdings of pension investments. Banking crises have a direct impact on people's wealth by depreciating financial investments.

5. With pensions invested in financial markets, I mean the assets in pension funds. Thereby, I don't distinguish the type of asset classes, e.g. between stocks, bonds or deposits. Although stocks are riskier than other asset classes, even pension funds with little or no stocks are risky and fell in value during the crisis. For instance, the pension funds in Slovakia which hold only bonds or deposits lost about 12 percent in 2008, and in Germany, the value of pension funds, consisting mostly of bonds, dropped about 9 percent (OECD, 2009c).

In countries with defined-contribution pension systems, the largest investments of many people are their pension savings. The crisis creates large financial risks for people with funded pensions. Politicians recognize this threat to large parts of the population. And elections motivate politicians to mitigate these risks and intervene forcefully with bailout programs. These risks and politicians' motivation to mitigate them increases with the holding of private pension assets. If bailouts follow broad societal interests, rather than the narrow interests of bankers, I expect bailouts to be larger in countries with funded pension systems.

A positive relation between pension assets and banking rescues would speak against the sellout view of bailouts. It would suggest that policymakers bail out banks to act on voters' interests rather than nourish their friendships with bankers. I test this correlation in a quantitative analysis in Chapter 3. This analysis includes responses to the banking crisis in some 50 countries around the world.

Conflicting interests and structural business power

Restoring financial stability is in the interest of the voters as well as banks. Both voters and banks want the government to calm markets, sustain asset prices and protect deposits. To this extent, the interests of banks and voters align. But for other issues, the two interests collide. Most importantly, this conflict occurs for the distribution of risks and costs. Who bears the risks of the interventions and who pays for them—the banks or the taxpayers?

Among the crisis responses, the American bailout has received particular attention. Scholars, journalists, and former regulators have written about TARP and other crisis programs. The dominant argument is that banks were generously saved because they had direct access to policymakers. The revolving door between banks and government brought in bankers into government, which gave banking CEOs an open ear at the Treasury. Additionally, banks had given so much money to parties that either side catered to banks. Essentially, the argument is that banks enjoy instrumental power and control policy. While there were undoubtedly these connections between Wall Street and Washington, these accounts exaggerate the importance of instrumental power. Whether governments could make banks pay for the bailouts depended on banks' structural power. With that, I do not mean structural power in the sense that policymakers automatically conform to business interests (Lindblom, 1977), but that firms use their structural positions intentionally and strategically to influence policy decisions.

This notion of using structural power intentionally is at odds with the usual understanding of business power. In the last two decades, scholars have put business power into the two categories of instrumental and structural power. With instrumental power, they refer to the power that “stems from its ability to staff governments with business supporters and to exert direct influence on government decision makers through campaign contributions and lobbying efforts” (Hacker and Pierson, 2002, 280). And they set instrumental power in opposition to structural power which they understand as business’s “privileged position” (Lindblom, 1977): Politicians cater to business because they depend on business to create employment and economic growth.

Categorizing business power into structural and instrumental is useful, but it is misleading if structural power is equated to automatic power, and instrumental to strategic business power. Hacker and Pierson (2002, 281) write that structural power “is structural because the pressure to protect business interests is generated automatically and apolitically.” They imply that instrumental power is not automatic, but that it requires an intentional act. This way of classifying is intuitive, and it is accurate—for many cases. Instrumental power is often intentional, as structural power is often automatic. Business does not need to lobby politicians for them to know that lower taxes or less regulation will spur investment. Knowing about market incentives suffices. And instrumental power is often intentional and strategic. Giving money to parties or lobbying politicians to water down reforms are strategic acts. But for some cases, this classification is insufficient.

Not all forms of instrumental power are strategic. The revolving door exchanges personnel between government and business, and the presence of pro-business policymakers favors firms. But they involve no strategic action on the part of business. And neither are all forms of structural power automatic, as I will show below. Classifying business power requires, thus, a different definition.

It is better to define business power as structural when it stems from the function of the firm in the economy, when it derives from investing, producing and making profits. This is at the core of Lindblom’s privileged position. Politicians create a business friendly environment so that business does what it is meant to do: investing, making profit and generating economic growth. Business power is instrumental when it comes from activities other than the firm’s function in the economy, from giving money to political campaigns or hiring lobbyists to furnish policymakers with policy proposals. The revolving door and business-friendly

policymakers are also sources of instrumental power because they lie outside the core of business activities.

The advantage of separating the characteristics of intentional vs. automatic from instrumental vs. structural is that it recognizes other types of business power, in particular, instances of structural power that work not automatically, but with intent. Consider what Tasha Fairfield (2011, 429) calls investment strikes, namely a “deliberate political decision [by business] to withhold investment.” Like Lindblom’s privileged position, this power stems from business’s role in the economy. But unlike Lindblom’s characterization, investment strikes require an intentional effort; they don’t arise from firms producing and investing according to market incentives. The intentional effort is related to the core function of the firm, not to lobbying or access to policymakers. Accordingly, I take this as an example of intentional structural power.⁶ It is this type of business power that explains the banking bailouts. For bailouts, banks obtain power through their position in the economy. They need to be healthy, they need to be large, and they need to make most of their revenues abroad.

First, banks must be financially healthy. If they run out of liquidity, they depend on the government and have to accept any deal. These banks have no power to negotiate. Second, banks must be large. If a bank doesn’t matter to the overall economy because it is small, the government can ignore its demands. Third, banks must make most of their money abroad. Sustained by foreign revenues, these banks can absorb domestic regulatory costs. This impunity allows them to ignore the government’s threats and decline any unpleasant deal. Banks that depend on the domestic market are vulnerable to regulatory sanctions; penalizations by the regulator hit them in full. This affords the government the ability to make them an offer they cannot refuse. This power is structural because it depends on the position of the firm in the economy. Banks attain power through their importance in the domestic economy and through their foreign sources of revenue. However, this structural power is not automatic. Policymakers do not automatically heed banks’ interests. There are no market incentives that would tell policymakers whether banks will comply. Rather, these banks have to use their position strategically. They have to tell policymakers that they don’t need

6. In contrast, Tasha Fairfield (2011, 429) considers these types of strikes by business to fall “within the realm of instrumental power, not structural power, because this form of protest is politically-coordinated rather than market-coordinated.”

government help (because they are healthy), that they care little about regulatory costs (because they make their money abroad), and that they will not accept the government's deal. This strategic act by banks, based on their structural power, determines whether banks share the bailout bill. It helps to explain the sharply different costs of bailouts across countries. A large, healthy bank with large international revenues can block government efforts to include all banks in a support scheme. This veto leaves the government with the costly alternative to intervene in weak banks only. I demonstrate this argument using case studies in Chapter 4.

Legislatures in crisis

Before negotiating with banks over bailouts, most governments have to get a rescue law passed by their legislatures. Accordingly, the literature suggests that legislatures shape banking bailouts. Keefer (2007), for instance, argues that legislatures with veto power discipline executive policymakers and prevent them from privileging banks. With high salience and tough media scrutiny, legislators should be keen to avoid the impression of catering to bank's special interests. For legislators, high salience is a good antidote against selling out to business (Culpepper, 2011). On the other hand, legislators depend on banks to finance their political campaigns—especially in the United States. Blau, Brough and Thomas (2013) and Mian, Sufi and Trebbi (2010) find that banks' lobbying influences lawmakers to vote in favor of the bailout bill.

In contrast to both views, I argue that legislators neither curb nor extend favorable bailouts. Instead, legislators mostly defer to the executive branch. The reason for this unusual behavior by legislators is the crisis. A financial crisis changes the legislative calculus in two ways. First, the crisis creates urgency. The high pace of financial markets during crises require solutions quickly, in a matter of a few weeks or even days. Second, the crisis poses a threat. When financial turmoil ends in a domino of failing banks, the consequences for the economy and employment are disastrous. Policymaking, thus, becomes a gamble with huge stakes. These two crisis characteristics—urgency and threat—pose a dilemma for legislators. Legislators require a well-designed policy, but they have only very little time to work one out. Unfortunately for legislators, they are ill-equipped to develop a new policy fast. To do so would require the type of resources the executive branch has, a large staff and in-house expertise.

As legislators have little resources to design a policy on short notice, they can either fall back on a successful policy from the past, or they can grant authority to the executive branch. Given the potential disaster of the crisis, legislators loath experimenting and trying out new policies. One way out would be to copy successful policies from elsewhere, but in the crisis rush, it is difficult for legislators to assess how—and whether—these copied policies would work. They can fall back, however, on their own policies that did well before. Legislators know how these policies work, what the downsides are, and how they fit into their (partisan) preferences. But as no crisis is the same, legislators would rarely find a complete crisis solution among former policies. Rather, they will find policy elements that address recurring problems of crises. Legislators can include such elements into current legislation, and thus shape crisis policy.

When legislators find no successful policy off the shelf, they defer to the executive branch. In contrast to the legislature, the executive employs a large staff, including financial market experts. It can also increase its expertise by hiring consultants and lawyers. These resources make it much easier for the executive to come up with crisis policies and to adjust them to changing circumstances. Because a failure to contain the crisis leads to economic and electoral disaster, legislators have the incentive to delegate crisis management to the executive. Legislators, thus, expect the executive to manage the crisis. Rather than prescribing a bailout policy assembled in haste without the necessary expertise, legislators give the executive the autonomy to decide on the best policy.

Since the crisis prompts lawmakers to defer to the executive, it essentially eliminates the legislative veto point. In Chapter 5, I show the effect of crisis on legislative policymaking for a very strong legislature, the US Congress. Even there, the crisis shifts the power balance in favor of the executive. I relate this effect to the wider debates about legislative-executive relations, arguing that these debates have neglected the importance of real world events. Financial crises, akin to war, increase the power of the presidency over Congress.

In the next chapter, I develop categories to analyze bailout policies and describe the interventions across countries and over time. Subsequently, I demonstrate the argument with different empirical material. In Chapter 3, I use quantitative cross-national data to assess what determines the magnitude of bailouts. It speaks to existing empirical studies which argue that bailouts are a product of crony capitalism. Chapter 4 compares the crisis management in the United States

and the United Kingdom, and explains why the American government obtained a better deal against the odds. This chapter focuses on the banks' strategic use of structural power. These two chapters also show that legislatures, the US Congress in particular, have little influence on crisis management. In Chapter 5, I look closer at this finding and argue that the crisis shifts power from Congress to the president. Finally, I bring the results together in Chapter 6.

Banking and bailouts

Banking crises change democratic policymaking. They pose a large threat and require policymakers to act fast. This chapter lays out why this is the case. I start by describing what banks normally do, what banking crises are and what they imply for governments. Subsequently, I present the different ways to support struggling banks and analyze their distributive consequences. Finally, I recapitulate the rescue efforts during the recent crisis across countries and over time.

2.1 Banking – in good times and in bad

The essence of banking is to allocate savings to investments. Banks collect savings from households. These savings are small individually, but add up to substantial sizes through the sheer number of savers. Banks lend this money to a few businesses. These loans are large, and the banks grant them for a long period because businesses invest in large projects that need time to generate returns. This long time frame, however, conflicts with the needs of savers. Households can commit some money to the long-term, like savings for retirement, but they also need money to be available on short notice to cover costly contingencies. For instance, they may have to replace a car after an accident or pay for their children's weddings. Households need the bank to fund these unforeseen events, and banks meet these sudden withdrawals by borrowing from and lending to each other.

In this way, banks can attract savers, meet their demands and lend to businesses. Banks thus serve two functions: they bridge the size and the time discrepancies between households and businesses. In this way, they channel savings to investments and add value to the economy.

This description, of course, sounds like a romantic account of banking, long gone. It leaves out many forms of modern banking. Banks today also buy out and sell off companies, they hedge risks or speculate for their clients and their own accounts. But the point is that this simple task of banking—taking deposits and giving out loans—makes banking inherently fragile. Depositors can take out their money at any time, and if they withdraw it all at the same time, a bank runs out of cash. It has to liquidate loans before its investments are due. This involves losses, and the bank may find itself unable to redeem its depositors. Importantly, such a run can wreck a bank that was perfectly profitable. A rumor that a bank is bankrupt may be self-fulfilling, and it can trigger a banking crisis. This is not, however, what usually happens; banking crises start for a reason.

Banking crises emerge when there are deeper problems in the banking system: Asset prices rose to exaggerated heights, banks increased credit too fast and gave loans to dubious borrowers, or regulation was lax and missed some mistaken incentive in the market (Claessens, Ayhan Kose and Terrones, 2010, 248ff). Still, the above-mentioned fragility of banking remains important. When these problems loom in the banking sector, depositors have good reason to run to their bank and get their money when they hear a rumor about its insolvency. In turn, the bank is very susceptible to bank runs because it shares some problems with the wider banking sector (or indeed has more than its fair share of these problems). In this situation, it is difficult for a bank to find funding from other banks or to sell its assets. More specifically, the bank will get loans only at high interest rates, and it will have to sell assets at steep discounts. And this combination of high costs and low yields is what drives banks into bankruptcy whether they were insolvent before or not.

For this reason, the traditional way for central banks to solve a crisis is to provide liquidity freely for solvent banks—a recipe propagated by Sir Walter Bagehot in the 19th century. In turn, the regulator should close down insolvent banks (c.f. Rosas, 2006). This recipe is clear in theory; in practice, however, it is ambiguous. In times of crisis, illiquidity and insolvency become indistinguishable (Beck et al., 2010, 14). One reason is that a bank's assets are opaque, and an outsider can hardly

determine their value. Another and more fundamental reason is the above mentioned discount: Selling long-term assets at fire sale prices generates losses and cause insolvency. A clear distinction may not even emerge when the crisis is over, as in the case of Northern Rock (Beck et al., 2010, 14).

What they say about swallows in early summer also applies to banking crises: One failure doesn't make a crisis. Failures of small banks occur regularly and often go unnoticed. In 2001, for instance, four American banks failed (Sinclair National Bank, Superior Bank - FSB, Malta National Bank and First Alliance Bank & Trust Co). More banks fail when the economy slides into recession. The burst of the Dot-com bubble and its ripple effects on the economy increased the number of bank failures. A year later, in 2002, not four banks failed, but eleven. And in the boom years of 2005 and 2006, no bank failed. This is not to say that individual bank failures cannot have disastrous effects and precipitate a crisis. The collapse of Baring Brothers in 1890, and recently, the failure of Lehman Brothers triggered banking crises with disastrous effects (Cassis, 2011, 8).

This discussion hints at the difficulty of defining a banking crisis. They eschew an easy definition because there may be a banking crisis in which not a single bank goes bankrupt. This happens regularly, and stems from government interventions or preventative action by other banks. That is, private—but most often—public actors save a failing bank in order to prevent the crisis from escalating.

A definition derived from the causes of banking crises is not convenient either, because they vary. Scholars resort in the end to a broad definition that refers to multiple actual or only potential banking failures. Claessens and Kose (2013, 12) propose this—relatively—concise definition: “In a systemic banking crisis, actual or potential bank runs and failures can induce banks to suspend the convertibility of their liabilities or compel the government to intervene to prevent this by extending liquidity and capital assistance on a large scale.” Reinhart and Rogoff (2009, 10) use a similarly terse definition; they merely add bank mergers and takeovers. Laeven and Valencia (2008) go a bit beyond that and include common consequences of banking crises:

Under our definition, in a systemic banking crisis, a country's corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time. As a result, non-performing loans increase

sharply and all or most of the aggregate banking system capital is exhausted. This situation may be accompanied by depressed asset prices (such as equity and real estate prices) on the heels of run-ups before the crisis, sharp increases in real interest rates, and a slow-down or reversal in capital flows. In some cases, the crisis is triggered by depositor runs on banks, though in most cases it is a general realization that systemically important financial institutions are in distress. (Laeven and Valencia, 2008, 5)

To return to the reference above and to stress the point, these scholars recognize the summer when they see or believe that there should have been some swallows. They define banking crises as “actual or *potential* bank runs” and “runs on banks, though in most cases...the *general realization* that...financial institutions are in distress” (Laeven and Valencia, 2008, 5). I do not mean to criticize these definitions, but want to emphasize the difficulty of pinning down banking crises. The causes and the symptoms of banking crises vary and allow only a broad definition. And these definitions show that the government is a core element in the course of banking crises. More often than not—and unfailingly in the crises of the past thirty years—the government or the central bank intervened.

Moreover, this definition emphasizes that “financial crisis” is not synonymous with banking crisis. Instead, financial crisis is an umbrella term for different types of crises involving the financial sector (Claessens and Kose, 2013, 11f): One of these crisis types is a *currency crisis*. This crisis involves a speculative attack on a currency, which leads to a drop in the country’s international currency reserves or even to a devaluation of the currency. Another type is a *balance of payment crisis* in which investors withdraw money from a country. This often increases the interest rate (or credit spread) for government bonds. In other words, the country has to pay more to borrow money. Finally, there are *debt crises*. In a *foreign debt crisis*, the government defaults on its debt by not redeeming its bonds. In a *domestic debt crisis*, the government defaults on its debt by means of inflation. High inflation melts away its debt in real terms.

These types of crises describe distinct phenomena, but in practice, they can occur together. For instance, banking crises often precede a currency crisis, which in turn aggravates the problems in the banking sector (Kaminsky and Reinhart, 1999). For this, Kaminsky and Reinhart (1999) coined the term “twin crisis.”

Similarly, the crisis experience of Spain in 2012 shows that a vicious circle exists between banking and balance of payment crises as well. In this case, the currency was stable, but the downgrading of the government bonds and the increase of the credit spread interacted with the problems in the banking sector, magnifying each other. Nevertheless, these types of crises show distinct characteristics, and the crisis of 2007-09 clearly constitutes a banking crisis.

2.2 The threat and urgency of banking crises

As banking crises are not “real,” in the sense of being nominal and relating to the currency, what is its impact on the economy? The impact is real, devastating and poses a threat to policymakers. Scholars widely agree that banking crises are linked to economic downturns (Reinhart and Rogoff, 2009, 165). Ben Bernanke (1983) lays out the basic, destructive impact of banking crises. They inhibit credit to the real economy, which depresses aggregate demand and slows down growth. While recessions may spark banking crises, banking crises themselves aggravate the economic contraction. Some studies disentangle the simultaneity problem between banking crisis and economic contraction. For instance, Peek and Rosengren (2000) show that the Japanese banking crisis caused credit to contract in the United States (where the economy was fine) and slowed down the real economy there. Dell’Ariccia, Detragiache and Rajan (2008) also confirm the effect of banking crises by showing that sectors that rely more on external financing suffer more. Thus, it seems safe to say that banking crises cause or amplify the economic downturn.

The public was not aware of these studies, but it gaged the possible effects of the financial turmoil from the well-known banking crises. The images from the Great Depression in the news and the public’s collective memory illustrated what could be coming: run on banks, lost livelihoods and unemployment. Indeed, the 1930s were grave. Between 1929 and 1932, world industrial output fell by 36 percent, and the average unemployment rate in the United States was around 30 percent (Cassis, 2011, 22). This was the world’s worst crisis, but others depressed growth as well. The Japanese crisis in the 2000s led to a “lost decade” with stagnating growth and lost output of more than half of Japan’s GDP (Hoshi and Kashyap, 2004; Laeven and Valencia, 2012). Japan’s crisis management is commonly criti-

cized, but even well-managed banking crises cost dearly. For example, Laeven and Valencia (2012) estimate that the banking crisis in the 1990s cost Sweden a third of its economic output. These dire consequences are the background against which crisis management takes place. And this threat of economic disaster is one of the characteristics that distinguish policymaking in times of financial crisis from normal policymaking.

Another characteristic is urgency. The crisis requires policymakers to find a solution fast. Financial markets distinguish themselves by the speed of market movements. Stock markets are infamous for their sudden sharp drops. For instance, on “Black Monday” in the fall of 1987, the American stock market fell 20 percent on a single day (Carlson, 2007, 2). Bank deposits can dry up at comparably high speed. Only hours after Robert Peston of the BBC leaked the emergency loans for Northern Rock, the first people started to withdraw money (House of Commons Treasury Committee, 2008, 66). More people stood in line over the next few days, and the run only subsided after the government guaranteed their deposits three days later. This run, when people needed to physically go to their bank and demand their money, was quick. In wholesale markets, where investors queue electronically, a run can drain a bank of its liquidity even faster. The American investment bank Bear Stearns ran out of liquidity in a week. The bank’s treasurer said that he had never worried about liquidity—that repo lending would disappear—up until the first week of March 2008 (Financial Crisis Inquiry Commission, 2011, 288). On the following Thursday, Bear Stearns was out of cash. These crisis events set the pace for crisis management, and it is fast.

All policymakers involved in the recent banking crisis emphasize time pressure. Ben Bernanke, the Chairman of the Federal Reserve said that he would call his book on the management of the crisis “Before Asia opens” (Wessel, 2009, 1). This title refers to the recurrent weekends when Bernanke and his colleagues in the Fed and the Treasury rushed to devise interventions before the markets opened Monday morning in Asia. In some cases, wholesale runs on troubled banks required interventions the same day. Alistair Darling recounts how the Royal Bank of Scotland (RBS) would have been out of money at the end of the day: Only the emergency liquidity from the Bank of England carried it over the banking hours (Darling, 2011). For the systemic interventions in the fall of 2008, the governments in the United States and the United Kingdom had more than just hours. Both governments had created contingency plans before the crisis turned

systemic. But from that point, both governments devised and implemented a sector-wide scheme in less than three weeks.

In sum, banking crises pose a big threat to policymakers, and they require a fast reaction. Historic experience showed that full-blown banking crises have devastating effects. And banking crises escalate at high speed, which forces policymakers to react in a short amount of time. These two characteristics—threat and urgency—change policymaking.

2.3 Comparing bailouts

To stabilize the banking system, what can governments and central banks do? In this section, I present the different instruments that governments used during the crisis. This overview provides the basic terms to compare how government in different countries intervened in their banking sectors.

Policy options

A bank's balance sheet offers the clearest layout to organize the basic "menu" of policy options. It provides a categorization of policy instruments by their intended target on the balance sheet of banks. The balance sheet, as presented in Figure 2.1, lists assets on the left-hand side and liabilities on the right-hand side. Accordingly, one set of measures targets the liability side of the balance sheet. One of these measures aiming at the liability side is for the central bank to provide liquidity to banks (L_1 in Figure 2.1). When the central bank gives liquidity to solvent banks it acts as "the lender of last resort," and this support is a standard function of central banks. Another measure is for the government to insure the deposits of ordinary savers (L_2). This is very common and relatively uncontroversial in the economic debate of banking regulation. Deposit insurance helps prevent bank-runs and protects retail savers.

A more extensive step is for the government to guarantee not just the deposits of ordinary savers, but the bank's entire debt (L_3). This guarantee helps the bank to receive funding, because the government pledges to stand behind the bank's debt in case the bank were to fail. The state's guarantee allows the bank to obtain credit again at low interest rates, which improves its liquidity. The flip-side is that the government bears the risk of the guaranteed debt. Since bank debt can be-

come very large, so does the risk for the government. An important governance problem with this intervention is that the creditors no longer have an incentive to monitor the bank. Finally, the government can inject capital into a bank (L₄). Thereby, the government pushes up the capital in order to absorb losses and it becomes a shareholder of the bank. As a shareholder, the government participates in the future losses, but also in the future profits, and could share the fruits of a recovering economy.

Assets		Liabilities	
<i>Assets</i> (<i>e.g. loans</i>)	A ₁) Widening central bank collateral	<i>Debt & deposits</i>	L ₁) Liquidity
	A ₂) Asset guarantee		L ₂) Deposit insurance
	A ₃) Asset purchase	<i>Equity</i>	L ₃) Debt guarantee
			L ₄) Capital injection

FIGURE 2.1: Balance sheet targets of government interventions

The second set of measures targets the left-hand side of the balance sheets, the assets. First, the central bank can widen its collateral standards, which means it accepts lower quality assets in exchange for funds (A₁). This intervention allows banks to get additional liquidity. The second type of measure is an asset guarantee. By issuing this guarantee, the government insures banks' assets against future losses in exchange for a fee (A₂). This makes the bank a more secure business partner by eliminating the bank's "tail-risk." That is, other banks don't have to fear that the bank will incur huge losses on these questionable loans. Instead of merely insuring assets, the government can buy them (A₃). Usually, governments subsequently sort the assets, the decent ones into a "good bank" to later sell them again, the poor assets into an "asset management company" or "bad bank" to wind them down. One rationale for the government to purchase all assets, including the poor ones, is that the government can keep them until they recover. Assets regain their value if they were sold at depressed prices in a fire sale—when everybody tries to sell at the same time. That was the case in the Nordic crisis in the 1990s (Borio, Vale and Von Peter, 2010), but may not be the case in this crisis, because assets were overvalued (Hellwig, 2009). Both asset programs should take the risks from the bank's balance sheet so that others trust the bank again and provide it with credit.

Governments can implement these interventions in different ways. For bad banks, for instance, an important distinction is whether the assets are integrated into a centralized asset management company (AMC) run by the state or left in custody with the banks (Klingebiel, 2000; Gandrud and Hallerberg, 2013). A centralized AMC offers the advantages of having many assets in one place including better possibilities to standardize practices and to securitize these assets and of having some leverage over debtors. At the same time, the centralized company may be more difficult to wind down and has less information on borrowers than a decentralized AMC for the original bank (Klingebiel, 2000, 6).

A further distinction is whether the government saves an individual failing bank or whether it intervenes in the whole banking sector. In the course of the crisis, governments often do both. In the early part of the crisis, a number of governments, among them the American and the British, rescued individual banks. Later, when the crisis affected the banking sector as a whole, they drew up systemic interventions for all banks. In the next section, which describes how the crisis progressed over time, I will come back to this pattern.

Official reports on banking interventions commonly use these distinctions to compare policies across countries. A number of countries, like Ireland, tried to stabilize their banking sectors with debt guarantees. When the guarantee is credible, it solves the liquidity problems of banks. However, such a policy, does not remove any bad loans from banks' balance sheets. So that banks can clear their balance sheet, they require more capital or need to transfer these assets to "bad banks."

While a comparison according to these distinctions helps explain the mechanics of the bailouts, they do not speak to the success of the bailouts or how the costs were divided between banks and the state. These questions require further ways to compare policies.

The costs of bailouts

For many people, the most important question about a bailout is: Does it work? But whether a bailout is successful is an intricate question. There are a case in which this judgment is easy. In Ireland, for instance, the bailout failed. The government guarantees in the fall of 2008 failed to calm markets, and the banks collapsed anyway, forcing the Irish government to seek assistance from the IMF and the EU. On the other hand, in the United Kingdom and Germany, the bailout was

successful in the sense that it stopped the crisis and stabilized banks and markets. But considering their impact on state finances, one cannot say that they were a success with the same confidence.

While the public cares about how the bailout worked, whether it averted crisis or not, this yardstick is less helpful for an analytic comparison. The policy outcome—whether it worked—depends on a myriad of factors, not only the government policy. Accounting for all relevant factors is impossible. The policy output, however, can be compared. The policy output includes which types of instruments governments used and how much money they spent.

Like every policy, bailouts have several aspects that can be compared. One aspect is the overall size of the bailout, or the amount of money the government pledges to support its banking system. Aggregating the different measures is not without problems. With some instruments, like capital injections, the government spends actual money; with guarantees, there is merely a certain probability that the government will have to spend that money. Chapter 3 addresses this problem in more detail and analyzes the size of interventions across countries.

Another important aspect is who pays for the intervention, the state or the banks. Surely, the main goal for the government should not be to make money off the banking rescue. The government is not an investment bank which buys out and re-sells companies for profit. Its aim is above all to restore financial stability. But one aim, governments often state, is to minimize the costs to taxpayers. That is, the government should not generate profits, but it should not be left with losses either. For that, one can look at who pays for the stabilization efforts.

One option is to make creditors pay. This way of stabilizing a bank is known as “bail-in.” Rather than the state bailing out the bank and servicing all of the bank’s debt, those who hold the bank’s debt forgo full repayment or convert their debt into equity. The creditors usually targeted are the bond holders who rank above common bank depositors. The purpose of the bail-in is to restructure the bank’s liabilities to restore its solvency. If successful, this debt restructuring puts the burden on private investors, and the state gets off the hook. The advantage of this resolution is not only that the state avoids subsidizing the bank and its creditors, but that it fosters market discipline: If bond holders know that they have to pay if a bank fails, they should monitor the bank closely and withdraw their funds if they anticipate problems in a bank. And to attract funds at reasonable rates, bank managers should be more careful about the risks they incur (Goodhart and Av-

gouleas, 2014; Zhou et al., 2012). The main disadvantage of bail-ins is the risk of contagion (Goodhart and Avgouleas, 2014). Cautious bond holders induce discipline in good times, but they may also escalate the crisis. If they withdraw their money from banks, they can cause liquidity to drain from the market and drive banks into bankruptcy. During the systemic banking crisis of 2008-09, governments abstained from bailing in creditors.

Other options include the government outlays, which may still require the private sector to bear some of the costs. The government can retrieve its investments to save weak banks by several means. It can get back the money from the other banks, those that did not fail. This is for good reason in that they too can profit from a stabilization of the banking system. Saving the failing banks is an implicit guarantee that the government will save the remaining banks too should they fail. This provides them with a direct monetary advantage: their cost of borrowing becomes lower due to this implicit guarantee. Thus, this payment is a cross-subsidy among banks.

There is another cross-subsidy, not among banks, but over time. A bank that failed during a crisis may become profitable again in the future, after it has been saved. The government can achieve this cross-subsidy over time by obtaining warrants or shares of the weak banks. Warrants give the holder the possibility to later purchase further shares at a previously fixed price. If the bank performs well, and its share price rises, the government can sell the shares at a profit to recoup the investment.

Another possibility to cross-subsidize the rescue was, alas, not available when the crisis started. This alternative is to levy a fee in good times, and use these funds to support banks in times of crisis. For deposit insurance systems, this is common practice.

These analytical distinctions of cross-subsidies, across banks and over time, often mix in practice. For instance, the costs guaranteeing the deposits of a failing bank is partly covered by that bank's earlier contribution to deposit insurance. Yet, other banks paid into these funds too, and they may never receive a dime from the deposit insurance system. That does not mean, however, that these banks pay for nothing. To the contrary, they receive protection from the deposit insurance which makes them trustworthy. Depositors who save their money in a bank that participates in a deposit insurance system know that they will keep their savings even if the bank fails.

Also, the government can combine a cross-subsidy over time with one across banks. The American government supported weak banks on the condition that healthy banks accept capital and offer warrants. In 2009, many of these healthier banks recovered and the warrants paid the government handsome returns.

There are a number of ways for the government to attempt to get its money back, but one particular way is unlikely to work, to charge weak banks. Charging for support during the crisis—like a hefty fee for a guarantee or a capital injection—only undermines the already weak position of the bank. This approach may require the government to put more capital into the weak banks. As a result, the government owns a larger share of the bank. This has an unwanted effect: if the government charges a high fee, it ends up charging itself. Thus, high fixed fees for government support is likely to be ineffective in getting the money back.

Taken together, the expected cost for the government is a useful metric for comparing bailout policies. Its calculation is, however, very difficult. First, it requires detailed knowledge of the individual terms and requires, even more daunting, reasonable assumptions about how the bailed-out bank, the banking sector and the economy will fair in the future. For the United States and the United Kingdom, it is possible to compare the two policies and state that the expected return is larger for the American program than for the British one. But it is beyond the scope of this thesis to provide a precise estimate for a large sample of countries for statistical analysis.

2.4 Bailouts during the recent crisis

In this dissertation, I focus on the recent bailout programs for the banking sector as a whole and compare them across countries. But governments' efforts happened not all at once, and governments didn't start with sector-wide programs. They began supporting banks as early as 2007, and most governments continued some form of help until 2009. Their large programs came, however, in the fall of 2008.

In this section, I turn to this sequence of the crisis response, and I focus here on the events in the United Kingdom and the United States. They mirror the crisis experience of many other countries. The first signs of the crisis concerned single banks, like Northern Rock in the United Kingdom. Later, when Lehman Broth-

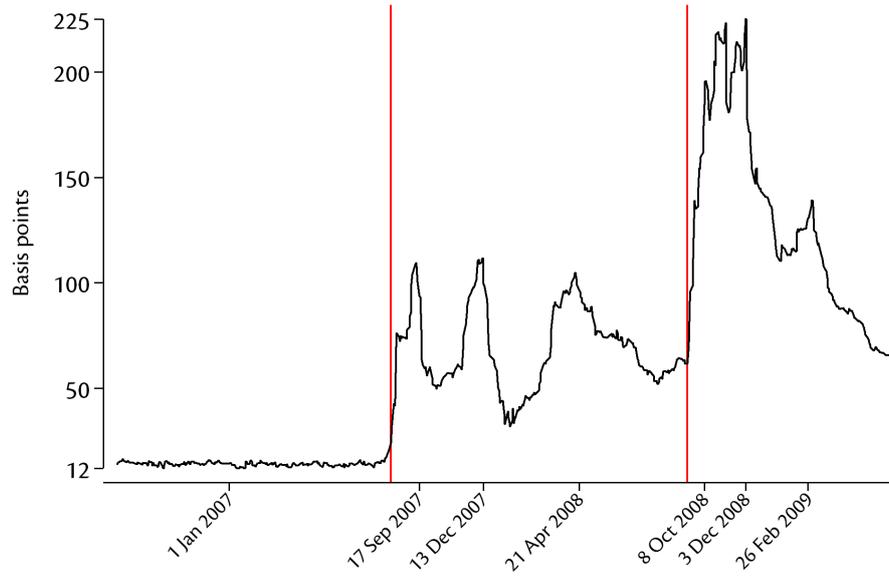
ers declared bankruptcy, the crisis struck the whole banking sector—and caused financial turmoil around the globe. To avoid further escalation of the banking crisis and restore financial stability, governments around the world bailed out their banks.

The recent crisis is neither the only global crisis, nor is it the only banking crisis in the United Kingdom and the United States. Both countries saw banks fail before. In the City of London, Baring Brothers & Co. collapsed in 1890, and on Wall Street, Knickerbocker Trust failed in 1907. Both failures caused a crisis with international repercussions (Cassis, 2011, p. 8ff). The other large, global crisis is the Great Depression between 1929 and 1933. More recently, the United States experienced a major crisis during the 1980s when hundreds of Saving and Loan institutions went bankrupt (Isenberg, 2013). The focus of this thesis, however, is on the recent crisis. The banking failures, and the rescues by the state, occurred at the same time in response to similar shocks and was understood in similar terms. Even within this setting, the crisis responses varied considerably, and I aim to explain this variance. Thus, I concentrate on the Great Recession.

The early crisis: Individual failures

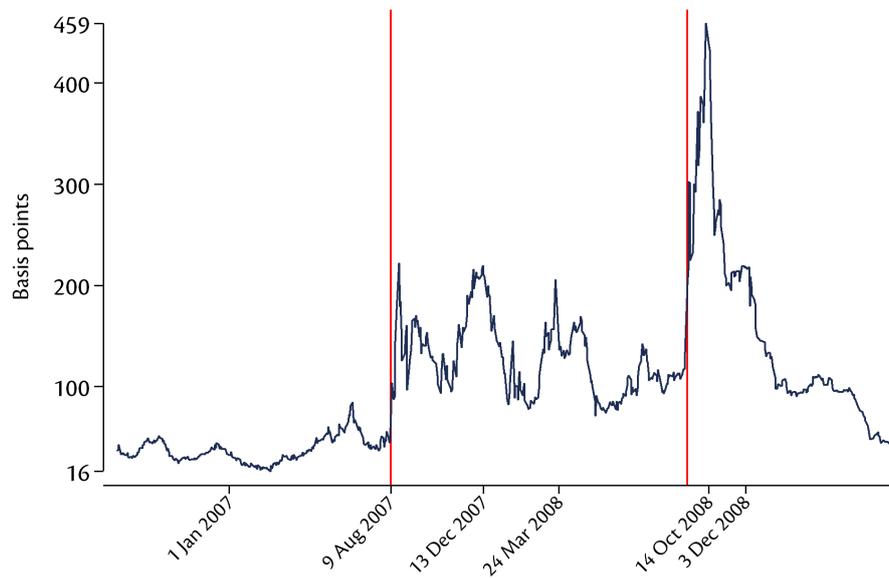
The beginning of the global financial crisis is commonly dated at the beginning of August 2007 when problems with sub-prime investments in the American housing markets became evident. On August 9, the French bank BNP Paribas announced that it could not value some sub-prime related assets and suspended the trading of three of its investment funds (Financial Crisis Inquiry Commission, 2011, 250). This served as a wake-up call for markets, and fear of hidden risks spread. Banks were reluctant to lend to each other, and the interest rate in interbank markets shot up. This hike is clearly visible in Figures 2.2 and 2.3, which depict the risk premium in the British and American interbank markets. The risk premium reflects the mistrust of banks in each other and traces the course of the crisis. These figures include vertical reference lines to mark important dates of the crisis.

The most prominent victim of the liquidity squeeze in the summer of 2007 was Northern Rock, a British bank headquartered in Newcastle. Northern Rock, a former building society, relied heavily on short-term, wholesale funding and had not arranged sufficient insurance or standby facilities. This left it incapable of coping with interbank markets drying up (House of Commons Treasury Committee,



Solid lines at August 9, 2007 (BNP announcement) and September 15, 2008 (Lehman bankruptcy). Source: Reuters EcoWin as in European Commission (2009a).

FIGURE 2.2: Risk premium in UK interbank market. Spread between 3-month Libor and T-bills



Solid lines at August 9, 2007 (BNP announcement) and September 15, 2008 (Lehman bankruptcy). Source: Reuters EcoWin as in European Commission (2009a).

FIGURE 2.3: Risk premium in US interbank market. Spread between 3-month Libor and T-bills

2008, 19). The Financial Services Authority (FSA) became aware of Northern Rock's funding difficulties shortly thereafter. The Tripartite authorities, which consists of the Treasury, the Bank of England and the FSA, debated several solutions. They favored a private take-over by another bank, but they failed to find a viable bid without substantial government subsidies. Moreover, the Bank of England did not provide extra liquidity in August.

The authorities considered covert liquidity support for Northern Rock, but found it impractical. Thus, they agreed to an emergency facility by the Bank of England. The bank would be granted access to liquidity against collateral at a penalty rate. Importantly, they agreed to postpone the announcement from September 13 to the next Monday in order to finish the details of the facility. However, news about the help leaked to the press causing depositors to go to the bank and withdraw their money. Queues formed outside the bank's branches. The official statement about the emergency support, including an emphasis on the solvency of the bank, only increased the queues. The Tripartite authorities perceived this visible bank run to threaten the general trust in the British financial system. For this reason, Chancellor Darling announced that the government would guarantee all savings and certain wholesale liabilities of Northern Rock on September 17. This stopped the retail run on the bank. It also calmed interbank markets, as shown in the drop of interbank credit risk in Figures 2.2 and 2.3. However, it did not solve the underlying problem that Northern Rock was greatly exposed to the mortgage market. In the following months, the authorities intervened several times providing liquidity, granting loans and purchasing equity in order to avoid the collapse of the bank. Yet, a sustainable solution still had to be found.

Under the existing law, both bankruptcy and nationalization bore major difficulties. Bankruptcy would have meant that retail depositors would lose money, as they would rank just above shareholders in bankruptcy proceedings. On the other hand, nationalization through the purchase of equity by the Treasury would have triggered takeover rules: Shareholders could have blocked a takeover at the low prices the Treasury as prepared to pay. Hence, the Treasury's preferred solution was a private takeover. But it didn't find a buyer that would have met its conditions.

For these reasons, the authorities decided to introduce new legislation and nationalize Northern Rock. Chancellor Darling rushed the Banking Special Provision Act 2008 through parliament in only three days (Black, 2010, 100). It pro-

vided the government the power to nationalize banks in difficulties, which it used to take over Northern Rock only a few days later on February 23, 2008. As part of the resolution process, the government split Northern Rock into a bad bank (Northern Rock Asset Management) and a good bank on January 1, 2009. The good bank was subsequently sold on November 17, 2011 to Virgin Money. The bad bank was to be wound down.

The Northern Rock episode is important for the whole course of the crisis in the United Kingdom because it tested and changed the crisis management structure. Early into the crisis of Northern Rock, the Treasury Select Committee of the House of Commons started to investigate the bank's failure and the oversight and interventions by the FSA, the Bank of England and the Treasury. It published the report "Run on the Rock" about six months into the crisis, shortly before the nationalization of the bank (House of Commons Treasury Committee, 2008). It criticized the Tripartite authorities heavily, in particular the insufficient communication and coordination among them. The authorities heeded the Committee's recommendations. Recapitulating the crisis, the National Audit Office (2010, 7) observed that their handling of the upcoming crisis episodes had improved.

On the other side of the Atlantic, in the United States, the investment bank Bear Stearns struggled and finally was taken over by J.P. Morgan Chase in March 2008 with the backing of the Federal Reserve. Bear Stearns had invested heavily in risky mortgage related assets and financed them mainly with short-term funding. On Monday, March 10, the rating agency Moody's downgraded Bear Stearns. Its lenders panicked and withdrew their funds. On that day, it had \$18bn in cash; it had none left by Friday. On Sunday, J.P. Morgan announced the takeover of Bear Stearns, the crisis's first big American casualty.

As the credit conditions tightened during this first phase of the crisis, central banks started to ease monetary policy and increase their supply of liquidity. On December 13, 2007, the major global central banks—of the UK, the US, Japan, Switzerland and the ECB—announced a coordinated action. It included swap arrangements in order to help European banks meet their funding needs in US dollars. This announcement marked the beginning of further coordinated efforts for financial stability by these central banks. Individually, central banks also intervened in support of their national financial systems. For instance, in response to increasingly strained markets, the Bank of England introduced its Special Liquidity Scheme on April 21, 2008 (House of Commons Treasury Committee, 2009a;

Winters, 2012). This liquidity program allowed banks to swap mortgage-related securities against highly liquid Treasury bills. Like the earlier, coordinated, central bank intervention, this eased the spreads in interbank markets (see Figure 2.2).

The crisis turns systemic

By September 2008, the crisis turned systemic. On September 7, the US regulatory authorities took over the mortgage giants Fannie Mae and Freddie Mac. These two “Government Sponsored Enterprises” (GSEs) were publicly traded institutions, but people widely believed that the government would back them if they came into difficulties. This is what the government did after they fell short of liquidity. In a first attempt to help them, Treasury Secretary Paulson asked Congress for a “bazooka”—the power to give them lines of credit, buy their assets, and to inject capital (Financial Crisis Inquiry Commission, 2011, 317). The mere ability to save the GSEs, however, did not suffice. The Treasury needed to actually rescue them, thereby acquiring \$5.3 trillion of mortgages.

That same week, the investment bank Lehman Brothers faced a run. Paulson tried to broker a takeover similar to the one of Bear Stearns. But he was reluctant to commit taxpayer money (like the Fed had done for Bear Stearns). Without government support, Bank of America withdrew its offer. The British bank Barclays was still interested, but needed a waiver from its regulator to finish the deal in time. Unwilling to “import [the American] cancer” (Sorkin, 2009, 348), Darling refused to grant the waiver. On September 15, Lehman filed for bankruptcy. This news sent shock waves through markets around the world.

One day later, the rating agencies downgraded the huge insurance firm AIG by multiple notches. The New York Fed had been worried about AIG for some weeks. The firm had seen more and more liquidity flow out of its accounts. It had issued massive amounts of credit default swaps, effectively insuring banks against losses in the sub-prime market. The downgrade forced AIG to give banks further collateral, which it did not have. In contrast to the handling of Lehman, the Treasury and the Fed decided they could not let AIG fail; they stepped in to rescue it. The turmoil also started a run on money market funds. On Friday, the Treasury stopped this run by issuing a guarantee using the Exchange Stabilization Fund. This fund had been established in 1934 to counter exchange rate crises.

After this turbulent week, Secretary Paulson proposed a bill to Congress for a broad rescue program. The House of Representatives rejected the bill on Septem-

ber 29, which caused the largest single-day fall of the Dow Jones. Four days later, the president signed the bill into law after it had been passed by the Senate and the House. It gave the Secretary of the Treasury the authority over \$700 billion to stabilize the financial system.

Paulson intended, at first, to stabilize banks by buying their bad assets. However, he changed course and used the funds to inject capital directly into banks. He forced the biggest nine banks to accept state capital. Subsequently, the Treasury developed a capital program for smaller banks. Some additional programs followed in 2009, for instance the program for Citi.

The financial turmoil also reached London. In the same week Lehman failed, the British government waived its competition rules to allow the merger between Lloyds TSB and the struggling bank HBOS. On September 28, it transferred the deposits and branches of Bradford & Bingley and nationalized the remainder of the bank using the powers granted by the Banking Special Provision Act 2008.

The most comprehensive response by the British government followed on October 8. Gordon Brown announced that his government would guarantee newly issued bank debt up to £250bn and would provide £50bn to recapitalize British banks. Additionally, the Bank of England extended its Special Liquidity Scheme to £200bn (House of Commons Treasury Committee, 2009a, 55).

At the same time, the failure of Icelandic banks affected the British financial system. As a response, the government transferred the deposits of Kaupthing Singer & Friedlander—the subsidiary of the Icelandic Kaupthing bank—to the Dutch bank ING and put the rest into administration. Moreover, Chancellor Darling announced that he would protect all British depositors of Icesave, which belonged to the Icelandic bank Landsbanki, and froze the bank's assets using anti-Terrorism provisions (House of Commons Treasury Committee, 2009b, 22, 33).

As funding difficulties persisted, the government introduced a second round of system-wide interventions. On January 29, 2009, it announced a new set of measures especially geared towards RBS and Lloyds. Both banks had taken part in the recapitalization scheme in October the previous year, and the government had purchased preference shares. To avoid a fixed payment for these shares, the government agreed to convert them into common shares. Thereby, the government increased its shareholdings in RBS from 58 percent to 70 percent. Additionally, the government announced an Asset Protection Scheme: It would guarantee certain assets against future credit losses. RBS and Lloyds agreed in principle to

participate in the scheme. In November 2009, Lloyds withdrew from the agreement to take part in the scheme. It paid £2.5bn as an exit fee for the implied protection since the announcement of its participation in the scheme.

Governments and central banks

In financial crises, central banks are crucial actors because they can provide liquidity to banks. Market conditions eased markedly when the major central banks announced international swap agreements or launched liquidity programs (see Figures 2.2 and 2.3). Nevertheless, the focus of this dissertation is not on their interventions but on those by governments. Government interventions differ from those of central banks in that they can assume losses. Central banks can ease the funding of banks, but central banks have only limited equity which precludes them from taking losses off banks' balance sheets. In other words, dealing with solvency problems requires actions by the Treasury. And during the recent banking crisis, the central banks—particularly the Fed and the Bank of England—required the governments to assume the fiscal risks of solving the crisis (Wessel, 2009; Darling, 2011; Sorkin, 2009). Thus, the following analysis takes as given that central banks contributed to stabilize financial markets, but that their reach was ultimately limited.

The assumption that central bank's efforts were insufficient to resolve the crisis does not imply that their interventions were unimportant. To the contrary, central banks' policies were crucial to ease the impact of the crisis, and without their liquidity programs, more banks would have failed, and governments would have had to intervene on a larger scale. In other words, I assume that in most countries, the governments faced a banking crisis with lacking solvency which central banks alone couldn't solve. Thus, these governments needed to decide how to restore solvency in the banking system. And that decision was up to parliaments and governments. That is the subject of this dissertation. For this focus, I take liquidity programs as given, and leave the analysis of central bank decision making for further study.

Around the world

The Lehman failure reached beyond the United States and the United Kingdom. In high-income countries around the world, governments switched from piecemeal interventions to comprehensive programs to stabilize their financial sectors.

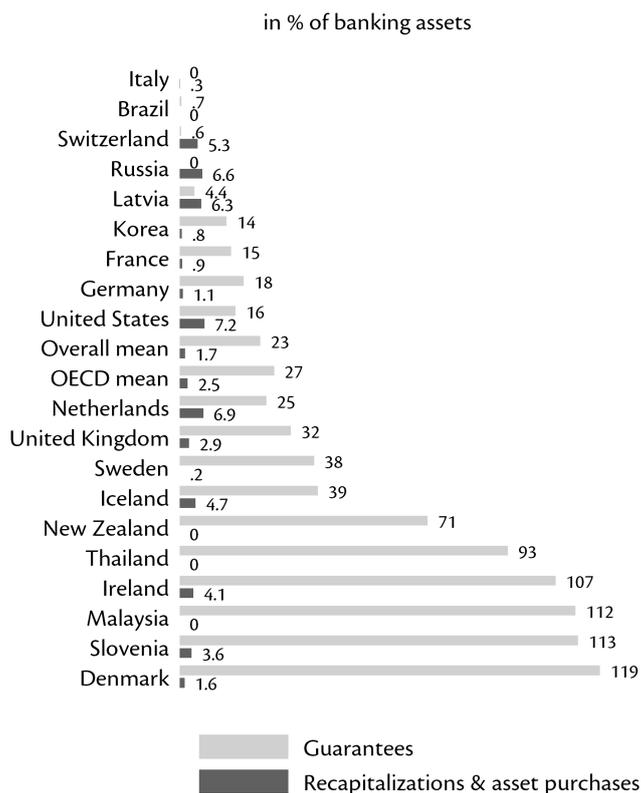
In many countries, they added further interventions until the spring of 2009, after which the banking crisis abated.

In most countries, the crisis packages comprised debt guarantees, which allowed banks to raise funding using the state's creditworthiness, and direct government interventions: Governments injected capital into banks or supported problematic assets. Figure 2.4 provides an overview of the size of these policies relative to the size of the banking sector (expressed in total banking assets). The wide variation in magnitudes of bailouts is striking. The guarantees in Ireland and Denmark covered the entire size of their banking sectors; the interventions in Italy are minuscule.

To counter the repercussions of the financial crisis, governments resorted to Keynesian demand stimuli. Figure 2.5 displays the discretionary fiscal stimuli for 2008-2010 alongside the aggregated financial policies. The American fiscal package was comparatively large, amounting to 5.6 percent of GDP. European countries engaged more cautiously in discretionary measures, also because they relied on their automatic stabilizers. On average within the OECD, governments implemented fiscal stimuli amounting to 1.4 percent of GDP¹. They relied more on tax cuts than spending increases (OECD, 2009a). This leads Pontusson and Raess (2012, 21) to characterize the recent crisis management as "liberal Keynesianism" rather than as the "social Keynesianism" of the 1970s, which had a stronger emphasis on spending. However, a few countries, including Iceland and Ireland, conducted harsh pro-cyclical policies. They faced severe budgetary pressures not least because of the banking bailouts.

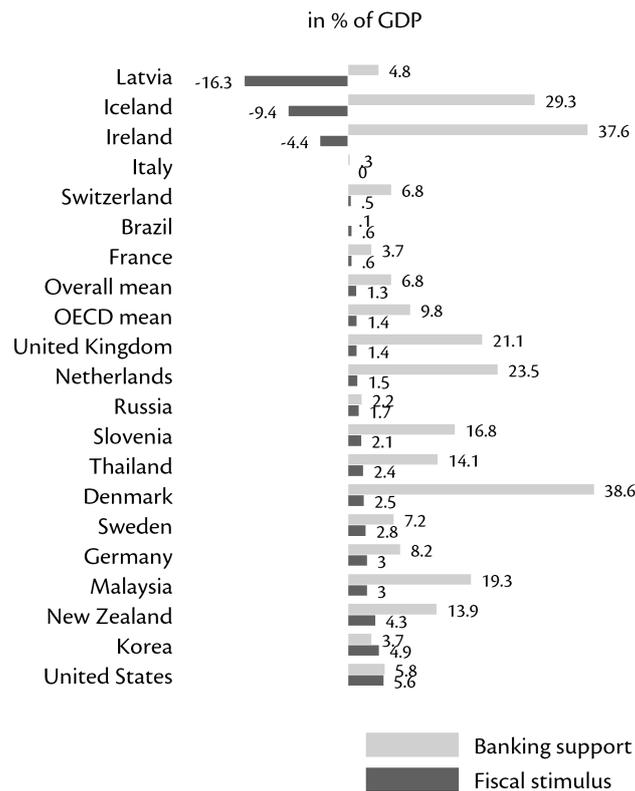
Comparing the two types of responses yields another insight: They follow a clear geographic pattern. Governments around the world stimulated their real economy, but only affluent countries hurried to save their banking sectors. In figure 2.6, I plot the fiscal stimuli (the circles) against the drop in exports (shaded areas). Contrast this with Figure 2.7, in which I graph the banking support measures (circles) against non-performing loans (shaded areas). The stimulus circles cover the world map much more equally than the bailout circles. The latter are concentrated in Europe, North America and in the affluent countries of Asia and Oceania. In sum, the recent financial crisis prompted governments around the world to stabilize their financial sectors. These efforts varied enormously, also

1. The plain average of fiscal stimuli for OECD countries is 1.4 percent of GDP. It is 3.2 percent of GDP when it is weighted by the size of the countries' economies.



Note: Guarantees comprise liability and asset guarantees; recapitalizations comprise capital injections and asset purchases. Source: Laeven and Valencia (2011), own calculations.

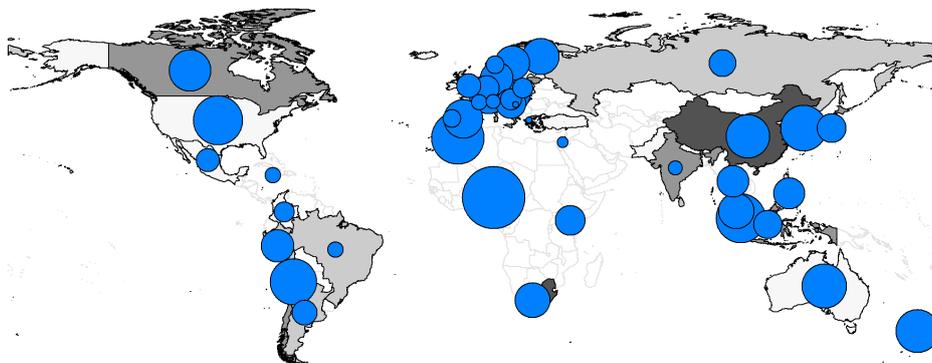
FIGURE 2.4: Financial sector interventions in 2008/09 in selected countries by type



Note: Banking support is weighted by instrument: 15% for credit guarantees, 100% for recapitalizations and asset relief. Source: Laeven and Valencia (2011), own calculations.

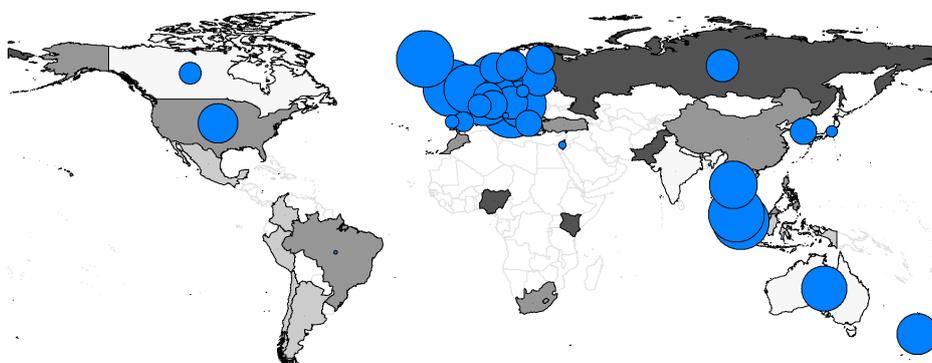
FIGURE 2.5: Announced discretionary fiscal stimuli for 2008-2010 and total financial sector support in selected countries

and in particular, in advanced, democratic countries. Although electoral accountability in these countries is comparably high, the size of their interventions varied. Thus, electoral accountability—as crony capitalist accounts have it—cannot explain the variation in the size of bank bailouts.



Note: Discretionary fiscal stimuli measured as the change in the structural balance taken from Laeven and Valencia (2011) based on data from the OECD (OECD, 2009a) and the IMF Fiscal Monitor (Horton, Kumar and Mauro, 2009) which reflect the size of announced discretionary fiscal stimuli until March 2009 with effects on the fiscal balances over the period of 2008-2010 (Laeven and Valencia, 2011, 10f).

FIGURE 2.6: Discretionary fiscal stimuli for 2008-2010 around the world



Note: Banking support is weighted by instrument: 15% for credit guarantees, 100% for recapitalizations and asset relief. Source: Laeven and Valencia (2011), own calculations.

FIGURE 2.7: Financial sector support (weighted) in 2008-09 around the world

2.5 Conclusion

Like most policies, bailouts are messy. From this chapter's efforts to make sense of this mess, three insights stand out. First, banking is inherently fragile. Banking crises have occurred repeatedly, and they move fast and bear large costs. This causes the crisis to change the conditions for policymaking. Second, governments can use various instruments to save banks, but how much of the bill ends up with the taxpayer depends not on the choice of instruments. In Chapter 4, I show that the burden sharing depends instead on how much the government can bring strong banks to participate. I analyze the bailouts in the United States and in the United Kingdom in depth and demonstrate why American banks accepted to bear bailout costs, while the British government was left with large losses. Third, the last section showed that some governments intervened little and others a lot. This variation across developed democracies is at odds with the crony capitalism account of bailouts. I argue that the people's vulnerability, including their holding of pension assets, explains different sizes of bailouts. This is the topic of the next chapter.

Public money, public profit

As a response to the financial crisis, governments across the world helped their banks. How they supported them varied, however, from country to country. Denmark and Ireland backed their banking systems with a multiple of their GDP, while Italy hardly intervened at all. This variation across countries allows an assessment of competing explanations of bailouts. In this chapter, I use this variation to test the private interest explanations, those that emphasize crony capitalism and instrumental power against the argument that bailouts follow the interest of voters.

Scholarship offers two distinct views of banking bailouts, and they imply vastly different drivers of bailouts. The mainstream view holds that bailouts privilege the interests of a few over those of many. Failing banks receive public money, making taxpayers pay the bankers' speculations. The second view of bailouts is more benign. It emphasizes that bailouts stabilize the financial system, prevent depression and generate benefits for society as a whole. Bailouts may impose costs to taxpayers, but they also benefit them because they keep the economy running. In other words, one view dismisses bailouts as illegitimate side-payments to bankers, and the other regards them as public investments to avoid further harm.

These opposing assessments of bailouts invite different explanations. Scholars that see the bankers as profiteers explain bailouts with the influence of narrow private interests. In their view, the efficient crisis resolution is, as Bagehot (1873) prescribed long ago, to grant liquidity to the system and to shut down in-

solvent banks. And it is deleterious to keep failing banks open by guaranteeing their debt or injecting capital (c.f. Rosas, 2006). Most contributions to the literature fall onto this side of the debate, although they emphasize different aspects of influence. In one version, bailouts arise because of cronyism. In crony-capitalist countries, politicians face little accountability, and they profit from embezzling public money (Rosas, 2006; Keefer, 2007). In another, politicians grant bailouts because of earlier campaign contributions (e.g. Dorsch, 2011; Blau, Brough and Thomas, 2013), or because of close ties to bankers (Jabko and Massoc, 2012). All of these accounts argue that policymakers privilege private interests over those of voters and the general public. What causes bailouts, according to these arguments, is the influence of special interests and a lack or a distortion of democratic accountability.

The benign view of bailouts leads to a different interpretation. If bank bailouts benefit the population at large, because they stabilize the economy, democratic accountability drives policymakers to bail out banks instead of letting them fail. In this chapter, I take this latter side of the debate and argue that policymakers rescue banks for their concerns for voters.

Scholars of the recent crisis continue the ongoing discussion in political economy whether partisanship matters for policy. One side has it that, when times get tough, there is little room for politicians to respond in a partisan way (Pier-son, 2001; Mair, 2009). Others argue that crises highlight societal cleavages giving parties additional incentives to respond to their electorate (Armingeon, 2013). The evidence from the overall responses to the recent crisis seems to be mixed (Bermeo and Pontusson, 2012; Pontusson and Raess, 2012). For banking bailouts specifically, some scholars do detect partisan effects. Ansell (2012) and Smith (2013, 2014) find that social-democratic governments intervened more heavily to rescue banks, and Weber and Schmitz's (2011) observe that they were more generous. With this chapter, I contribute to this debate arguing that the partisanship of the governments does not matter for the banking rescues.

Overall, I maintain that the bailout literature overstates the influence of bankers. Governments bail out banks not merely because bankers want them to, but because letting banks fail creates an economic catastrophe. The threat of a crashing banking sector aligns the interests of voters with those of bankers. Bankers may want the government to step in and restore financial stability, but so does the majority of voters. For this reason, bankers' interests become epiphenome-

nal. For policymakers, saving the economy and avoiding losses to voters becomes far more important than returning favors to bankers. Accordingly, I argue that the amount of resources they commit depends on how much the crisis harms citizens. There are two analytical elements of this crisis threat. The first is the severity of the crisis: How damaged is the banking sector? The second element is how vulnerable citizens are to the crisis. A financial crisis loots citizens' savings and investments—especially assets in funded pension systems. Thus, banking rescues are large where the banking system struggles severely and where the pension system exposes people to financial risks.

3.1 Public money, private profit

There are good reasons that many observers judge bailouts as products of special interests. When rescuing banks, governments channel large amounts of money into banks, or they take on huge risks from banks. During the last crisis, governments spent on average about 3.5 percent of GDP on recapitalizing banks and buying bank assets. They further guaranteed bank debt of about 39.5 percent of GDP.¹ Some countries went well beyond that. Governments spent and risked large parts of the public purse in favor of banks. And banks, in turn, paid millions on bonuses for their senior executives, despite their losses in the wake of the crisis.² The bailouts thus apparently profited those most who caused the crisis—the bankers.

That bankers profit from public policy comes as no surprise. Banks gave large amounts of money to political parties. For instance, the American financial sector gave \$514 million to Republicans and Democrats, equally divided between the two. These contributions were more than the parties received from any other sector.³ Bankers usually have close ties to policymakers, and they can offer lucrative jobs to politicians for the time after public office. Hence, politicians have the in-

1. The figures reflect the average interventions by OECD member countries.

2. Groom, Brian, "Finance workers enjoy growing pay premium helped by taxpayer," *Financial Times*, 7 April 2014; Story, Louise and Eric Dash, "Bankers reaped lavish bonuses during bailouts," *New York Times*, 30 July 2009.

3. The date is taken from OpenSecrets.org, Center for Responsive Politics, accessed on March 24, 2014.

centive to favor bankers over other interest groups, which helps banks to get out on top.

And even where campaign finance is tightly regulated and where it is difficult for banks to lure politicians with job offers, bankers have an advantageous position during times of financial turmoil. Politicians are amateurs in financial markets; they lack the expertise about the intricacies of markets. And they have little information about what skeletons may be hiding in banks' closets. It is, therefore, difficult for politicians to argue against bankers' claims about the negative consequences of a bank failure or about the money banks would need to stop the run. Bankers' expertise and information helps them to tweak bailouts in their favor, even in the absence of campaign contributions or lucrative job offers.

The aftermath of bailouts often match the expectations about influential bankers. In Ireland, for instance, policymakers bankrupted the state by guaranteeing banks' debts. And some scholars found that bailouts delay the recovery from the crisis (Honohan and Klingebiel, 2003). In addition, bailouts are likely to lay the seeds for the next banking crisis because they motivate banks to gamble: They keep the profits when they win, and they get bailed out when they lose (Brunnermeier et al., 2009). In short, bailouts can be devastating for the state, the economy, and the prospect for future crises.

Philip Keefer (2007) distills this special interest view of bailouts into a formal model. I present it here to show what most accounts of bailouts fail to see and why this view is inadequate. Examining the model helps in identifying the key assumption that leads many observers to overemphasize the influence of special interests. The model is also useful for the empirical assessment of bailouts, because it makes explicit assumptions and predictions which can be tested.

The most prominent cases Keefer includes in his analysis take place in Latin Americana and Asia, like the Argentinian crisis in 1980 or the crises in Indonesia, Malaysia and in other Asian countries in 1997. The scope of his study, however, is not restricted to these regions or to developing countries. Like Rosas (2006), Keefer makes his arguments on a general level and sets these crisis episodes against those in high-income countries. Thus, he—and Rosas—include the American Savings and Loans crisis and the Nordic banking crises in the late 1980s and early 1990s. Because of this generality, it is possible to apply his analysis to the recent wave of banking crises.

Keefer takes the model's bare bones from Ferejohn (1986), and he considers three types of actors: policymakers, voters and special interests. It is a model of economic voting in which politicians can either provide public goods or cater to special interests, and voters re-elect politicians if the general welfare meets their expectations.

The government decides on a policy q , which takes on values between zero and one. Voters prefer the policy to be zero, and anything above zero generates rents to special interests which voters have to pay ($\pi(q)$). The politicians get a share of those rents (a), which they share among all veto players in government (n). They also get, if re-elected, the general benefits from staying in office (R). Their overall benefit is then $(a/n)\pi(q) + R$. Voters pay for the rents that politicians are giving out. But they suffer also when a negative shock hits the economy (δ), such as a banking crisis. Thus, the costs to voters are $\pi(q - \delta)$.⁴

TABLE 3.1: Original (Keefer 2007) and modified model assumptions

Assumptions	Keefer (2007)	Modification
Policy	$q \in [0, 1]$	
Voters preferred policy	$q = 0$	
Rents	$\pi(q)$	
Economic shock	δ , random variable distributed over $[-d, d]$	
Politicians share of rents	a	
Benefits from staying in office	R	
Number of veto player	n	
Total benefits for politicians	$(a/n)\pi + R$	
Cost to voters	$\pi(q - \delta)$	$\pi((q + \delta)^2)$

The model has four consecutive steps. Firstly, voters select a performance threshold, say $\bar{\pi}$, beyond which they will re-elect the incumbent politicians. Secondly, the economy experiences an external shock, such as a boom or a bust. Thirdly, politicians make policy, which means they decide how much rent they extract to share between them and special interests. Lastly, voters vote on the basis of the performance threshold, not knowing how much politicians took as rents. Voters can only observe the combined costs of the policy and the economic shock.

4. The expression includes the economic shock with a negative sign, because a *positive* shock ($\delta > 0$), such as a boom, *reduces* the costs to voters. A crisis is represented by a negative value ($\delta < 0$) and increases the costs to voters.

The key parameter is how low voters can push down the cost threshold. Their trade-off is that a lower threshold reduces the rents politicians can take out and still get re-elected, but it also means that politicians forego re-election more often and take the maximum rents instead. Algebraically, one can solve for the equilibrium threshold with the following condition (Keefer, 2007, 614):

$$(3.1 \text{ a}) \quad (a/n) \pi(\bar{q}) + R = (a/n) \pi(1) \\ \text{for } \pi(\bar{q} - \bar{\delta}) = \bar{\pi}, \text{ and } \pi(1) - \bar{\pi} \leq m,$$

and

$$(3.1 \text{ b}) \quad (a/n) \pi(q) + R < (a/n) \pi(1) \\ \text{for all } q \text{ satisfying } \pi(q - \delta) = \bar{\pi}, \delta < \bar{\delta}.$$

The first part of the condition (indicated by 3.1 a) states that politicians seek re-election and take a moderate amount of rents if it is relatively easy for voters to get rid of greedy politicians and if the economic shock is not too severe. That is, $\delta \geq \bar{\delta}$, so that there is a policy \bar{q} which can fulfill the condition $(a/n) \pi(\bar{q}) + R = (a/n) \pi(1)$. In this case, politicians will take “moderate rents.” Moderate rents mean the biggest amount that allows politicians to still win re-election. The second part of the conditions states that, for a severe shock ($\delta < \bar{\delta}$), politicians will forego re-election and take all the rents they can ($\pi(1)$). They benefit more from taking all the rents than from taking some rents and getting re-elected.

For Keefer’s model, the crucial parameter, hidden in these two twisted lines, is m . It represents how difficult it is for voters to throw the government out of office. In the equation it is part of an auxiliary condition: $\pi(1) - \bar{\pi} \leq m$. This condition means that the incumbents will only restrain favors to special interests, if voters will actually bother to replace a corrupt government. And voters bother when the costs of getting a new government (m) is lower than the damage from rent seeking politicians. In other words, when throwing out incumbents is easy (i.e. m is small), the chances are larger that the government attempts to meet the re-election threshold and settle for moderate rents. Thus, the model’s main result is that “a decline in expulsion costs, m (freer elections), reduce rents” (Keefer, 2007, 615).⁵

5. The second result Keefer derives from the model is that more veto players reduce rents. But he argues that the number of veto players has “no observable effect on rents” because they

The model has an additional implication of the model. It predicts that politicians give out smaller rents when the crisis is more severe.⁶ In other words, larger crises provoke smaller bailouts. This implication follows from the condition that politicians adhere to voters' performance threshold:

$$(3.2) \quad \pi(q - \delta) = \bar{\pi}$$

$$(3.3) \quad q = \pi^{-1}(\bar{\pi}) + \delta$$

Solving condition (3.2) for the policy q shows that the economic shock increases the policy. This result means that a sharper crisis (a more negative δ) results in a smaller bailout. Keefer doesn't emphasize this effect, but it is central to model. The effect springs from the assumption that voters cannot discern between the costs from the economic shock and politician's rent seeking. They only find out about the overall welfare loss. So when the economy contracts, politicians have less leeway to give rents to banks and still meet the threshold.

The model's empirical implication, and Keefer's key hypothesis, is that democratic governments have smaller bailouts. This hypothesis, however, is not borne out in the evidence from the recent crisis. There is no significant difference in the size of bailouts in democratic countries compared to those in autocratic countries.⁷

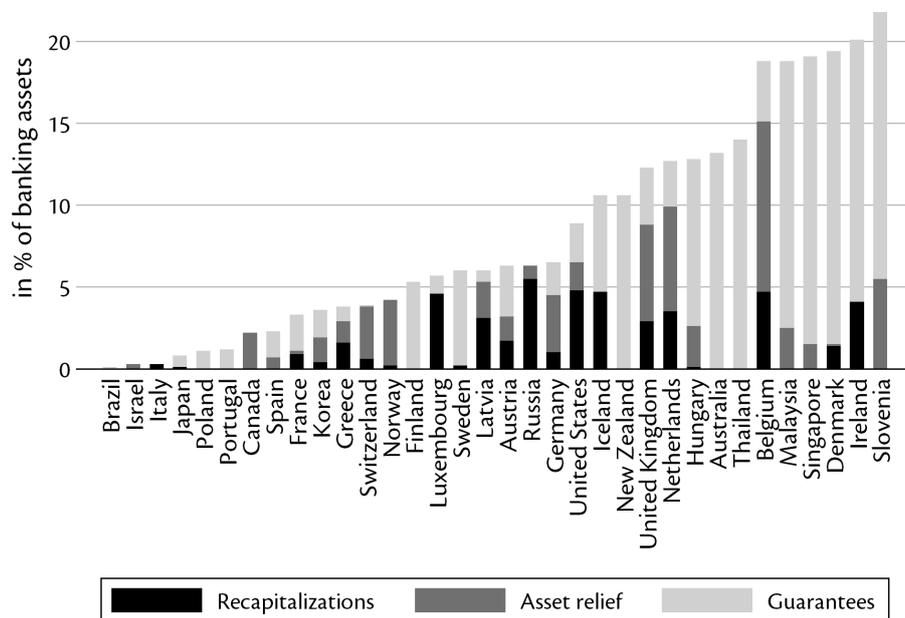
As democracy is its main determinant, this model fails to explain another kind of bailout variation. The bailout sizes are not, as one would expect from the model, similar within the group of democratic countries. Instead, democracies employed a large variation in the size of bailouts. Figure 3.1 shows the banking interventions by country and type of instrument (the instruments are weighted to make them comparable) during the banking crisis of 2008/2009. The interventions range

also delay crisis resolution, which increases costs and cancels out any gains from reduced rents (Keefer, 2007, 615f).

6. There is a case when the model allows for larger rents as a consequence of severe crisis. That is if the economic shock goes beyond a certain limit for which the politicians' incentive condition cannot be met, i.e. $\delta > \bar{\delta}$. But this is in Keefer's account an insignificant corner solution.

7. The weighted sum of banking interventions (recapitalizations, asset relief and guarantees) is 7.09 percent of GDP in autocracies and 7.25 percent in democracies (based on data from Laeven and Valencia, 2011). A t-test finds no significant difference for this comparison, or for a comparison of the interventions expressed in percent of bank sector size or for the comparison when the sample is restricted to a minimum crisis shock (such as a fall of bank shares by at least 50 percent).

from essentially zero in Italy to 20 percent of banking assets in Slovenia and Ireland. (When the unit is GDP, and guarantees are taken at full nominal value, the difference is even more extreme: zero to above 200 percent in GDP.) This difference echoes the severity of the crisis. The larger the crisis is, the larger the bailout. But this relation is the opposite of what the model suggests. In sum, the model does not fit the evidence from the recent crisis. It emphasizes the distinction between democracies and autocracies, but the variation of bailouts is as large within the group of democracies as between democracies and autocracies. And the severity of the crisis increases the bailouts.



Note: The figures indicate the weighted sum of the used banking support interventions with the following weights: 15 % for guarantees, 70 % for asset relief and 100 % for recapitalizations. Source: Laeven and Valencia (2011).

FIGURE 3.1: Government support for banks in 2008-2009

But if the model's predictions don't hold for the recent crisis, what does the model miss? And more importantly, does this observation call into question not just the formal model, but the broader account of bailouts as a product of special interests? I argue that the mainstream view of bailouts and the model suffer from the same mistaken assumption. Both assume that the crisis management of banking crisis is a zero sum game between the public and the banks. They take as

given that bailouts benefit banks and hurt the public. Keefer justifies his choice of model with the reasoning that “[f]orbearance and fiscal transfers [to banks] actually do serve private interests at the expense of [the] public” (618).⁸ And Keefer’s model assumes plain corruption; politicians and banks share rents from public policy. Rosas (2006) argues similarly, while other scholars base their arguments on more subtle forms of favoritism. Some argue that the favors are ensured through campaign contributions (Dorsch, 2011; Mian, Sufi and Trebbi, 2010; Blau, Brough and Thomas, 2013), some point to banks’ political connections (Duchin and Sosyura, 2012), and some see favors in exchange for “future, albeit still indeterminate counter-gifts” (Jabko and Massoc, 2012, 562). But regardless of the channel of influence, all of these accounts share the assumption that bailouts benefit banks at the cost of the public.

3.2 Beyond private profits

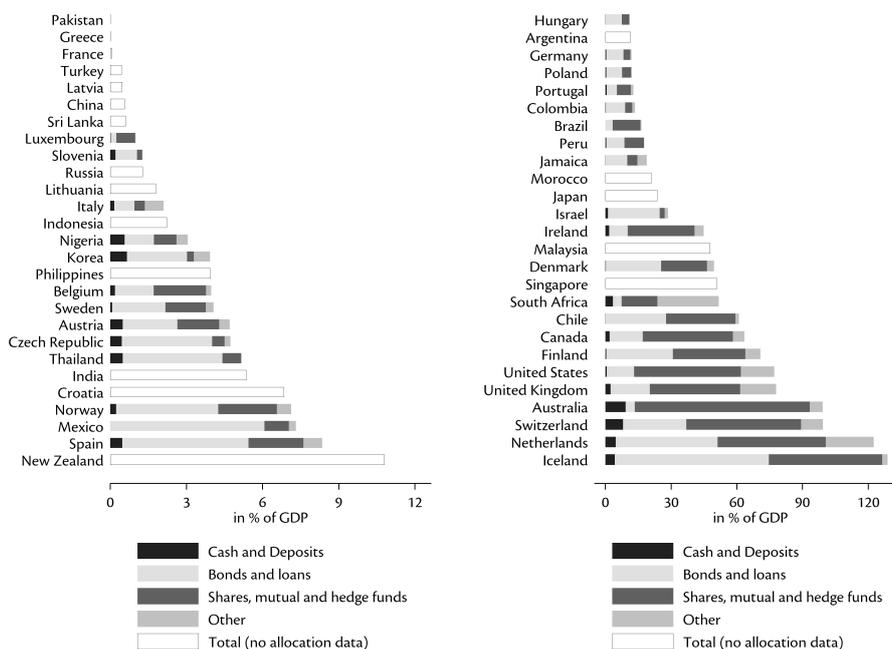
The costs for the state, the risks for future crises and bankers’ access to policymakers and their bonuses, all suggest the same explanation: Bankers pushed politicians to bail out banks, and politicians obeyed. But as plausible as this explanation appears, it misses the essence of banking bailouts and exaggerates the links between politicians and bankers.

One goal policymakers pursue with bailouts is to stabilize the financial system. They want to mitigate the effects for the wider economy. As such, the rescue is a policy response to the economic shock, and one would expect the response to be more forceful the larger the initial problem is. This is akin to a government’s response to a flu pandemic: the number of vaccines the government orders depends on how much the disease spreads. For a banking crisis, the spread of the flu equates to the losses in the banking system. The amount policymakers spend on a banking rescue corresponds to how many loans go bad, and how much new capital it takes to cover the losses.

8. He gives another reason why this model captures bailouts well: “cross-country differences in responses are not likely to be caused by heterogeneous distributions of interest groups” (Keefer, 2007, 618). But I show in Chapter 4 that interest group heterogeneity, i.e. their diverging structural power, actually does explain cross-country differences in bailouts.

Another purpose of banking rescues are to mitigate the direct risks to citizens. During financial crises, people face a number of financial risks. People may lose the money they hold in savings accounts, in stocks and in their pension funds. For savings accounts, the risks are usually limited because most countries have deposit insurance schemes to protect them. But the risks are unfettered for stocks and pension funds. For this reason, stabilizing the financial systems supports not only banks, but mitigates risks for citizens. Citizens' exposure to these risks are not the same in every country. Some countries have relied heavily on financial markets to organize their pension systems. When people's pensions are mostly held in pension funds, they are particularly vulnerable to the crisis. Accordingly, a financialized pension system gives more reason for policymakers to stabilize financial markets. Continuing the comparison with the flu epidemic, the pension funds correspond to the people's vulnerability. If the flu seriously threatens people's long term health—or even their life—a government would invest more in vaccines and emergency programs than if the flu's threat is limited to three days of light fever.

The holdings of pension funds vary across countries, both in terms of size as well as content. Some pension funds hold a large share of assets in stock markets which are risky, while others prefer safer assets like deposits and bonds. More striking is the differing size of pension funds across countries. Some countries have pension fund assets of less than 10 percent of GDP while others have more than 50 percent. Figure 3.2 plots the overall amount of assets in pension funds and the allocation of those asset in terms of asset classes. The figure reveals a positive relation between the total amount of pension assets and the holdings of shares. In other words, the countries which use pension funds extensively tend to invest more of these funds in riskier asset classes. This asset allocation reinforces the motivation for policymakers in these countries to intervene and support the market to lessen the impact on pensions assets. At the same time, even the pension funds with relatively safe assets lost in value during the crisis. For instance the pension funds in Germany, which are invested mostly in bonds, dropped about 9 percent in value (OECD, 2009c). Thus, supporting pension funds is in principle a concern even in countries with relatively safe assets. But pension assets pose less of an electoral threat for policymakers where the pension system relies more on pay-as-you-go elements rather than on invested funds.



Note: The graph on the left includes countries with pension asset holdings of 11 percent of GDP or less (scale from 0 to 12 % of GDP) ; the graph on the right includes countries with more pension assets (scale from 0 to 130% of GDP). The data for the absolute size of pension fund assets are taken from the World Bank’s Global Financial Development Database and national sources. The data on the asset allocation come from the OECD Pension Statistics.

FIGURE 3.2: Asset allocation in pension funds in 2007

In general, funded pension systems add incentives for policymakers to rescue banks. They are not a necessary condition for banking bailouts. Even if a country has no funded pensions, there are still risks from the crisis, and policymakers may support banks to reduce the shock to the economy and employment. But risks through invested pension assets are an additional reason for supporting banks and restoring financial stability.

In sum, there are good reasons for policymakers to bail out banks other than securing campaign contributions or pleasing rich friends. This is not to say that bankers do not gain from bailouts; they do. Their banks escape bankruptcy, and they keep their jobs and bonuses. But reducing bailouts to the payoffs for bankers hides a fundamental point. Because the banking system is intimately linked to the economy, and one falls with the other, voters' interests and those of bankers go in the same direction. Both voters and bankers gain from the government's efforts to restore financial stability. Only because bankers are the largest beneficiaries of bailouts is no proof that they write policy. Pharmaceutical companies benefit when governments launch a large-scale flu vaccination program. But governments don't do that because pharmaceutical companies bankroll political campaigns, but because they want to avoid a flu pandemic.

3.3 Bailouts and voters

In line with the last section, I argue that voters' interest align with those of special interests, and it is this alignment that explains the widespread use of bailouts. Overlooking this motivation for bailouts leads to the exaggeration of special interests.

I base my argument on the fact that banking crises threaten people's livelihood and cause the economy to contract (Furceri and Mourougane, 2009; Furceri and Zdzienicka, 2012; Dell'Ariccia, Detragiache and Rajan, 2008; Deltuvaite, 2011; Reinhart and Rogoff, 2009). Adapting to the downturn, firms fire workers, and at the same time, people lose money because banks fail and stock markets crash. The risks from banking crises are thus not limited to any specific group of the population, but they affect the vast majority. Politicians in government, therefore, have the incentive to halt the crisis and mitigate its risks. They recognize the threat the crisis poses to voters, and they quell it in order to prevent electoral defeat.

Electoral accountability, thus, motivates politicians to restore financial stability by bailing out banks. Without electoral accountability, leaders may still rescue banks, to sustain the economy or to cater to the elites. But in contrast to earlier contributions, I don't expect that democracy reduces banking bailouts.

The motivation to rescue banks in democracies applies to governments from the left, right or center. The risks from banking crises do not spare any party's constituency. The crisis harms businesses and workers. It harms the well-off, who fear for their investments, and workers, who fear for their jobs. And, in many countries, the crisis affects most people directly by threatening their retirement savings. The risks from banking crisis includes the constituencies of both left- and right-wing parties and, certainly, the median voter. For this reason, I argue that the partisan affiliation of the government makes no difference for the scope of the banking rescues.

There are, however, other factors that make a difference for banking bailouts. First, the volume of the rescue efforts depend on how big the crisis impact is. Banks in some countries faced a severe crisis because they had been exposed to the American subprime market or to their own domestic bubble. In other countries, banks were much less hurt. Additionally, the importance of the banking sector varies. A crisis's repercussions are graver when the economy relies heavily on banks. The extent of the crisis shock for the economy shapes policymakers' response; a deeper crisis requires a larger rescue.

Second, the volume of rescue efforts depends on how vulnerable people are to financial risks. The same crisis may have very different effects depending on how much people are exposed to these risks. People are especially exposed if they hold assets invested in financial markets. This concerns the vast majority of people in countries where retirement savings are held on financial markets. In the United States, for instance, those who worried about their 401(k) plans were many.

In short, I argue that governments anticipate the exposure of large parts of the electorate, including the median voter, to the crisis and determine the size of the banking rescues accordingly. The exposure depends foremost on the severity of the crisis, the size of the banking sector and the amount of pension assets.

What Keefer's model misses is that voters' interests are aligned with those of banks in times of crisis. If this alignment is included, which requires only a small change to the model, the results differ and square much better with the evidence from the recent crisis.

The reason for the alignment is that banking failures cause large disruptions and impose losses on voters. Voters, therefore, want banks to survive an economic shock, and they tolerate policy that supports banks to the extent it helps them to overcome the crisis. Naturally, voters object to government support beyond what is necessary. In particular, they would suffer from politicians giving public money to banks in good times. Accordingly, the cost of public policy for citizen can be modeled as $\pi((q + \delta)^2)$. This term means that citizens prefer politicians to compensate any negative shock to the economy: The cost function is minimal when $q = -\delta$. But any policy beyond that, any $q > -\delta$, creates costs to voters. This higher cost for voters associated with a larger policy, i.e. bigger rents, corresponds to Keefer's original formulation.

This alternative cost function for citizens changes Condition 3.1 to:

$$(3.4 \text{ a}) \quad (a/n)\pi(\bar{q}) + R \geq (a/n)\pi(1)$$

$$\text{for } \pi[(\bar{q} + \bar{\delta})^2] = \bar{\pi}, \text{ and } \pi(1) - \bar{\pi} \leq m$$

and

$$(3.4 \text{ b}) \quad (a/n)\pi(q) + R < (a/n)\pi(1)$$

$$\text{for all } q \text{ satisfying } \pi[(q + \delta)^2] = \bar{\pi}, \delta > \bar{\delta}.$$

The first part of the condition applies when politicians adhere to the performance threshold. The second part states when it is better for them to take the maximum amount of rents ($q=1$). In this version of the model, politicians seek reelection when the economy falls into crisis. They chose to conform to the performance threshold because both voters and politicians prefer a favorable treatment of special interests. Voters and politicians achieve a consensus, but their motivations differ. The voters are concerned about avoiding the costs of the banking crisis. The politicians are motivated by staying in office and by the pecuniary benefits they get by favoring special interests.

Accordingly, the crisis has a different impact on policy. Politicians in this alternative model set policy q according to:

$$(3.5) \quad \pi[(q + \delta)^2] = \bar{\pi}$$

$$(3.6) \quad q = \sqrt{\pi^{-1}(\bar{\pi})} - \delta$$

The economic shock, δ , affects policy negatively. That is, politicians react to a negative economic shock with a large policy response. In the model, bailouts are larger, when the crisis is more severe. And in this case, politicians react this way not because they collude with special interests and stab voters in their backs, but because there is an alignment of interests between special interests and voters. Politicians seek re-election and strive to adhere to voters' expectations. In this way, electoral accountability does not prevent politicians from bailing out banks, but brings them to do so.

A highly stylized model, such as this, is no evidence for an argument, but it makes the underlying assumptions explicit and shows how altering one assumption affects the dynamics and results. The key assumption of Keefer's model is that crisis management is a zero-sum game with bailouts benefiting banks at the cost of the public. Relaxing this assumption and assuming instead that interests of voters and banks are aligned during times of crisis turns Keefer's result around. Bailouts increase with the severity of crisis, and electoral accountability drives bailouts, not only special interests.

Importantly, this zero-sum assumption is not only the basis for Keefer's model but also for the mainstream view of bailouts. Scholars vary on how special interest get politicians to bail out banks—with campaign contributions, promises of future jobs, crony connections, or other future gifts—but they assume that politicians, were they to act in voters' interests, would not bail out banks. Analyzing this model, therefore, has a broader import. It shows that allowing for interest alignment between special interests and voters reverts the effect of electoral accountability. It also suggests that the mainstream account has exaggerated the influence of special interests.

3.4 Evidence from the recent financial crisis

Distinguishing between the two arguments—whether bailouts were driven by special interests or by their alignment with voters—faces the methodological obstacle that special interest influence is difficult to measure. I address this difficulty by setting the diverging empirical implications of the two approaches against the evidence from the recent crisis.

The basis for my argument is that bailouts have benefits for the majority of voters, not only for special interests. These benefits accrue indirectly by restoring financial stability and avoiding further financial turmoil. That most people benefit from restoring financial stability is beyond debate. There has been a consensus that banking crises are harmful for financial investment, the economy, and for employment (Dell’Ariccia, Detragiache and Rajan, 2008; Hutchison and Noy, 2005; Reinhart and Rogoff, 2009). The crucial question is whether there is an alternative to bailouts which stops the crisis and avoids burdens to the public. If there were an alternative, one could argue that bailouts, in as much as they transfer public money to banks and the alternative doesn’t, generate profits for banks at the cost of the taxpayer. As both policy responses would stop the crisis, the benefits from avoiding further damage would fall out of the equation. And this is indeed what scholars and pundits have argued (Honohan and Klingebiel, 2003; Rosas, 2006; Keefer, 2007; Woods Jr, 2009). The government does not have to bail out banks to stop the crisis, so their argument, it can alternatively shut down failing banks and provide liquidity to the rest. Rosas (2006) puts this alternative into the concise question, Bagehot or bailout? But this is an illusory choice.

Modern financial systems are tightly interconnected, and letting banks fail during financial distress escalates the crisis. The Great Depression has exemplified how failing banks ruin the economy. And merely providing liquidity is insufficient because systemic banking crises are rarely confined to liquidity. Systemic crises involve problems of capital. During these crises, it is not the case that banks are healthy and only temporarily run out of cash. Instead, many banks incurred large losses, lack capital and cannot repay their debt. Therefore, economists, as far as they ever can agree, have found a consensus that financial crises require government interventions to save failing banks (e.g. Borio, Vale and Von Peter, 2010; Beck et al., 2010). The public debate took this consensus up as “systemic risk” and “too-big-to-fail,” the notion that banks have grown so big that they cannot be allowed to fail lest they tear down the economy. In a systemic crisis, in which banks have inadequate capital, liquidity support is insufficient. And bankruptcy, in the sense of a pre-set procedure to wind down a failing bank, is illusory because it cannot avoid macro-economic disaster unless it involves a back-door government bailout (Levitin, 2011). Solving the crisis without further havoc leaves no other choice than some form of bailout.

This dichotomy between Bagehot and bailout policies also implies that all bailout policies, including asset purchases, recapitalizations, guarantees and forbearance (cf. Rosas 2006), are equally bad, in the sense of channeling public money into private institutions. The experience of the recent crisis has shown, however, that bailout policies can generate a positive return for the government and for the wider economy. For the American government, the recapitalizations generated a profit of about \$9bn (Congressional Budget Office 2014 Chapter 4 of this dissertation). And Veronesi and Zingales (2010) estimated that this program's overall benefit—including the positive externalities for the economy—are about \$100bn. Other governments, however, lost money. Although these governments used similar “bailout policies,” they distributed the burden between the state and banks quite differently. This speaks against the assumption that bailouts necessarily profit special interests at the cost of the public.

One justification that scholars give for assuming that bailouts profit special interests but not the general public is that bailouts have been found to make the crisis impact on economic output worse (e.g. Honohan and Klingebiel, 2003; De-tragiache and Ho, 2010). And some countries in the recent crisis seem to confirm this effect. Guaranteeing all of banks debt, the Irish government steered into a sovereign debt crisis. It received a “bailout” from the European Union, implemented hard austerity measures, and its economy endured a recession. But the experience in most other countries stands against this relationship. The bailouts in countries like the United States, Germany, and France stabilized their financial systems within a few months, and the following recession was mild, considering the depth of the crisis in these countries. Along this line, Furceri and Zdzienicka (2012) find that bailout policies, in particular liquidity support, forbearance, recapitalizations, and nationalizations, soften the output loss after banking crises. While it is difficult to assess the long-term growth effects of bailouts, as they need to be separated them from the effects of the crisis, it is clear that scholars' initial assessment was too bleak.

3.5 Analyzing bailouts quantitatively

So far, I addressed the empirical implications of the mainstream view on bailouts referring to other studies. In this section, I focus on implications that I test ex-

plicitly in a cross-country analysis. I start by showing where the views of bailouts produce contradictory empirical implications.

Hypotheses

As mentioned above, Keefer and other scholars have argued that bailouts in democratic countries are small because electoral accountability restricts politicians to seek rents and bail out banks (Maxfield, 2003; Keefer, 2007; Rosas, 2006). I argue that electoral accountability does curb rent seeking, but it also brings politicians—if there is a banking crisis—to bail out banks to restore financial stability. For this reason, I expect that democracy has little influence on the size of banking bailouts.

HYPOTHESIS 1: Democracy does not decrease bailouts.

Democracy is not an absolute antidote to cronyism and political rent seeking. Competitive elections limit what politicians can do, but they do not prevent all corruption. For this reasons, if bailouts are a product of politicians' pursuit of personal gain, corruption may allow governments to bail out banks even in democracies. Rosas (2006), for instance, argues and finds that governments use bailout, rather than Bagehot policies, where corruption is high. Since I argue, in contrast, that politicians rescue banks because of electoral reasons and not because they favor cronies or reciprocate bribes, I expect corruption to have no effect on the size of bailouts.

HYPOTHESIS 2: Corruption does not increase bailouts.

If banking crises cause the interests of voters and banks to align, cross-country comparisons should show a number of relationships. First, just as the alternative model outlined above predicts, the crisis impact should be positively related to the size of banking bailouts.

HYPOTHESIS 3: Bailouts increase with crisis severity.

Beyond the crisis impact, the important factor for the interest alignment is how much voters are exposed to financial market risks through pensions. Financial crises affect people directly, and strongly, when they hold financial assets in pension funds. If politicians consider the electoral effects of the crisis management, they should act more boldly when the pension system relies on financial markets.

HYPOTHESIS 4: *Bailouts increase with holdings of pension assets.*

Losses to pension savings, recession and increasing unemployment lead in all likelihood to a severe electoral punishment for whoever happens to be in government when the crisis hits. The negative impacts of a banking crisis affect the constituencies for both left- and right-wing parties, including the median voter. For this reason, I argue that the government's partisanship has no effect on the size of banking bailouts. This argument stands not necessarily against the crony capitalism or special interest literature, but against Ansell's (2012) application of asset theory on banking bailouts as well as the findings by Smith (2013, 2014) and Weber and Schmitz (2011).

HYPOTHESIS 5: *As both left- and right-wing governments have incentives to bail out banks, partisanship has no effect on the size of bailouts.*

A usual suspect for an important determinant for any policy is the number of veto players. Here, I treat veto players only cursorily because my expectation that additional veto players have little influence on bailouts conforms to previous arguments, albeit for different reasons. I argue that the legislature, the main veto player for the executive branch, lacks the time and resources during crises to take positions about bailouts against the executive. The experience of the recent crisis seems to confirm this as most legislatures rubber-stamped the crisis response. This differs from earlier arguments about veto players and bailouts. Keefer (2007, 607), for instance, has argued that "checks and balances have no effect on government responses to financial crises" because the delay they cause for the crisis management cancel out the benefits from veto players' curbing effect on rent-seeking. But despite the differences, the expectations for a quantitative analysis are the same, both expect veto players to have no effect on the size of banking bailouts. And testing for veto players using the conventional measures finds indeed no significant effect.

Variables and data

In response to the recent global crisis, governments around the world intervened to support their banking sectors. These crisis policies were decidedly domestic. While there were common trends, compared to earlier crises, the policies varied in composition and size. Some countries had huge programs, some had none,

and many something in between. While the big central banks acted in coordinated steps, the governments acted on their own. Even within the EU, which has the most institutionalized set-up for coordination, the governments pursued their own, distinctly national policies. There was a vast variety of policies, particularly in terms of size (Petrovic and Tutsch, 2009). This set-up lends itself well to a cross-national quantitative analysis because governments reacted to the same crisis, at the same time with domestic programs. In this section, I describe the variables for this analysis. The next section covers the analysis and the results.

BAILOUTS Governments used a variety of instruments to stabilize banking systems. They guaranteed debt, bought distressed assets and injected capital. Across countries, the interventions differed also regarding pricing, bankers' pay restrictions, and requirements for bank lending (see IMF, 2009; Panetta et al., 2009). Nevertheless, I analyze the sizes of these programs. There are several reasons for this choice. First, the size captures different policies in a single measure. Second, size is a key element of crisis policies; it captures how much money governments put on the table to stabilize their financial system. This measure is meaningful for comparisons within and across countries because deciding on fiscal outlays implies trade-offs with other policy areas. The more that is spent on the banking system, the less can be spent on the best alternative: social policy, tax cuts and so on. Third, measuring size means measuring policy output and not outcomes. Outcomes for financial policies are interesting, such as the net cost of bailouts or the impact on growth. But outcomes depend on a myriad of accompanying factors, far beyond policy determinants. And this would make any analysis difficult.

Comparing the size of bailouts poses one operational difficulty: The nominal sizes of interventions represent different types of obligations. For capital injections and asset purchases, nominal size expresses what governments have to pay. For guarantees, the nominal amount expresses what governments *may* have to pay. In other words, guarantees are not outlays, but contingent liabilities. The nominal amount of guarantees state the maximum the government is on the hook for. Thus, equating a million dollars of capital injections with a million dollars of guarantees exaggerates the importance of the guarantees. Still, guarantees are by no means free. Guarantees can cost the state dearly if they are called upon. They also increase the credit risk of the state and thus drive up borrowing costs. In short, guarantees impose costs on governments, but not to their full nominal amount. I

apply, therefore, the approach of the European Commission to evaluate the “state aid element” of guarantees during the financial crisis (Naess-Schmidt, Harhoff and Hansen, 2011; European Commission, 2009*b*). The Commission estimated the implied subsidy in guarantees to be on average 15 percent of the nominal value. For recapitalizations, the Commission counted the full nominal amount. And for asset relief programs, it estimated the state element, on average, to be about 70 percent. This approach facilitates a sensible aggregation of government interventions. It takes account of all the measures and reduces the distortions caused by guarantees.

The European Commission was faced with a difficult situation in the fall of 2008. Because Article 87 of the EC Treaty on competition law generally ruled out subsidies by member states to their industries, the European Commission needed to decide whether the support to the banking sector could be seen as one of the exceptions, in particular as the exemption mentioned in Article 87(3)(b)₅ about “aid...to remedy a serious disturbance in the economy of a Member State.” Since the member states were intent to rescue their banks, the Commission had the choice between water down its competition rules by granting exemptions or risk that member states would ignore them altogether (Koenig, 2008, p. 629). The Commission decided to approve the rescue programs quickly and to ask adjustments in later reviews. It hired new staff and, rapidly, devised rules and guidelines about banking support (Jaeger, 2009; Doleys, 2012).

For the assessment of the rescue programs, the European Commission first distinguished between recapitalizations and guarantees. It decided to count the state aid value of recapitalization as its full amount. The rationale is that the government transfers money to the bank upfront and that the risk is high. For guarantees, it counted only parts as state aid, because they require no transfer and the risk is more limited. To account for differences of risks, the Commission estimated the implied subsidy for well-capitalized banks as 10 percent and for banks in difficulties as 20 percent. Second, the Commission considered asset purchase programs on a case-by-case basis, depending on the conditions of the program. As the state receives assets in exchange for the investment money, the subsidy should be less than the nominal amount. For all asset purchase programs, the average estimated amount of state aid for these were about 70 percent.⁹ These figures are only esti-

9. Data available at http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html [accessed 30 October 2014.]

mates, because the actual implied subsidy depends on the risks which varies with the overall economic situation. Nevertheless, they provide a useful way of comparing different interventions.

One problem that could arise from using these weights is a bias introduced by member states trying to game the system. For instance, governments could move resources from recapitalizations to guarantees because the European Commission counts a smaller part as state aid. Fortunately, the incentive for this type of gaming was low. The European Commission approved the programs quickly, and it communicated early on that it would do so—it emphasized “it would be part of the solution, not part of the problem” (Jaeger, 2009, p.4). Thus, governments knew that their rescue programs—using whichever instrument—would be approved by the Commission.

By measuring interventions this way, I introduce a new operationalization and depart from those of earlier contributions. Some scholars use the plain sum of banking interventions (e.g. Weber and Schmitz, 2011; Grossman and Woll, 2014), and others avoid the aggregation and analyze the instruments individually (e.g. Ansell, 2012). But both alternatives carry shortcomings for a quantitative analysis: Adding up the nominal amounts of guarantees to the other instruments inflates their importance. A dollar guaranteed is not the same as a dollar spent. And analyzing the instruments separately is misleading, because they are complementary. In other words, what the government provides in the form of capital, it does not need to provide in the form of asset purchases, and vice versa. Using the weighted sum of interventions avoids these shortcomings, and thus constitutes a simple but informative measure.

There are two common ways to make banking bailouts comparable across countries. One way is to express the interventions relative to GDP or relative to the size of the banking sector. I use the second method, because the size of the banking sector serves as a more meaningful measurement for bailouts. It relates the bailout directly to relevant quantity. When the banking sector experiences a given level of problems, a country with a larger sector requires larger interventions. Normalizing the bailouts by banking sector size makes them more comparable across countries with differing sizes of banking sectors. All regression models shown in Table 3.4 use therefore bailout size relative to banking sector size. This way of measuring takes away some the explanatory power of some variables, such as the crisis impact and pensions, because they correlate positively with bank

sector size, but this normalization relates the interventions to the most appropriate dimension. And if the analysis finds significant effects for these variables, it strengthens the findings.

CRISIS IMPACT To measure the crisis impact, I use the fall in the value of banking equity from peak to trough between the beginning of 2007 until the first quarter of 2009. This indicator measures the crisis impact specifically in the banking sector and covers the time period, when governments launched the rescue programs. As such, it avoids the difficulties economists encountered trying to find key indicators for the overall crisis (Aizenman and Pasricha, 2012; Rose and Spiegel, 2010, 2011; Berkmen et al., 2012). Few if any indicators predict well the contraction of economic activity because there have been many ways in which the crisis spread. For some countries, the crisis erupted because of losses in the banking sector, for others, because of the fall in global consumption or the flight of capital. It is easier to find a predictor for bailouts, because they are the response specifically to the problems in the banking sector, not to a number of other factors in the economy. And the fall of bank equity is particularly suited as an indicator because it captures the sector's problems regardless of their origin. Banks' equity falls both when they are hurt by losing money at home (e.g. in a popping housing bubble) or abroad (e.g. on the American sub-prime market).

To create this indicator, I take the operationalization form Aizenman and Pasricha (2012) and the data from Thomson Reuters Datastream. For the countries Datastream has no bank equity index, I use the financial sector index or the general stock index.¹⁰ This indicator captures specifically the problems of the banking sector, which prompted governments to respond with banking bailouts.

To test the other hypotheses, I use existing indicators and indices. For instance, I test the hypothesis on people's vulnerability through pensions using the assets of pension funds relative to GDP. Therefore, I estimate the effect of partisanship with the share of cabinet seats occupied by social democratic and other left-wing parties. As an alternative, I estimate the effect with a dummy variable indicating whether the party of the executive belongs to the left. I list the definitions and sources for all variables in Table 3.2, and their descriptive statistics in Table 3.3.

10. Specifically, the variable uses the financial sector index for Iceland and New Zealand, and the stock index for Jamaica, Kenya, Latvia, Lithuania and Nigeria.

TABLE 3.2: Variable definitions and sources

Left cabinet (share): Cabinet positions of social-democratic and other left-wing parties as a percentage of total cabinet posts (<code>gov_left</code>). Sources: Armingeon et al. (2010), The Statesman's Year Book
Pension assets: Ratio of assets of pension funds to GDP. Source: Global Financial Development Database, World Bank
Peak-trough fall in bank equity index: Fall in bank equity index, trough (2008Q4 – 2009Q1) – peak (2007 – 2008), as percent of peak value. Fall in financial sector index where bank index is not available. See Aizenman and Pasricha (2012, 351). Source: Datastream, own calculations
Per capita GDP, log (t-1): Log of per capita GDP on purchasing power parity in 2005 international dollars. Source: World Development Indicators, World Bank
Democracy (UDS): Unified democracy score (posterior mean). Source: Pemstein, Meserve and Melton (2010)
Corruption Perceptions Index: Survey based corruption index, ranging between 10 (highly clean) and 0 (highly corrupt). Source: Transparency International, Teorell et al. (2013)

3.6 Results

In this section, I present the results from a quantitative analysis of crisis management. I start out with a plain, economic model and add consecutively the variables for institutions and politics. This economic model includes the size of bailouts, the fall of bank equity index during the crisis and per capita GDP. The results of the economic models are shown in Columns 1 and 2 in Table 3.4.

Crisis impact (Hypothesis 3)

The first independent variable in Table 3.4 is the percentage change of the bank equity index during the crisis, from the peak in 2007 to the trough in 2008/09, which measures the crisis severity. To recapitulate, the hypothesis on the crisis stated that the more severe it is, the more politicians would spend on saving banks. The estimate confirms this hypothesis. Since a drop in the bank index is coded as a negative number (like δ in the model), a negative coefficient indicates a positive correlation between the crisis shock and the bailout size. The estimate is statistically significant at one percent in the first model and at ten percent in the other

TABLE 3.3: Summary statistics

Variable	Mean	Std. Dev.	Min.	Max.	N
Banking interventions in % of banking assets, log	1.205	1.165	0	3.127	54
Peak-trough fall in bank equity index	-0.697	0.159	-0.992	-0.348	54
Per capita GDP, USD (t-1), log	9.047	1.32	6.132	10.94	54
Left cabinet (share)	0.348	0.362	0	1	54
Democracy (UDS)	1.09	0.754	-0.781	2.25	54
Pension fund assets to GDP (t-1)	25.125	33.41	0.007	128.763	54
Population, log	16.957	1.706	12.668	20.986	54
Veto player index (DPI)	3.722	1.204	1	6	54
Bicameral System	0.778	0.42	0	1	54

Note: The data refer to 2008 for all current variables and to 2007 for the lagged variables. The sample is based on Laeven and Valencia (2011) and includes OECD countries and important upper-middle and lower-middle income countries: Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Croatia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Korea, Latvia, Lithuania, Luxembourg, Malaysia, Mexico, Morocco, the Netherlands, New Zealand, Nigeria, Norway, Pakistan, Peru, Philippines, Poland, Portugal, Russia, Singapore, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, Turkey, United Kingdom and the United States.

TABLE 3.4: Banking bailouts (I)

	(1)	(2)	(3)	(4)	(5)	(6)
Peak-trough fall in bank equity index	-3.724‡ (0.757)	-1.972† (0.865)	-1.964† (0.864)	-2.083† (0.853)	-2.094† (0.840)	-2.294‡ (0.838)
Per capita GDP, USD, (t-1), log		0.430‡ (0.0811)	0.431‡ (0.0833)	0.484‡ (0.140)	0.358‡ (0.0808)	0.441‡ (0.122)
Left cabi- net (share)			0.0331 (0.343)			0.0191 (0.341)
Democracy (UDS)				-0.136 (0.279)		-0.232 (0.269)
Pension fund assets to GDP (t-1)					0.0061* (0.0032)	0.0068* (0.0035)
Constant	-1.391† (0.570)	-4.062‡ (0.604)	-4.075‡ (0.668)	-4.476‡ (0.954)	-3.643‡ (0.664)	-4.306‡ (0.903)
N	54	54	54	54	54	54
R ²	0.258	0.439	0.439	0.442	0.464	0.472

Note: Robust standard errors in parentheses; * $p < 0.1$, † $p < 0.05$, ‡ $p < 0.01$. The sample includes the countries listed in Table 3.3. The dependent variable is the weighted sum of the used banking support interventions with the following weights: 15 % for guarantees, 70 % for asset relief and 100 % for recapitalizations.

TABLE 3.5: Banking bailouts (II)

	(1)	(2)	(3)	(4)	(5)
Peak-trough fall in bank equity index	-1.982 [†] (0.874)	-1.896 [†] (0.878)	-1.877 [†] (0.866)	-2.195 [†] (0.863)	-2.160 [†] (0.850)
Per capita GDP, USD (t-1), log	0.370 [‡] (0.0993)	0.411 [‡] (0.0849)	0.416 [‡] (0.0887)	-0.0809 (0.131)	-0.123 (0.137)
Corruption Perceptions Index	0.323 [‡] (0.0826)				0.317 [‡] (0.0885)
Population, log		-0.0908 (0.0715)			-0.0587 (0.0767)
Veto player index (DPI)			0.0999 (0.101)		0.0960 (0.0893)
Bicameral System				-0.199 (0.295)	0.0762 (0.314)
Constant	-1.442 (0.875)	-1.989 (1.800)	-4.204 [‡] (0.604)	-3.709 [‡] (0.856)	-0.421 (1.679)
N	54	54	54	54	54
R ²	0.535	0.452	0.449	0.444	0.549

Note: Robust standard errors in parentheses; * p<0.1, † p<0.05, ‡ p<0.01. The sample includes the countries listed in Table 3.3. The dependent variable is the weighted sum of the used banking support interventions with the following weights: 15 % for guarantees, 70 % for asset relief and 100 % for recapitalizations.

models, and it is important in size. A one standard deviation change in the crisis intensity (such as between Canada and Sweden, or Sweden and the United States) is associated with a 23 percent increase of the bailout. This result indicates that politicians use bailouts indeed as a problem solving policy; the policy solution depends on the size of the problem.

The second variable, added to the crisis impact, is per capita income. The reason for including it is not to test any particular hypothesis, but as an important control variable. Per capita output represents development, including the available resources as well as the importance of finance for the economy. It effectively tests to some degree the crisis impact, because it has been found to be a strong predictor for the recent crisis impact (Rose and Spiegel, 2011; Aizenman and Pasricha, 2012; Frankel and Saravelos, 2012). The data confirm the latter in the sense that including GDP reduces the estimated effect for the bank equity index. It is an important control for pension assets in particular. Not controlling for income could find a spurious effect for pension assets because of its positive correlation with development. The estimated coefficient for per capita output is positive, indicating that higher income and development are associated with bigger bailouts, and it is highly significant.

Democracy (Hypothesis 1)

The crucial variable for the crony-capitalism account of bailouts is democracy (Rosas, 2006; Keefer, 2007). According to this account, bank bailouts should be smaller in democracies, because competitive elections reduce politicians' ability to seek rents and to give out favors. Additionally to the simple t-test between democratic and autocratic countries presented above, I test for democracy in the cross-national regression (Column 4). The regression finds no statistically significant influence of democracy on bailouts and cannot confirm that electoral accountability would discipline politicians to curb bailouts. (If anything, it is the opposite: When the GDP per capita is left out of the regression, democracy shows a highly significant positive effect, meaning that more consolidated democracies are associated with larger bailouts.) This result speaks strongly against viewing bailouts as a phenomenon of crony capitalism. Democracy does not curb banking bailouts. But bailouts may still be a product of cronyism if it occurs through corruption.

Pension assets (Hypothesis 4)

Column 5 in Table 3.4 presents the results for the regression with pension assets which show that there is a positive relationship between them and the size of bailouts, significant at the 5-percent level. As hypothesized, pensions holdings correlate positively with the size of bailouts, and this effect is strong. A difference of 33 percent of GDP in pension assets is this variable's standard deviation and corresponds to the difference between Germany and Denmark. This difference increases bailouts by 26 percent. And this finding matches the view that politicians consider the voters' vulnerabilities to financial turmoil. When voters stand to lose their retirement savings, which would blow chances of re-election, politicians put more resources into saving banks and restoring financial stability. Electoral accountability prompts bailouts.

Partisanship (Hypothesis 5)

If electoral accountability is important, it could well be that left- and right-wing governments behave differently. And some scholars argued that they do (e.g. Ansell, 2012). On the other hand, as I have laid out above, bank bailouts address economy-wide damages that reach beyond any one party's constituency. Pensioners and those old enough to worry about their retirement, alone, are too large a group that either conservative or leftist parties could afford to ignore them. The results are in line with this hypothesis. The regression, of which the results are listed in Column 6, could not detect any influence of government partisanship. There is no significant difference in the size of bailouts implemented by parties from the left or from the right. This result holds for different measures of government partisanship, whether coded as share of cabinet seats (reported in Column 3 in Table 3.4) or a dummy variable (not reported).

Corruption (Hypothesis 2)

In Model 1 in Table 3.5, I control directly for corruption using Transparency International's index of perceived corruption. This index ranges from zero ("highly corrupt") to ten ("highly clean"). Again, the hypothesis would be that higher levels of corruptions increase bailouts. But the regression clearly rejects this hypothesis. The estimated coefficient is highly significant and indicates the opposite result. Less corrupt countries (with higher scores on the index) are associated

with larger banking bailouts. And this effect is also economically large. A one standard deviation—equivalent to the difference between the Czech Republic and the United Kingdom, or between France and Sweden—increases the bailout size by 80 percent. Even when the estimation includes only the effect beyond per capita GDP, it still accounts for an increase of 26 percent.¹¹ Contrary to the crony-capitalism hypothesis, less corrupt countries have larger bailouts. As such, bailouts spring not from favors from politicians to their cronies. Instead they seem to be legitimate crisis solutions that arise in countries with low corruption.

Controls

In the same table, Table 3.5, I include controls for the absolute size of the country, institutional and partisan veto players (Models 2 to 5). The absolute size of the country (measured as the population in Model 2, or as the absolute size of GDP, results not shown) seems to have no effect on the size of banking bailouts. Similarly, the analysis finds no effect of veto players, whether partisan or institutional. Model 4 shows the estimation results when using DPI's check variable (Beck et al., 2001; Keefer and Stasavage, 2003), which measures both institutional and partisan veto players. The coefficient is not statistically significant at any conventional level. Model 5 reports the result of a dummy variable indicating that a political system has at least bicameral system of medium strength without a statistically significant effect (Lijphart, 1999; Armingeon et al., 2010). The same was found using other measures of institutional veto players, like coding the bicameralism dummy for weak or strong forms of bicameralism, or using a dummy variable indicating a unitary political system.

Additionally, I repeated the regression analysis for a wider sample which includes earlier crisis episodes. Since the bank equity variable is not available for these cases, I used the peak value of non-performing loans to measure the crisis impact. The disadvantage of this indicators compared to the fall in the bank equity index is that non-performing loans may be influence by governments' rescue policies. Further, I include a dummy variable for the recent crisis because the dependent variable, the weighted sum of rescue measures, is constructed in a slightly

11. I estimate this additional effect by including the residuals of regression the corruption index on per capita GDP into the regression model (results not shown). In this model specification, the estimated coefficients of both per capita GDP and the corruption index are statistically significant.

different way. They comprise the fiscal costs of the recapitalizations and the blanket guarantees, calculated as covering all bank deposits and weighted at 15 percent as above (Laeven and Valencia, 2008, 2012). As in Table 3.4, the estimation finds a significant, positive effect of assets in pension funds on banking bailouts.

The analysis failed to confirm any of the hypotheses from the special interest view of bailouts (Hypotheses 1, 2, and 3). If bailouts were driven by politician's private interest, we would expect bailouts to be larger where there is less electoral accountability and more corruption. And bailouts don't decrease with larger crisis shocks as Keefer's model predicts. Instead, bailouts are larger when the crisis hits harder and where people are more vulnerable—because they hold financial pension assets.

3.7 Conclusion

During the economic boom in the 2000s, banks generated large returns for shareholders and paid extensive bonuses to their bankers (DeYoung 2012). But when the wind turned, and the crisis hit in 2008, governments spent billions to bail them out. And bankers still got their bonuses.¹² Given the banker's excellent access to policymakers, it seems naïve not to conclude that bankers persuaded politicians to help them out. And this conclusion has built the common narrative of bailouts, told by scholars, journalists and even former policymakers: Politicians rescued banks as favors to bankers. For instance, Jabko and Massoc (2012) conclude that "the [French] bank support plan should be viewed as a gift that members of the same elite group extended to each other." Dorsch (2011) suggests that "the votes to save Wall Street banks were for sale."

In this chapter, I have argued that this narrative exaggerates the influence of special interests. The studies that stress gift exchanges, campaign contributions and crony connections miss a crucial point of bailouts: During banking crises, bankers' interests coincide with those of voters. Voters, like bankers, benefit from the government halting the crisis. Thus, I put forward a different narrative for bailouts: Politicians bail out banks because restoring financial stability is in the

12. See *supra* note 2 on page 41.

TABLE 3.6: Banking bailouts – including earlier banking crises

	(1)	(2)	(3)	(4)	(5)
Non-performing loans, log	0.270 (0.178)	0.272 (0.177)	0.266 (0.180)	0.265 (0.169)	0.262 (0.170)
Per capita GDP, USD (t-1), log	0.562‡ (0.0930)	0.523‡ (0.156)	0.560‡ (0.0935)	0.473‡ (0.104)	0.471‡ (0.155)
2008/9 crisis (dummy)	-0.962‡ (0.331)	-0.952‡ (0.335)	-0.976‡ (0.349)	-1.052‡ (0.328)	-1.060‡ (0.348)
Democracy (UDS)		0.0935 (0.281)			0.0039 (0.270)
Left cabinet (share)			0.0936 (0.388)		0.0614 (0.392)
Pension assets to GDP (t-1)				0.0091† (0.0035)	0.0090† (0.0036)
Constant	-3.308‡ (1.145)	-3.071† (1.385)	-3.296‡ (1.157)	-2.634† (1.174)	-2.620* (1.395)
N	78	78	78	78	78
R ²	0.314	0.315	0.315	0.345	0.346

Note: Robust standard errors in parentheses; * $p < 0.1$, † $p < 0.05$, ‡ $p < 0.01$. The sample includes the 2008-09 crisis in the countries listed in Table 3.3 and the following earlier crises: Argentina, 1989, 1995, 2001; Bulgaria, 1996; Bolivia, 1994; Brazil, 1990, 1994; Colombia, 1982, 1998; Czech Republic, 1996; Dominican Republic, 2003; Ecuador, 1998; Finland, 1991; Jamaica, 1996; Japan, 1997; Korea, 1997; Sri Lanka, 1989; Nicaragua, 2000; Norway, 1991; Philippines, 1997; Paraguay, 1995; Russia, 1998; Sweden, 1991; Thailand, 1997; Turkey, 2000; Uruguay, 2002. The dependent variable is the weighted sum of the used banking support interventions with the following weights: 15 % for guarantees, 70 % for asset relief and 100 % for recapitalizations. Source: Laeven and Valencia (2008, 2011).

interest of voters. Electoral accountability, therefore, does not prevent politicians from bailing out banks, but motivates them to do so.

In this chapter, I have analyzed the policy responses to the recent financial crisis, and the evidence bears out the alternative narrative which emphasizes politicians motivation to rescue banks because of voters. Contrary to the accounts of crony capitalism, democratic accountability does not reduce banking bailouts. Governments in democracies intervene as forcefully as do non-democratic governments. But within democracies, the size of bailouts varies significantly, and this variation confirms in multiple ways the positive link between accountability and bailouts.

First, the difference across countries indicates that bailouts are indeed a solving policy that serves the public good. Keefer (2007, 618f) points out that for bailouts to be in the public interest, they should be bigger the larger the insolvency problem is. During the recent crisis this is indeed the case. The size of bailouts correlates with the severity of crisis.

Second, better accountability in terms of lower corruption is associated with larger bailouts. In contrast to previous findings, politicians do not spend more in countries with higher corruption; to the contrary, politicians use more money to support banks where corruption is low. This finding contradicts directly the argument that bailouts are a product of crony capitalism and corroborates the positive effect of accountability.

Finally, that politicians consider voters' interests is further supported by the positive correlation between bailouts and financial pension assets. In countries where people hold much of their pension savings in financial assets, they are especially exposed to financial turmoil. There, electoral incentives should motivate politicians to intervene more. The analysis confirms this link between citizens' exposure and politicians' interventions. Bailouts are larger where pension systems rely more on financial markets.

Overall, I emphasize the public good character of bailouts and politicians' considerations for voters. However, there are limits to this benign narrative. I do not argue that banks have no influence on bailouts. The point is rather that even without any bank lobbying, politicians rescue a failing banking sector. Thus, the large instrumental power that banks enjoy is not the decisive factor. Banks pushed for rescues and surely succeeded in making them more bank friendly. And this is the target I suggest for further investigation. Once it is acknowledged that

politicians bail out banks already because of electoral incentives, one can move the analytical attention to the generosity of bailouts. That is, given that governments in any democratic country bail out their banks, where do banks obtain an especially sweet deal, and why? I address this question with the comparison of the British and the American bailout in Chapter 4.

I focus on bailouts as a response to the financial crisis, which I take as given. Explaining the occurrence of the financial crisis is beyond the scope of this dissertation, but one can argue that the behavior of banks and their lobbying increased the likelihood of crisis. In that case, banks' instrumental power determined indirectly the bailouts by causing the crisis. The evidence in this dissertation doesn't speak to this possibility, and banks' influence through instrumental power may be larger than suggested here if considering the likelihood of crisis. Nevertheless, the global nature of the recent financial crisis suggests that the occurrence of crisis was not determined by any one actor or country. And comparing country experiences, like those of the United States and the United Kingdom in Chapter 4, does suggest that previous lobbying can explain the outcomes of bailouts.

In short, I am not suggesting that bailouts are a magic policy that is immune to special interest influence. Rather I argue that bailouts are a crisis policy like others, for instance fiscal stimuli. It is a policy that emerges in response to a severe crisis. As such, it is driven by politicians concerns for voters and the public at large. At the same time, special interests try to tweak the policy in their favor. Bailouts, like fiscal stimuli, are shaped by special interests, but bailouts per-se are not the giveaway to cronies as they are often made out to be.

Structural power of banks and the state¹

This chapter compares the bailouts in the United States and in the United Kingdom. The difference—the US government came out on top, the UK government did not—emerged because of the structural power of its banks. The chapter starts out pointing to existing theoretical debates, before showing why the British banks could block the government’s preferred policy, while the American banks could not.

Moments of political crisis throw into relief the underlying power conflicts in society. The vast transfer of risks from big banks to American and British taxpayers in 2008, in the service of preventing a financial meltdown, is perhaps the best recent example of this phenomenon. Scholars and former officials have pointed to the American bailout as a case of crony capitalism run amok (Bair, 2012; Barofsky, 2012; Johnson and Kwak, 2010). A Republican Treasury Secretary and former head of Goldman Sachs gave the largest nine banks \$125 billion to keep the system of credit from freezing up. The banks got the money, none of their CEOs was fired, and attempts to channel some of the aid toward mortgage relief for the broader economy were in vain. Meanwhile, in the United Kingdom, a Labour government injected \$111 billion into two of its largest banks. That help came at a steep price, as the government fired the CEOs of these banks, while ensuring that healthier British banks shored up their balance sheets independently of govern-

1. This chapter is a collaboration with Pepper D. Culpepper and appears as Culpepper and Reinke (2014), “Structural Power and Bank Bailouts in the United Kingdom and the United States” in *Politics & Society*.

ment funding. The UK government seemed more punitive than the US government while being more conservative with taxpayer money, a result that presumably reflects the greater power of American banks in the US political system.

This, at least, is the conventional story of the American and British bailouts (Woll, 2014; Grossman and Woll, 2014; Bell and Hindmoor, 2014a).² It is wrong, both in its claims that the UK government drove a better bargain for the taxpayers with its large banks and that the US bank bailout reflects the domination of the US government by large financial institutions. In fact, the US government got a better deal from its banks than did the British government, and it did so because American banks wielded less power than their British counterparts. Why has the conventional wisdom so misunderstood the character of the American and British bank bailouts? Observers have focused on the generosity of bailout terms, including the firing of the chief executives, of weak banks: those on the brink of insolvency. However, the important difference between the British and American bailouts lies in the terms imposed on healthy (clearly solvent) large banks. Financially strapped banks could not challenge the government in either country. They had to accept whatever policy the government offered, because only with government aid could they have survived. But healthy banks were not dependent on state aid. Healthy banks in Britain were in a better position to resist the state, and they drove a better deal for themselves, than did American banks. As a result, the British government absorbed more risk than the US government and lost taxpayer money, while effectively providing a costless subsidy to its healthy banks, which benefited from the stabilization provided by the bailouts. In contrast, the United States made a profit from its bank bailout, because it was able to bully healthy large banks such as JP Morgan and Wells Fargo into a collective recapitalization plan.

Theoretically, we return to a fundamental debate about the role of business in politics (Hacker and Pierson, 2002; Smith, 2000; Lindblom, 1977). The bank bailouts illustrate how social scientists have focused on the instrumental power of banks while ignoring their structural power. Instrumental power includes firms' lobbying capacity and their campaign donations; on these measures, the United States looks like an especially captured system (Hacker and Pierson, 2010). But

2. Bell and Hindmoor (2014a) argue that UK government policymakers have become more skeptical of bank threats to exit, post-crisis, which has convinced them to move away from the pre-crisis "light touch" regulation. This may well be true, but our concern in this chapter is only with the character of the bailout policies themselves, not post-bailout regulatory reforms.

when looking at the structural power of banks—which we operationalize as their ability to defy national regulators because of the internationalization of their markets—the situation of American and British banks changes dramatically. Because all the large banks in the United States rely on the American market for their future revenues, they enjoy less structural power vis-à-vis the American government than do their counterparts in other countries, such as the United Kingdom, that do not depend heavily on a given domestic market.

In the next section we discuss the distinction between structural and instrumental power of business, arguing that recent scholarship has neglected structural power because it has not conceptualized the ways in which structural power can be used strategically. Section 4.2 explicates our methodological approach, which employs evidence from the structure of the banking sectors in the United States and the United Kingdom and from process-tracing, in which we use interviews with senior policymakers to evaluate our claims about the power of American and British banks in negotiating with their governments. Section 4.3 evaluates the policy design of the two bailouts, and Section 4.4 tests hypotheses of structural and instrumental power of banks against the evidence of policy development in the two cases. A penultimate section extends the argument comparatively to bailouts in France and Germany. A final section concludes with directions for future research.

4.1 Two dimensions of business power

To understand the character of business influence on important policy outcomes such as the bank bailouts of 2008, we revisit the conceptual distinction between the structural and instrumental power of business. Instrumental power comprises the various means, unrelated to the core functions of the firm, through which business influences politics: donations for campaigns, privileged access to policymakers, and lobbyists and organizations that defend business interests (Miliband, 1969; Culpepper, 2013; Fairfield, forthcoming). Structural power, by contrast, inheres in the fact that firms are agents of economic activity in capitalist democracies. Because the state relies on firm investment to generate growth, the ability of companies not to invest can cause damage to the economy and thereby to the politicians governing it. Since a negative policy, or even the anticipation of

one, may lead firms to reduce their rate of investment, scholars have characterized the democratic state as being structurally dependent on capital (Przeworski and Wallerstein, 1988; Swank, 1992). Governments are predisposed to adopt policies that promote firm investment, even without business leaders necessarily having to do anything (Lindblom, 1977; Block, 1980).

Scholarship from the 1970s and 1980s recognized the fact that this structural power, for example, in the form of coordinated “capital strikes,” could be exercised strategically by business as part of a campaign to change government policies (Block, 1977; Vogel, 1987; Ward, 1987; Bowles and Gintis, 1986). Yet a strange thing happened to the literature on business power: as the influence of neoliberal ideas waxed in the advanced capitalist countries, analytical attention to the ways in which business exercises influence on the state waned. In this process, the concept of structural power as a resource that could be used strategically by business disappeared from the literature, to be replaced by a version of structural power that operated only as an automatic adjustment of the level of investment, which would punish politicians who adopted policies to which business is averse, and whose anticipation therefore would deter adoption of the policy in the first place. Charles Lindblom may in this sense have been a victim of his own rhetorical success in describing business disinvestment as the “automatic punishing recoil” mechanism through which business disciplines government (Lindblom, 1982, 324-336). By the 1990s, the relatively scarce political science scholarship that used the term structural power conceptualized it exclusively in the sense of the automatic reaction of policymakers to the investment decisions of companies (Swank, 1992). When current scholars of business write about “capital strikes” that involve any deliberate action, they now classify them as instrumental power—erroneously, in our view (Fairfield, 2011, forthcoming). Where capital strikes involve coordinated political action among companies, the power exercised by business flows directly from the role of the capital holder in the economy and its growth and employment capacities, not from the investment in lobbying offices or trade associations.

For political scientists, this means that structural power as a causal variable is now only conceptualized as a background condition against which politics plays out, not as an active resource employed by business in the political arena. Thus, when Jacob Hacker and Paul Pierson attempted to revive analytical interest in the concept of structural power in an influential 2002 article, they argued that federal political systems increased the structural power of business by giving companies

easy exit options (Hacker and Pierson, 2002). However, even Pierson and Hacker bought into the prevailing definition of structural power, arguing that this “power is structural because the pressure to protect business interests is generated automatically and apolitically” (Hacker and Pierson, 2002, 281). Thus, for them, “the extent to which business influences specific policy choices will be a function of instrumental rather than structural power” because the possibility of disinvestment “can set the agenda for governments and help to define (or rule out) alternatives, but this signal cannot tell governments what to do” (Hacker and Pierson, 2002, 282). In this now typical formulation, structural power sits in the background of agenda-setting, while instrumental power does the hard causal work on specific pieces of legislation.

Following this line of thinking, scholars, journalists, and former regulators examining the American bank bailout have converged on a similar diagnosis: the government bailed out the banks because they enjoyed privileged access to Washington’s policymakers (Bell and Hindmoor, 2015). American banks have consolidated this Washington-Wall Street axis by donating so much money to Republicans and Democrats that both parties work in the interest of large financial institutions (Hacker and Pierson, 2010; Duchin and Sosyura, 2012; Igan, Mishra and Tressel, 2012). Their special influence is reinforced by the infamous revolving door, which circulates policymakers into lucrative jobs in banks and bankers into public office (Braun and Raddatz, 2010).

We argue that the outcome of the bank bailouts can only be understood by reference to the structural power of big banks vis-à-vis governments. Much of the contemporary research is blind to this fact because many scholars have collapsed structural power into the much narrower category of “structural power that works automatically through the anticipation of policymakers.” Although structural power can certainly work automatically, it can also be deployed deliberately, with strategic intent. In fact, both structural and instrumental power have automatic aspects, in that they require no conscious activation in order to function. Disinvestment and the possibility of exit are the most prominent features of the structural power of business; both work automatically, through the anticipation of policymakers. But the instrumental power of business in capitalist democracies includes the presence of decision-makers who, by virtue of their background, are friendly to business (Miliband, 1969). This is a resource that helps business, whether companies take any action or not. A similar sort of instrumental power

arises from career ladders that involve a “revolving door” between senior positions in government and the private sector (Braun and Raddatz, 2010). These operate automatically in the individual calculus of decision-makers. Such considerations are correctly classified as elements of instrumental power, just like lobbying organizations and campaign contributions, because they involve influence on decision-makers that is based on something other than the function of private firms in a capitalist economy.

As this discussion suggests, there are in fact two dimensions of business power, which previous work has combined into the single dichotomy between structural and instrumental power. The first refers to the source of power: structural power flows from the economic position of the firm in an economy, whereas instrumental power flows from resources extrinsic to the firm’s core economic activity. If we imagine business as a poker player, structural power refers to the cards she holds in her hand. Instrumental power refers to everything beyond the cards—from the quality of her poker face to the incentives of her poker companions to let her win because she might be able to offer them a job in the future.

The second dimension of business power, which the past twenty-five years of scholarship has ignored, refers to the way in which these resources are mobilized by business: automatically or strategically (through deliberate choice). Automatic capacities require no action on the part of business. They work through the anticipation of the object of possible action: in this case, policymakers, who fear the possibility of disinvestment and change policy spontaneously. Strategic capacities, by contrast, do have to be deliberately exercised in order to be effective. Lobbying organizations and campaign contributions are intentional efforts by business to get something from policymakers; but so too is the bargaining position adopted by large firms when negotiating with policymakers. Whether business leaders have bought access or not is a past product of their strategic instrumental capacities. But, in any given negotiation, their bargaining position itself is a product of the structural position of their firms. If the poker play is holding a straight flush, it doesn’t matter whether or not she has a good poker face. She is likely to win the hand. Those who would require structural power to work through the automatic adjustment of policymaker preferences assume that she will win the hand as a result of the other players automatically folding. We argue that the act of putting one’s cards on the table is a deliberate use of the cards, one that requires the exercise of some agency on the part of the winning poker player.

Table 4.1 shows the intersection of these two dimensions. The columns distinguish strategic from automatic aspects of business power, while the rows separate instrumental from structural power. The difference between automatic and strategic structural power lies in the way in which the structural role of a company in the economy has an effect on policy. Is power exercised through the policymaker's anticipation of a business logic (i.e., "it is not worth it for us as a company to produce widgets at tax rate x ")? Or does it instead result from the deliberate use of economic power (i.e., "we as a company refuse to do what the government asks us to do, and we cannot be forced by the government to do it")? Disinvestment (or exit), which works through its anticipation by policymakers, is an automatic resource. Strategic structural power is a bargaining resource, one that has to be invoked if a bank wants to deter a government's preferred policy.

TABLE 4.1: Two Dimensions of Business Power

	<i>Strategic</i>	<i>Automatic</i>
<i>Instrumental</i>	Organizational Lobbying Campaign Contributions	Pro-Business Policymakers Public-Private Revolving Door
<i>Structural</i>	Outside Option Investment Strike	Disinvestment

Borrowing the language of game theory, we describe this resource as an outside option: the payoff the bank gets if it refuses the deal on offer from the state. The outside option is not necessarily a threat to exit; it is to have enough alternative business revenue to be able to ignore the threat of regulatory sanctions in one jurisdiction.³ The outside option of large banks depends on how much state policymakers can credibly threaten to influence their future income stream. The existence of a plausible outside option confers on large companies a degree of regulatory impunity.

Regulatory authorities in profitable jurisdictions have their own power over banks, one little remarked on in the current literature: the ability to impose future costs. From a legal perspective, it is very easy for banks to leave the United Kingdom or the United States. Exiting those countries, however, means sacrificing the

3. The existence of a viable outside option does imply that a firm can exit a jurisdiction if the cost of sanctions imposed by a regulator become too high.

profits to be made there. And there are substantial gains to be made for banks operating out of London and New York. Banks dependent primarily on their profits from these markets lack a viable outside option in bargaining with the state, because the costs a regulator can impose in the future dramatically lower the bank's payoff if it refuses to accept the state's deal. The more money banks expect to make in these jurisdictions, the higher the cost of crossing regulatory authorities. The strategic structural power individual banks can use vis-à-vis the state is therefore a function of the dependence of a bank on the domestic market (Marsh, 1983). Structurally powerful banks—those with an outside option—are those that earn a large share of their revenue abroad.

4.2 Financial crisis as a test case of strategic structural power

Unusual events provide the opportunity to test the empirical implications of rival theories, which are often rather close in practice. A famous example comes from the fact that most of the predictions of Einstein's theory of relativity resemble those of Newtonian physics. One key distinction—the extent to which gravity would bend light—could only be observed during a total solar eclipse, as occurred in 1919. Einstein's theory predicted that astronomers would be able to observe distant stars located behind the sun, because the sun's gravity would bend the light around the sun. And thus the theory of relativity received empirical support that was difficult to find in a lab.

Financial crises offer similar methodological advantages for purposes of empirical testing. Just as the brightness of the sun washed out the ability to observe stars located behind it, so too does the glaring flow of money into politics—the most visible weapon of strategic instrumental power—wash out the observable effects of structural power. It is only when a crisis of substantial magnitude throws into clear relief the contending play of different sorts of business power, by channeling government action into a discrete number of negotiations between banks and the government over a few days, that we can evaluate the relative strength of various sorts of business power in politics.

A hypothesis derived from strategic structural power predicts variation between countries if some have large banks that are highly internationalized and thus capable of resisting regulatory pressure. We do not assume that governments

automatically make the policy that banks prefer. The leaders of banks have to exercise this power in negotiation—they have to lay their cards on the table. This is an exercise of strategic structural power, and it is a prediction made only by our theory. In contrast, a hypothesis of strategic instrumental power predicts that variation should occur between countries on the basis of where businesses have contributed the most to politicians (Johnson and Kwak, 2010); where they have developed the best lobbying apparatus (Bernhagen and Bräuninger, 2005); or where they are most likely to find politicians who by partisan disposition are more sympathetic to the interests of business (Fairfield, forthcoming). If these different sources of strategic instrumental power mapped differently onto our two cases, that would pose a problem of untangling different causal strands of strategic instrumental power. Fortunately, from a methodological point of view, all three types of strategic instrumental power produce the same prediction for our core comparison: the United States, with its powerful lobbying groups and oceans of money from finance allowed to flow into politics, should unambiguously yield an outcome more friendly to healthy banks than should the United Kingdom, if instrumental power is the primary determinant of bank bailout policy.⁴

Several considerations motivate our primary comparison between the United States and the United Kingdom. The two countries are both liberal market economies with large and globally important banks (Hall and Soskice, 2001). This similarity holds constant an important potential source of variation in the bailout policies adopted. London and Wall Street are the world's two leading financial centers, and the bailouts in these two countries were among the most substantively important in the international economy. The different policy options adopted in the United States and the United Kingdom will orient future policy discussions around the design of bank bailouts. A further objective is to incorporate the United States into a comparative political analysis of how banks exercise political power. The United States has been the subject of the most recent scholarship dealing with the political power of financial institutions (Hacker and Pierson,

4. There is another alternative explanation, not so much about instrumental, but about a more general structural power of banks: British banks could prevail over the government because the City of London is more important for Britain than Wall Street for the United States. If this importance to the domestic economy were the driver behind bailout policies, one would expect favorable deals for either all British banks or those that are particularly important for the British economy. The British experience doesn't meet these expectations. The bank with the largest market share, RBS, had to accept tough conditions, and HSBC, which blocked government policy, is a large bank, but smaller than RBS and Barclays.

2010; Johnson and Kwak, 2010; Duchin and Sosyura, 2012). Yet this work fails to compare outcomes in the United States to those in other capitalist countries. The political power of large banks is not unique to the United States; it is a feature of capitalism. Thus, the appropriate empirical question is not “how well did American banks do in the financial crisis?” but instead, “how well did American banks do compared to banks elsewhere?”

4.3 The British and the American bailouts

Lehman Brothers’ failure on September 15, 2008 sent shock waves through the international financial system. Other financial institutions failed or were near failure within days, catalyzing a chain reaction in the American and British banking sectors. Bank of America took over the investment bank Merrill Lynch. The Federal Reserve and the Treasury bailed out the insurance giant AIG, and regulators closed down Washington Mutual. This in turn, put pressure on Wachovia, which was eventually taken over by Wells Fargo. A week after the Lehman failure, the two remaining American investment banks—Goldman Sachs and Morgan Stanley—sought legal conversion into conventional bank holding companies.

In Britain, Lehman’s demise similarly brought two British banks close to collapse, Bradford & Bingley (B&B) and HBOS. The government nationalized B&B and transferred its deposits to another bank. HBOS agreed to merge with Lloyds after the government granted a waiver of competition rules. The UK banking sector had been marked by a relatively low number of independent banks, even before the crisis (Independent Commission on Banking, 2011, 166f). There had been nine independent banks in the index of the largest 100 companies traded in London. In the wake of the Lehman bankruptcy, only five were left: Barclays, Royal Bank of Scotland (RBS), HSBC, Standard Chartered, and Lloyds/HBOS.

Facing an existential crisis of their banking systems, the American and British governments both intervened on a sector-wide scale and provided liquidity, debt guarantees and recapitalizations. In many ways, these policies were alike. However, the US plan contained a number of design features that made it better, from the perspective of the government and the taxpayer, than the British plan. Critics of the American plan have downplayed or ignored these crucial elements of the policy (Grossman and Woll, 2014). The American Treasury Secretary, Hank

Paulson, managed to include all major banks actively in the plan; all of them took state capital, whether they needed it or not. This allowed Paulson to avoid putting public money exclusively in the weakest banks and to finance the bailout through cross-subsidies among the banks.

In the repertoire of bailout options, there are two different sorts of measures; banks want one, but not the other. There are policies that help banks get access to funding, which the government can grant through central bank liquidity or through guaranteeing banks' debt. The latter allows troubled banks to get loans in the market, because the government stands behind these loans and will pay creditors were the bank to fail. This is what every bank wants. The other type of measure is injecting capital; that is, the government gives money to the bank in exchange for shares in the bank. Banks loathe this policy, because the government becomes their shareholder. Existing shareholders take a hit in the value of their shares, and the government is likely to interfere with the management of the bank. It also marks them with a scarlet "B" for bailout, putting them at a disadvantage in future policy debates. For this reason, banks try to get around state recapitalizations when they can.

The only banks that can avoid a state bailout are the financially sound banks. If healthy banks achieve their preferred outcome of avoiding state recapitalization, the result is a poor outcome for the government: it puts state money in the worst banks only. When banks are left to choose whether to raise capital privately or to take it from the government, all the banks that can raise private money will do so. The ones that will take state capital are those with the weakest financial outlook.

Banks asked for more liquidity on both sides of the Atlantic, but they did not want recapitalizations (Sorkin, 2009; Darling, 2011). Jamie Dimon, CEO of JP Morgan, told his board that accepting the government's money "is asymmetrically bad for JP Morgan" (Sorkin, 2009). In the United Kingdom, Fred Goodwin from RBS continuously denied that his bank had solvency problems, and insisted it merely had problems of liquidity (Darling, 2011, 156). RBS agreed, eventually, to capital injections, because, as one observer told us, "they were wholly dependent on the Bank of England for cash. And they weren't in a position to argue about the terms, which is why Fred Goodwin said, it was like a drive-by shooting, not a negotiation."⁵

5. John Gieve, in interview with the authors, London, UK, June 20, 2012.

In the United Kingdom, the choice between private and public recapitalization clearly singled out the sickly banks. Standard Chartered, HSBC and Barclays could raise private capital, whereas Lloyds/HBOS and RBS took state capital and donned the scarlet B. The latter two banks had to write down large sums; the government's book loss a year later was £18 billion and rose to £32 billion in 2012 2012; 2009a.

The second reason the American intervention was better for the government is that it required healthy banks to share some of the fiscal burden, while the British program did not. Whether the burden is shared depends also on how the government tries to get its money back. One way is to charge proportionally to the amount of help. This approach counters "moral hazard" by punishing those banks that erred and encourages prudent behavior in the future. In practice this means asking a high dividend in exchange for state capital and a risk-adjusted fee for guarantees. Risk-adjusted fees compensate the government for taking more risk guaranteeing debt for a risky bank than guaranteeing the debt of a solid bank. The effect, however, is to leave the government and taxpayers worse off. The reason is that the owner of the sickly banks is the government itself; through recapitalizations it invested heavily in those banks. Charging sick banks heavily for interventions just means that the government charges itself.

Exactly such an outcome took place in the British case. The government started out demanding a 12 percent dividend from RBS and Lloyds/HBOS. Only four months later, the government put more capital into the banks through its Asset Protection Scheme, and as of this writing it is still in the red from its investments in these two banks.

The US government chose another way to get its money back. It included all large banks and charged all of them—regardless of how risky they were—a low, standard fee for debt guarantees and capital injections. At the same time, however, the government demanded warrants, which allowed it during the next ten years to buy more shares at the price they had at the end of September 2008. In other words, the government could get its money back when the banks recovered from crisis. This provided help for sickly banks and obliged the healthy ones to reimburse the government for the interventions. Because of this structure, the US government's TARP investments made money for the taxpayer, even though it developed a generous rescue plan. The government implemented a systemic rescue package, including guarantees and Fed liquidity, which supported the whole sec-

tor. According to some calculations, the interventions generated a net benefit to the American economy of between \$86 and \$109 billion (Veronesi and Zingales, 2010). With its payment structure—capital injections and warrants—the US government could recoup its money. It allowed the government to internalize some of the positive external effect of its rescue program. Getting the warrants in the nine major banks generated over \$4 billion, and \$3 billion of that sum was paid by banks that did not need capital injections: Wells Fargo, JP Morgan and Goldman Sachs (US Treasury, 2012).

TABLE 4.2: Design Features of the American and British Bailout Plans

		<i>United States</i>	<i>United Kingdom</i>
<i>Participation in state recapitalizations: Self-selection or not?</i>	Design	Required participation of major banks	Voluntary participation of major banks
	Effect	All nine major banks participate (incl. healthy Wells Fargo, JP Morgan)	Self-selection of sickest banks only (Lloyds/HBOS, RBS)
<i>Funding of recapitalizations and guarantees: Government subsidy or cross-subsidy from banks?</i>	Design	Low, flat upfront fees paired with long-term warrants	Steep upfront fees without warrants; risk-based fees for guarantees
	Effect	Generous help for sick banks; tough terms for healthy and lucky banks	High nominal charges for rescued, mostly state-owned banks
	Gains/losses	\$9bn gain from TARP's bank part (excl. auto bailout mortgage relief) of which \$4bn come from sales of warrants from JP Morgan, Wells Fargo and Goldman Sachs	€10bn (\$14bn) currently estimated losses; current book loss of £15.6bn (\$20bn) from RBS, Lloyds/HBOS

Table 4.2 summarizes the differences in policy design between the two countries. It is worth underlining that, despite these dissimilar policy designs, both

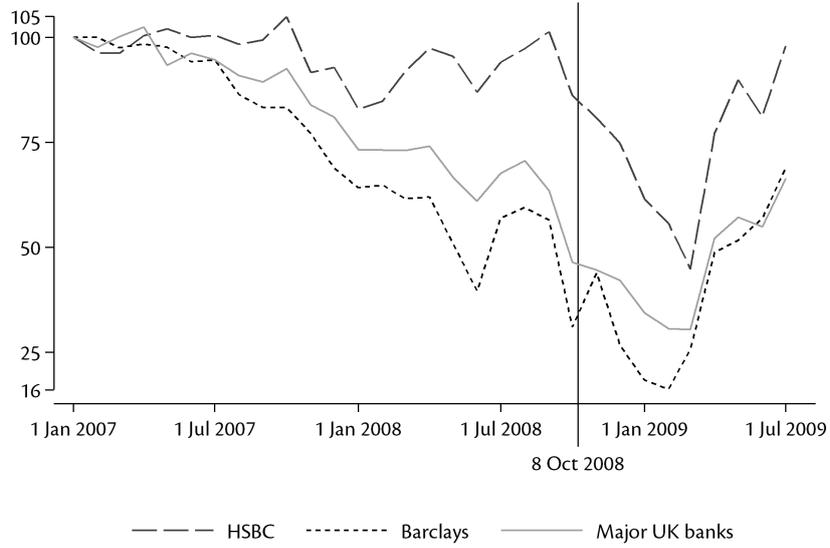
governments have publicly acknowledged that they had exactly the same objective: to prevent the implosion of the banking system and to have all banks in the program. Alistair Darling, the British Chancellor of the Exchequer, explained the goal of his government frankly: “The key was to get capital into the banks that needed it—primarily RBS and HBOS, which was now part of the Lloyd’s group—but at the same time to persuade a bank like HSBC, which had no obvious need for more capital, to join the scheme” (Darling, 2011, 140). US Treasury Secretary Paulson was similarly concerned with getting all large banks to participate in the plan, so as to avoid the bailout as being stigmatizing.⁶

4.4 Bank power: Structural and strategic?

Both the United Kingdom and the United States had banks that were too big to fail, and there were recalcitrant healthy banks in both countries that preferred not to receive equity injections from the state: Wells Fargo and JP Morgan in the United States, and HSBC in the United Kingdom. Why were the British banks, and in particular HSBC, able to keep policymakers from imposing their preferred solution, while the American banks were not? In this section we show that their financial health was necessary to resist the government, but not sufficient to explain this outcome. Instead, we show that even healthy banks will not defy their regulator, if a large proportion of their business lies within the jurisdiction of that regulator. Their structural dependence on the regulator is a weakness, one that the state can exploit in negotiation with healthy banks.

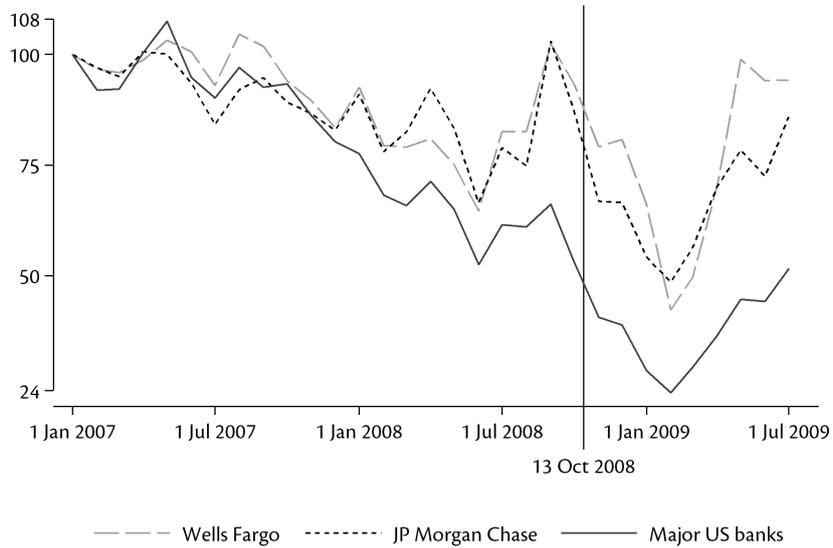
HSBC, JP Morgan, and Wells Fargo were all financially sound banks during the financial crisis. Figure 4.1 displays HSBC’s monthly market capitalization relative to the British banking sector for the thirty months from the beginning of 2007. The crisis left the stocks of most banks battered. Compared to the market capitalization in January 2007, banks had lost on average about 45 percent of their market value in October 2008. HSBC saw its capitalization drop by only 14 percent. HSBC profited from a broad deposit base, which provided stable liquidity during the crisis, and from its business in Asia.

6. Barney Frank, in interview with the authors, Washington, DC, November 16, 2012.



Note: Included are Alliance & Leicester, Barclays, Bardford & Bingley, HSBC, Lloyds/HBOS, RBS and Standard Chartered. Source: Orbis – Bureau Van Dijk.

FIGURE 4.1: Monthly Market Capitalization of British Banks



Note: Included are Bank of America, Citi Group, Goldman Sachs, JP Morgan Chase, Merrill Lynch, NYB Mellon, State Street and Wells Fargo. Source: Orbis – Bureau Van Dijk.

FIGURE 4.2: Monthly Market Capitalization of Major American banks

Wells Fargo and JP Morgan, like HSBC, were healthier than other big banks. Unlike most of its peers, which got into trouble in the mortgage market, Wells Fargo had been strict in its lending standards and had kept toxic housing assets off its balance sheet. Figure 4.2 illustrates the capitalization of Wells Fargo in comparison to the major banks still in business by the end of September. Wells Fargo's market value was down only 7 percent from its pre-crisis level and JP Morgan was down 13 percent; the rest of the large banks had dropped by 47 percent.

There was no difference between the financial health of HSBC, JP Morgan and Wells Fargo. All three banks had stable sources of liquidity. However, they drew on different markets. In 2005-2007, HSBC generated only about 20 percent of its profits at home in Britain, even though it was a dominant player in the concentrated British banking market. Only the much smaller bank Standard Chartered makes a lower proportion of its money from outside the United Kingdom (Figure 4.3). Even though HSBC operates out of London, the bank doesn't depend on the British market. It makes more profit in Hong Kong than in the United Kingdom (HSBC, 2007).

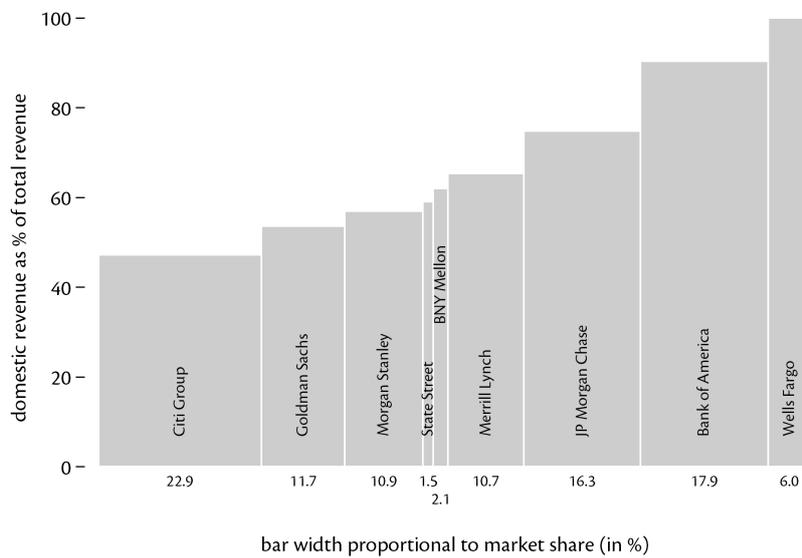
In contrast, as Figure 4.4 illustrates, Wells Fargo operated solely in the American market. Even after Wells Fargo acquired additional international business through the purchase of Wachovia in 2008, 95 percent of its loans were to American debtors (Wells Fargo, 2012). JP Morgan's business looks similar in this respect, with 75 percent coming from the United States. Figure 4.4 shows how much revenue these and other major banks make in their domestic markets, and highlights how—compared to HSBC—Wells Fargo and JP Morgan depend more on their domestic market.

This structural situation meant American regulators could make Wells Fargo and JP Morgan an offer they could not refuse. In the decisive meeting between the CEOs of the nine major banks and senior US government officials—Paulson, Bernanke, Tim Geithner of the New York Fed, Sheila Bair of the FDIC, and Comptroller of the Currency John Dugan—this regulatory threat was explicit, and it was repeated. In the talking points prepared for the meeting on October 13, 2008, recalcitrant banks got this message: “If a capital infusion is not appealing, you should be aware that your regulator will require it in any circumstance” (US Treasury, 2008). After Paulson's presentation of the plan, which reiterated the unpleasant consequences of not accepting the aid, the CEO of Wells Fargo complained to the other CEOs “why am I in this room, talking about bailing you out?” Paulson's



Note: Data refer to domestic revenue in 2005-2007: for Barclays, HBOS, HSBC and Standard Chartered, they refer to domestic income. Source: Banks' annual reports.

FIGURE 4.3: UK Bank Revenues from the Domestic Market



Note: Data refer to domestic revenue in 2005-2007. Source: Banks' annual reports.

FIGURE 4.4: US Bank Revenues from the Domestic Market

response was a threat of regulatory consequences: “Your regulator is sitting right there [pointing to the head of the FDIC and the comptroller of the currency]. And you’re going to get a call tomorrow telling you you’re undercapitalized and that you won’t be able to raise money in the private markets” (Sorkin, 2009, 542). This is an explicit threat from a regulator against a financially healthy bank. The regulator could make trouble for the bank in unsettled markets—the regulator knew it, and the bank’s CEO knew it.

In contrast, UK officials could not make this threat. The UK government wanted to include HSBC in the recapitalization plan, but HSBC refused. Multiple figures associated with the bailout repeated that the UK government had no tools to force HSBC to take state capital, even though it was the government’s first preference. A senior government minister said, “the British government does not have the power simply to acquire capital in somebody else’s bank.... You can’t insist, on an innocent third party, where [the state] is going to take a great wadge of your bank off you.” Another senior UK government advisor said the same thing. “We couldn’t force HSBC.... They made clear that we had no power, and if we tried it they would take us to court.” The United States has a court system too, and banks have never been averse to using it to protect their interests. Banks can only fight the government, however, when they do not view a hostile relationship with bank regulators as too costly. HSBC’s threat to take the government to court was the sort of threat that only a bank unconcerned with its future relationship with national regulators could afford to make.

HSBC’s refusal was a deliberate act. British policymakers had not foreseen these objections and automatically designed a recapitalization program that excluded HSBC, which is how automatic structural power would work. Yet neither was HSBC’s calculated move dependent on lobbying or influence bought with the executive. As the phone logs and memoirs of Hank Paulson and Alistair Darling made clear, US banks had much more frequent access to the top of the Treasury than did UK banks (Woll, 2014). The conventional story, according to which large American banks have developed strong instrumental lobbying ties to officials, is borne out in our research. Moreover, though we cannot with any reliability observe automatic instrumental power, the US Treasury Secretary was a peer of the CEOs of the large American banks, as his former job was CEO of Goldman Sachs. US banks had substantial instrumental power. But they lacked structural

power that would have given them the credibility to stand up to Paulson's regulatory threat.

HSBC's action was intentional, but it was a product of its structural position in the market, not the result of its lobbying access. HSBC made clear to the UK government that it neither wanted nor needed state recapitalization, and that it would sue the government if challenged. The bank then reinforced that case by refusing to cooperate with the government. The former Deputy Governor Sir John Gieve of the Bank of England characterized their response to the government this way: "HSBC said effectively: 'We've got no problem in financing our business. We've got this massive deposit collection business in the Far East; we may have made massive losses in the US... but actually we are perfectly solvent; the world believes we're solvent; we don't need any money.' They also resisted the implication that the whole their whole group was dependent on the UK authorities and made a point of sending their UK man, ... not their chief executive or chairman - to meetings with the Chancellor."⁷ This behavior contrasts with the alacrity with which the CEOs of the nine largest American banks showed up for the October 13 meeting when Paulson summoned them only the Sunday night before the Monday meeting.

HSBC was not the only large bank to avoid state capitalizations. Barclays raised private capital from Qatar and Abu Dhabi. Unlike HSBC, Barclays relied substantially on the British domestic market (see Figure 4.3). The actions of Barclays do not contradict our argument, as can be observed from the sequence of its actions. Barclays was financially weak and therefore lacked the capacity to block a government plan for mandatory recapitalizations (see Figure 4.1). Barclays never wanted state capital, but when the government negotiated the plan, it was unsure it could raise capital privately. Once HSBC quickly announced it would not take state capital,⁸ Barclays made clear it would go to extraordinary lengths to refinance itself through its shareholders rather than taking state money.⁹ Barclays kept the option of state capital open until, a few days later, it succeeded in raising the required capital. By then, the government had announced its debt guarantee programs, which eased funding for Barclays and helped the bank to

7. Gieve, in interview with the authors, London, UK, 20 June 2013.

8. Peter Thal Larsen and George Parker, "Banks Search for Ways to Avoid Government Help," *Financial Times*, 10 October 2008.

9. "UK Bank Bail-Out." *Financial Times*, 9 October 2008.

convince investors to provide capital. Reflecting on Barclays' negotiation, John Gieve from the Bank of England said: "[Barclays] played us very cleverly, in that they managed to negotiate a sum of capital, which they had to raise and that they could raise—from their friends in Singapore and the Middle East and so on. And thereby pass our test, while still getting the benefit of the overall government guarantee." Barclays avoided state recapitalizations, but without HSBC's lead, it would have had to accept capital from the government.

The case of Barclays is also instructive about the government's pricing of state capital. The steep nominal pricing of 12 percent by the British government may give rise to the objection that rejection of the deal by healthy British banks was endogenous. That is, British banks may have only refused to cooperate because the government—mistakenly—demanded too high a price. Had Darling asked for a coupon of only 5 percent as did Paulson, would the British banks have participated in the recapitalization program? The available evidence suggests not. First, the banks as well as the government found pricing to be a secondary issue. Barclays eschewed state capital but accepted even costlier private capital. Barclays sold its shares at a higher discount than the government had demanded and gave additional warrants to its investors.¹⁰ On the other side of the negotiation table, pricing seemed not to be the top issue for policymakers either. For Darling it was important to implement a recapitalization program, not how much banks would have to pay (Darling, 2011). Second, the nominal pricing of coupons differed, but the overall pricing of capital for healthy banks was actually similar. In contrast to the British plan, the American plan included warrants. These increased the costs of state capital, especially for the healthier banks that would recover quickly from the crisis. For this reason, the pricing was comparable and the rescue plans did not give HSBC any stronger reason to resist the program than JP Morgan or Wells Fargo.

This examination of policymaking during the crisis of 2008 shows that strategic instrumental power cannot explain the variation in policy design between the United States and the United Kingdom. Instead the different policies resulted from the outside option open to HSBC, in its negotiations with its regulators, because of its structural position as a global bank with a deep deposit base in exter-

10. Robert Peston, "Barclays Protects Its Bankers' Pay," *BBC Blog*, 31 October 2008, available at http://www.bbc.co.uk/blogs/thereporters/robertpeston/2008/10/barclays_protects_its_bankers.html, accessed 04 April 2013.

nal markets. This is an exercise of what we have called strategic structural power. However, we also want to consider the possibility that the difference in bailout policies might have been a product of lobbying during a prior time period. That is, that the policy adopted at time t was only possible because of the exercise of strategic instrumental power at time $t-1$ (Hindmoor and McGeechan, 2012).

It would be foolish to deny the abundant evidence that American and British banks used their growing economic resources to advocate politically for financial deregulation—and that this financial deregulation played some role in creating banks that were “too big to fail” (McCarty, Poole and Rosenthal, 2013; Bell and Hindmoor, 2015). However, this general finding holds for both the United Kingdom and the United States. And of the two, the United States is widely regarded as the more captured system with respect to financial regulation (Woll, 2014). An alternative hypothesis based on the exercise of strategic instrumental power at time $t-1$ to account for the variation we observe at time t would have to show how past lobbying in Britain allowed HSBC to frustrate government attempts to adopt forced recapitalizations, while foreclosing that possibility to American banks. We can think of no such plausible account. A lobbying account for an outcome in which US healthy banks do worse than UK healthy banks is difficult to square with the strong evidence that the instrumental power of US financial institutions has exceeded that of their British counterparts since the late 1990s.

There is a “revolving door” alternative hypothesis that we should also consider. The fluid labor market between regulators in Washington and banks in Wall Street might have given US policymakers greater expertise about the sector, and thus accounted for their ability to adopt their preferred policy. The British civil service prioritizes the recruitment of generalists rather than specialists with either PhDs in economics or private experience in finance (Fourcade, 2009). This could handicap the government in bargaining with banks. British banks, in this account, would be able to play on their expertise to drive a better deal from Treasury mandarins with limited experience of the actual functioning of banking than in the United States. Indeed, this lack of experience in finance was reinforced in the political sphere, where Hank Paulson, the ex-CEO of Goldman Sachs, clearly had a large informational advantage over his counterpart in the United Kingdom.

Her Majesty’s Treasury assuredly lacked some of the bank-specific expertise enjoyed by the US Treasury. However, the Labour government recognized this shortcoming and elevated Paul Myners, a finance veteran, to the House of Lords

so that he could be appointed Financial Services Secretary. It was his job to negotiate directly with the banks. Darling (2011, 156) noted that Myners' "expertise and experience were invaluable." Prime Minister Gordon Brown relied heavily on Shriti Vadera, a former investment banker at UBS Warburg. The government also brought private sector consultants into its negotiating team when devising policy. One of them told us in an interview that Vadera's economic and political expertise was instrumental in helping the government get the size of the bailout right so as to satisfy both political and economic constraints: "this is why we were lucky we had Shriti Vadera, because we had someone who was able to have the credibility to say, 'This is the number.' And people rallied behind it." We find no evidence that a lack of expertise on either the British or American side had anything to do with the policies chosen.

4.5 Further comparative evidence

Theories based on the use of instrumental power fare poorly in explaining the variation between the American and British policies, either at the time or bailout or as a prior cause that allowed the bailouts to take the form they did. We have shown that an account centered on the structural power exercised by HSBC provides the best explanation of these outcomes. In this section we consider comparative evidence from France and Germany, to see if the same dynamic holds in other cases.

In addition to expanding our number of observations, France and Germany provide useful empirical leverage on bank bailouts, because their inclusion allows us to consider two additional alternative hypotheses. The first is the economic concentration of the banking sector. A smaller number of banks (as in the concentrated UK sector) might coordinate more easily to resist state pressure than a larger number of banks (as involved in the US case). France has a highly concentrated bank sector, like the United Kingdom, with six banks accounting for 80 percent of bank lending. Germany has a less concentrated and more heterogeneous banking sector that includes private banks, cooperative banks, and public savings banks, much like the American banking sector. If banking concentration were important, we would expect to observe similar outcomes in the French and British cases and in the American and German cases.

We are also interested in considering another alternative hypothesis: the government of a medium-sized economy might face harder spending constraints than its counterpart in a large economy. The United States and the United Kingdom have independent central banks, and they can both print their own money. Interview subjects in Britain told us they were aware that they could create the money to fund a big bailout if they had to. But what if there is a logic under which the United Kingdom, a medium-sized economy, felt more pressure to keep the bailout small—so as to avoid being labeled a sovereign debt risk by international bond markets? We cannot test this hypothesis directly, but we can compare the dynamics of bank-state interaction in the United Kingdom with that in two other European states of similar size: France and Germany. These two latter countries, as part of the Eurozone, lack the capacity to print their own money, and so should theoretically be more constrained than Britain. The data in Figure 4.5 suggest that whatever motivated British bailout policy, it was not fiscal restraint: the United Kingdom spent far more on the bailouts, as a proportion of GDP, than did governments in the similarly sized French and German economies.

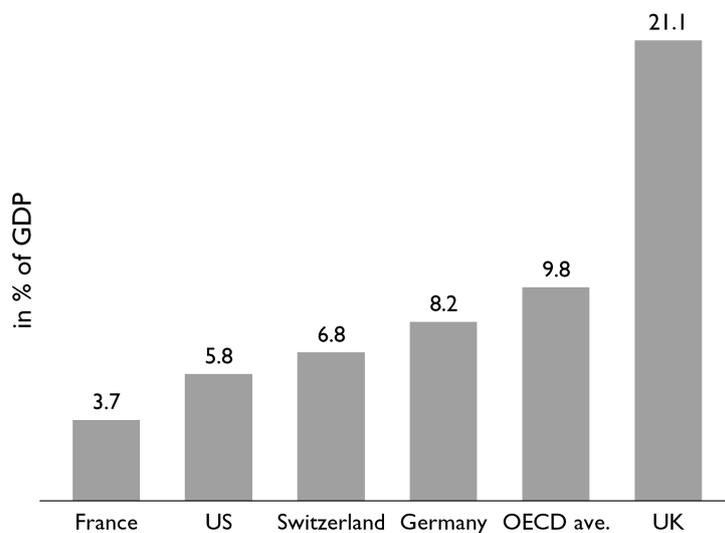


FIGURE 4.5: Banking Support across Countries in 2008-2009

Note: Following the accounting methodology of the European Commission, total banking support is weighted by the use of different instruments, 15 percent for credit guarantees, 70 percent for asset relief, and 100 percent for recapitalizations (for both schemes and ad hoc measures). Source: Laeven and Valencia (2011).

France and Germany shared a similar crisis experience as the United Kingdom and the United States. The Lehman collapse affected the whole banking sector, and governments responded with big rescue packages in early October 2008. The French government injected capital in all major banks and avoided a loss of taxpayer money, as in the American case. The German government supported the banks with a voluntary program, which funneled state capital to the few worst-off banks, and much like the British bailout, this plan generated large losses for the state. Neither the size of the economy nor the concentration of the banking sector can explain this difference. These economies are similar: the two banking sectors are of equal size, and they contribute to the same degree to the economy (financial service value added is 31 percent in Germany, 34 percent in France). Instead, the differential dependence of banks on the state explains the difference.

In Germany, the government's efforts to implement industry-wide recapitalizations ran into the resistance of Deutsche Bank. Deutsche is Germany's biggest bank, and it has moved away from only supporting German business, branching out internationally. In 2007, it generated only 27 percent of its income in Germany. Its financial health and the implicit threat to leave killed the possibility of an industry-wide initiative. Like his counterpart at HSBC, Deutsche Bank CEO Josef Ackermann publicly torpedoed a collective solution by excluding Deutsche Bank from it, saying he would feel ashamed if Deutsche had to admit it needed money from the taxpayer.¹¹ Since accepting state capital meant admitting failure and entailed a number of restrictions, only the weakest banks participated in the program, namely Hypo Real Estate, West LB and Commerzbank. And the interventions in those banks left the Germany taxpayers with large losses.

The French government faced no resistance from a large, international bank. The major French banks are solidly based in the domestic market. The strongest opposition came from a healthy bank, *Crédit Mutuel*, which didn't need any extra capital. But *Crédit Mutuel* is decidedly a domestic bank: 94 percent its income comes from France. *Crédit Mutuel* found itself in exactly the same position as Wells Fargo in the United States, as summarized in an interview reported by Cornelia Woll (2014, 125): "The four banks had roughly the same interest, the four

11. *Frankfurter Allgemeine Zeitung*, "Ackermann: Wir Sind Stark Genug," *Frankfurter Allgemeine Zeitung*, 2 November 2008, available at <http://www.faz.net/aktuell/politik/deutsche-bank-winkt-wieder-ab-ackermann-wir-sind-stark-genug-1727586.html>, accessed 2 October 2013.

biggest in fact. And the fifth, which was also the smallest, was really in perfect health, but it got its arm twisted.” The French government brought the banks together to establish the SFEE, a common fund for liquidity support, and all six major banks accepted state capital. This plan stabilized the banking sector and created a small profit for the French government.

There is no doubt that banks in France enjoy a close relationship with the state. Indeed, even more than the United States, scholars of French finance argue that the automatic instrumental power of French banks—the identity of interests between bank CEOs and the senior policymakers—is uniquely high. In the words of Jabko and Massoc (2012), What sets France apart [from the United States and United Kingdom] is that this privileged access rests on a sociologically stable and homogeneous elite of public and private actors. The social circles and career trajectories of private bankers and high-ranking state officials do not just intersect on occasion, but are almost indistinguishable from each other. These bankers were intimately involved with the drafting of the legislation bailing out French banks. But because the only healthy bank, *Crédit Mutuel*, was dependent on the domestic market, it did not have the structural power of HSBC in the United Kingdom to exclude itself from the collective French solution.

German banks have substantial instrumental influence on the German government. But the instrumental power of German banks is weaker than those of banks in France or in the United States: there is not the same uniformity of educational background that unites banks and the state in France, nor do German banks have preferential access to government officials provided by campaign contributions, as in the United States. Lobbying organizations of German banks follow the banking sector’s division of cooperative, savings and commercial banks. And the association of German commercial banks often struggles over internal tensions (Busch, 2009). The empirical record of the German bailout policy shows that banks were divided, and in the face of these divisions the German government eventually developed a bank support program without much input from the banks (Woll, 2014). Thus, in comparative terms, we classify the use of strategic instrumental power by German banks as lower than in the other three cases. It would contradict the available evidence to say that the strong lobbying capacity of German banks accounted for the costly German bailout program.

Table 4.3 arrays the outcomes observed across the four cases. In all four countries the fall of Lehman Brothers led to substantial contact between senior bankers

TABLE 4.3: Bank Power and Taxpayer Profits

	<i>Intentional Structural Power Large Banks</i>	<i>Intentional Instrumental Power Large Banks</i>	<i>Industry wide Plan?</i>	<i>Profit to tax- payer</i>
<i>US</i>	Low (JP Morgan, Wells Fargo)	High	Yes	\$9 bn
<i>France</i>	Low (BNP Paris- bas, Crédit Mutuél)	High	Yes	\$1.5 bn
<i>UK</i>	High (HSBC)	High	No	-\$14 bn
<i>Germany</i>	High (Deutsche Bank)	Medium	No	-\$55 bn

Note: The classification of structural power of healthy large banks is based on share of income from domestic business: JP Morgan (75%), Wells Fargo (100%), BNP Paribas (47%), Deutsche Bank (27%), HSBC (22%). Income shares are taken from banks' annual reports; taxpayer profit are taken from (Congressional Budget Office, 2013), and Eurostat, Supplementary table for the financial crisis, October 2014. The Eurostat figures denote the accumulated profit to the general government from 2007-2013 and represent a preliminary estimate of the total costs, which ultimately depend on the final selling price of assets (and converted with the average exchange rate of the past 12 months, Nov. 2013–Nov. 2014, of 1.35 €/€). The US CBO figures include the outcome for the overall financial intervention of the TARP, excluding the auto industry bailout and mortgage relief (Congressional Budget Office, 2013, p.5). The Eurostat figures for the United Kingdom correspond to the latest national estimates. The Office of Budget Responsibility lists an implied loss from the interventions in RBS and Lloyds of about £15.6 bn. Considering the gains realized through the guarantee and special liquidity programs, the direct overall loss of £ 0.6 bn, implying an overall financing costs of £ 18.4 bn (Office for Budget Responsibility, 2014, p. 154).

and senior policymakers. The German banking sector had the most heterogeneous interests, which compromised its lobbying capacity, so we classify it as having medium instrumental power. As is clear from the table, though, instrumental power is irrelevant to the outcomes observed. Where large banks exercised strategic structural power in negotiations with the government—because most of their revenue came from other jurisdictions—those banks were able to prevent governments from imposing an industry-wide solution. That HSBC and Deutsche Bank were able to overpower their respective governments was costly to British and German taxpayers, as the final column of Table 4.3 makes clear. In all four cases large banks were bailed out. This is an indicator of the central place that finance occupies in these economies. But our interest as social scientists lies in explaining consequential variations in policy design across countries. To do so requires putting analytical attention on the way in which the structural power of banks can be used strategically, not merely automatically.

4.6 Conclusion

Large banks are central to the functioning of financial systems, and when their failure risks bringing down the entire financial edifice, the structural position of these banks makes a bailout the most likely outcome. That is a feature of capitalism generally, not just American capitalism. We observe these bailouts in countries across the industrialized world. Our analysis of bailouts in four of the world's six largest economies demonstrates that the strategic exercise of structural power was a root cause of variation in the form of the bailouts chosen. After the fall of Lehman Brothers, the United Kingdom and Germany, like the United States and France, had to prevent their vulnerable banks from imploding. Yet the United Kingdom and Germany failed to force their preferred terms on the largest banks, because HSBC and Deutsche Bank were insufficiently dependent on domestic markets. Neither British nor German policymakers could pursue their optimal policy. Governments in the United States and France were in a stronger structural position, vis-à-vis their large banks, than were governments in the United Kingdom and Germany. American and French governments got a better policy deal from their large banks, in that they were able to capture more of the upside of healthy banks for taxpayers.

Our analysis runs counter to virtually all accounts of the American political economy, post-crisis. There are two reasons this literature has provided an incomplete account of the role of bank power in explaining bailout policies. First, most analysis of the American political economy does not situate the US case in a comparative framework. Without embedding arguments about political power of capitalists in the United States in a comparative analysis of the political power of capitalists in democratic capitalism, it is impossible to sort out the effects of capitalism, in which bankers are almost always privileged, from those of the specific privileges afforded to bankers in the US political economy.

Secondly, the existing literature has focused almost entirely on the way in which American financiers “buy” influence—or in other words, on the strategic exercise of instrumental power (Johnson and Kwak, 2010; Hacker and Pierson, 2010). We have shown that structural power can fruitfully be reincorporated into political analysis not only as a resource that acts automatically in the heads of politicians, but also as a resource on which banks draw deliberately in bargaining with governments. It is different from lobbying power. Lobbying power is about the access of banks to policymakers and the expertise their lobbying apparatus can mobilize. These features were irrelevant to the course of the bailouts in these four cases. Moreover, the ability to defy regulators, which was crucial to the strategy pursued by HSBC but foreclosed to JP Morgan and Wells Fargo, was a product of their strategic structural power. That is, of their deliberate use of their role in the economy as a resource in bargaining with the government.

Our theoretical innovation in this chapter is to reanimate the study of structural power by showing how it can be used as a strategic resource of business, not merely as an automatic threat of disinvestment that requires no agency on the part of business firms. This innovation, as remarked earlier, represents a return to earlier notions of the concept, which did not confine structural power to an ontology in which it is all structure and no agency (Bell, 2012).

We anticipate three sorts of challenges to our proposed conceptualization of structural power as a strategic resource. The first is that, if this power is really obvious and structural, why does it need to be used strategically at all? Why do politicians simply not adjust their expectations accordingly and automatically make the best offer they know they can get their banks to accept? Such an objection can only come from a scholar who stood at great distance from the uncertainty that surrounded the bank bailouts of 2008. Policymakers and bankers were highly un-

certain about each other's intentions and resources. The British government tried to achieve its best solution, which involved including all banks in the recapitalization agreement, but only then did policymakers discover that HSBC would refuse, and that policymakers could not credibly threaten the bank. Likewise, American policymakers were not certain, going into the meeting with the nine leading bank CEOs, that all banks would accept the deal. So they marshaled their regulatory might and personnel to remind the American banks of their dependence on American regulators. To insist that structural power has to take place only in the heads of politicians, as automatic adjustment, is to claim that structural power cannot be invoked in negotiations. This is an untenable theoretical proposition. Structural power is entirely consistent with deliberate political action.

We are not the only scholars to argue that structural power can require the use of agency. And it is from this theoretical position, largely occupied by constructivist scholars, that we anticipate two other potential objections. First, if structural power can be strategically deployed, and if instrumental power can have automatic features, then is there any useful distinction between structural and instrumental power? "Being instrumentally powerful can make business appear structurally powerful," as Hindmoor and McGeechan put it, calling into question the analytical utility of the distinction (Hindmoor and McGeechan, 2012). Secondly, as Stephen Bell (2012) has observed, theories of structural power require greater attention to the way in which politicians interpret that power, and how the perceptions of politicians and the public can change over time, thus changing the structural power that automatically accrues to business. Thus, potentially all structural power involves the use of strategic action.

The original distinction between business power as a resource acquired by lobbying, on the one hand, and business power as a resource that accrues to firms because of their position in the economy, on the other, remains a theoretical difference with real world policy implications. Political scientists need to put more attention on this distinction, not less, because it involves two different views of how power is consequential in politics. According to the lobbying view, banks are powerful because they can buy the best lawyers and lobbyists to defend their interests (Hacker and Pierson, 2010). Political debates animated by this perspective focus, for example, on the laws regulating spending in politics. The structural view, by contrast, focuses attention on questions regulating the size of banks, which can make them too big to fail. It also highlights the importance of international coop-

eration, through which governments can try to build international rules that limit the ability of large banks to escape regulatory scrutiny anywhere (Singer, 2004).

As for the argument that even the automatic structural power of business is always in part constructed by agents in the world: we agree. What goes on in the minds of politicians, and what they take as given in assuming business responses to tax policy, is certainly a question of interpretation, not simply an objective fact that is given unambiguously by economic structure (Bell, 2012). Our concern with this approach is largely methodological, because it involves empirically assessing what is going on inside the heads of policymakers. Automatic structural power changes when conditions change, as politicians alter their evaluation of the credibility of a threat of business disinvestment in the wake of different economic events. But even so, its short-term function is largely automatic and unobservable empirically; only its policy consequences can be observed.

The strategic use of structural power is conceptually distinct from the automatic use of business power. Strategic structural power can be observed through its effect in negotiations, of which there is an empirical record. It can be readily demonstrated through process-tracing that is embedded in an analysis of market position and of bank-government interaction. As such, it is a distinction that will allow other scholars to test our propositions about the dependence of companies on national regulatory authority in a globalized economy. This analytical innovation does not exclude that other scholars can productively explore the way in which the possibility of disinvestment is constructed through public discourse. But our approach may be easier to observe in practice.

Substantively, our analysis implies that large firms are empowered not only by the possibility of moving capital from one jurisdiction to another (the legal exit option), but also by the ability to absorb regulatory sanctioning costs in a given economy (the viable outside option). Where companies make much of their revenue in one country, those potential profits represent power in the hands of national regulatory authorities. The giants of American finance were well aware of the cost of not playing ball with a national regulator. Political scientists have paid extensive attention to the way in which the exit option makes mobile capital more powerful in political negotiations, and this has been the source of important insights (Marsh, 1983; Winters, 1994; Mosley, 2000). Yet the possibility of mobility may be illusory when the costs of leaving are high. For example, an increasing number of economies—the European Union and Switzerland are only

the most recent examples—have passed laws or initiatives that seek to regulate executive compensation. Large financial institutions routinely invoke the threat of exit from these jurisdictions in response, just as they did in the United States after the passage of new financial legislation adopting shareholder rights to vote on pay packages. The threatened exodus has yet to appear; moreover, it appears to have had little effect on lawmakers. When the United States and the European Union and Switzerland all adopt tough new regulations on executive pay, it is an open question whether financiers in these jurisdictions will be willing to follow up their threats to move to Asia.

Episodes such as the financial crisis of 2008 are rare political events. Because they open the possibility for such potential long-term damage, they reveal how state policymakers and powerful private interests bargain under time pressure and over high stakes. The instrumental power of financial institutions in these conditions is less important than their structural power. Large banks are privileged actors in all capitalist countries, but even privileged actors in an open economy must still contend with the costs that regulators can impose on them.

Not ruled by legislature

The previous chapter showed that the American bailout made banks pay dearly, while the British bailout left the government holding the bag. It argued that the varying degree of structural power of banks caused this difference. But rather than banks' structural power, the explanation for this difference could be that the American government needed Congress to pass a rescue package, while the British government did not. Thus the crucial place for the bailout may not be the interaction between banks and the executive, but within Congress. Keefer (2007), for instance, argues that legislative veto players curb rent seeking. Others see the legislature as important because banks could lobby lawmakers to vote for the bailout (Blau, Brough and Thomas, 2013; Mian, Sufi and Trebbi, 2010).

There are good reasons that scholars of bailouts emphasize the role of legislatures, especially of the US Congress. Judging from the literature on executive-legislative relations, Congress should have been in a strong position to determine policy. Compared to other legislatures, both in presidential and especially in parliamentary systems, Congress has large legislative powers vis-à-vis the president. And that should have been true especially for the bank bailout in the fall of 2008. Bailouts are highly salient and concern domestic policy (not aloof foreign policy). At the time of the crisis, government was divided; George W. Bush, a Republican, faced Democrat majorities in both houses of Congress. And the president was not only in the last months of his second term, but he also had abysmal public ap-

proval (around 20 percent). All of these factors shift the balance of power in favor of Congress.

Despite all of these factors, Congress deferred to the Treasury. The Treasury proposed a plan and within two weeks, it received \$700bn to prop up banks. It wasn't Congress that made the bailout strict. Congress didn't specify which instruments should be used. The Treasury decided to recapitalize banks, and it decided to include all major banks. Congress was thus not the disciplining veto player forcing the executive to curb rents. For this policy, the power balance was reversed. At a time when the administration should not have been able to get any major legislation passed, Congress deferred, and the Treasury came to vast new powers.

This raises the question why did the power shift to the administration? The reason for Congressional deference lies in the crisis. The crisis is what scholars of the presidency refer to as a "real world event." In this chapter, I argue that the financial crisis is just such an event that changes the power balance between the legislative and executive branches of government. Financial crises force policymakers to defuse an economic bomb within very little time. Given the threat and urgency, legislators defer to the executive.

The contribution of this chapter is twofold. First, I argue that Congress is inconsequential for the American banking bailout. My findings suggest that the explanation for the crisis response should focus on the executive instead. Second, I argue that financial crises are a class of events that change the circumstances of decision-making which shift authority from the legislature to the executive.

5.1 Focusing on Congress

In line with the overall thesis, this chapter uses a comparative perspective. It also aims to explain bailouts across countries and, in particular, the differences between the United Kingdom and the United States. One reason to look at the role of the legislature is to counter the argument that the bailout in the United States was tougher than in the United Kingdom because of its strong legislature. For this reason, however, the focus shifts to the United States and to what extent Congress determined the bailout. As the British institutional rules grant only few powers to Parliament, we expect it to have no say. But the focus on the American case

grants insights beyond this comparison. If any legislature matters for the management of banking crises, it is the US Congress. Legislatures in presidential systems are generally stronger than those in parliamentary systems. But even among legislatures in presidential systems, the US Congress inhabits a strong position. The US Congress has strong control over legislation (Haggard and McCubbins, 2001; Shugart and Carey, 1992), and the president has little possibilities to act unilaterally (Carey and Shugart, 1998): Congress controls the legislative agenda, and the president has merely a package veto and very limited decree powers. For these reasons, analyzing the American case constitutes a crucial case that is of wider importance.

5.2 The argument

Banking crisis set the legislature against the executive. To stop financial panic, governments need deep pockets. The average bailout program during the recent crisis amounted to 10 percent of GDP, which is equivalent to what governments spend on education, defense, public order and housing combined.¹ Large sums of money like these stir rivalries and imply trade-offs. Any policymaker surely knows some alternative area on which he or she would rather spend that money. Bailouts therefore pitch those planning to spend the money on banks against those granting it. This sets the executive against the legislative branch.

The legislature figures prominently in the bailout scholarship. Keefer (2007) argues that a legislature with veto power acts as a check on the executive and curbs rent-seeking. At the same time, he argues, veto players increase the crisis costs because they delay solving the crisis. So he finds, like others, no quantitative effect of veto players on bailout costs (Rosas, 2006; Weber and Schmitz, 2011). This view invites the explanation that the American bailout was tougher on banks because Congress forced the government to use the bailout funds efficiently rather than to hand out favors to friends and family.

1. In 2006, OECD member states spent on average 5.6 percent of GDP on education, 1.4 percent public order and safety, and 0.8 percent on Housing and community amenities. The total spending amounted to 43.5 percent of GDP, with the single largest item being social protection with 15.2 percent (OECD, 2009b)

Specifically on the recent crisis in the United States, some scholars emphasize the role of Congress in a different way (Dorsch, 2011; Mian, Sufi and Trebbi, 2010). They argue that financial firms lobbied Congress to pass the emergency legislation to rescue banks. Both Dorsch (2011) and Mian, Sufi and Trebbi (2010) find that banks' campaign donations increased the likelihood that lawmakers voted in favor of bailing out banks. In their view, Congress is crucial because it offered banks a channel to lobby for their interests and get the bailout. This view suggests that legislatures as veto players are advantageous to banks, and that Congress made the bailout more lenient (and Woll [2014] argues that the American bailout was indeed more lenient). Either account attributes substantial influence to Congress over the design of the banking bailout. This is no surprise given the scholarship on legislatures, Congress, and the American presidency. They all view the US Congress as a powerful actor. I argue in contrast that Congress abdicated its authority and deferred to the executive.

This chapter thus addresses also broader debates on the power balance between Congress and the president in American politics. This balance is not locked tight, but often shifts from one side to the other, and scholars have distilled a number of factors that give more weight to either Congress or the presidency. For the banking rescues, however, all these factors indicated that the power balance was strongly tilted towards Congress.

This institutional conflict takes place against the background of a broad power shift from Congress to the presidency (Fisher, 1972; Schlesinger, Jr, 1973; Rudalevige, 2005). The most crucial increase of presidential power came with Franklin D. Roosevelt. He vastly expanded his powers as president, and thereby created the "modern" presidency, which has become the centerpiece of American politics (Greenstein, 1988).

Within the modern, more powerful presidency, there are numerous factors affecting the relative power of the presidency, and they fall into three broad categories. First, there a number of outside factors that condition the influence the president has over lawmaking. His influence is greater when his party enjoys a majority in Congress (Coleman and Parker, 2009), when his public approval is high (Edwards III, 2009), or when he finds himself in the honeymoon period at the beginning of his term (and especially not at the end of his second term).

Second, presidential leeway also depends on the policy field. The American president has greater autonomy with foreign policy than with domestic policy

(Canes-Wrone, Howell and Lewis, 2008). The president is better informed on foreign affairs, and domestic issues weigh more heavily in Congressional elections. Lawmakers have therefore fewer incentives to secure their influence over foreign policy.

Third, there can be “real world events” that affect legislative-executive relations. Typically, scholars acknowledge that events can strengthen or weaken the power of the president, but eschew further elaboration by pointing out that they occur randomly and therefore have no systemic effect (e.g. Beckmann, 2010). One class of events, war, has stirred a vibrant debate about whether and to what extent war enlarges the powers of the presidency (Howell, 2011). Anecdotal evidence, like Abraham Lincoln’s suspension of habeas corpus, has long created the belief that presidents amass various powers during wartime. Howell, Jackman and Rogowski (2013) argue that this is true not only for certain well known anecdotes, but that lawmakers defer to the executive systematically during times of war. And some scholars have argued that more attention should be paid to the causal role of events (Mayhew, 2005).

In this chapter, I take up the events as a neglected factor of presidential power. I argue that financial crises are class of events that change the conditions of policymaking and shift the powers from legislatures to the executive. The reason for this shift derives from the inherent differences between the two branches of government. Legislators need time to devise adequate policy, and time is a resource they lack during crisis. The executive’s capacity to devise policy swiftly gives it an advantage which results in an effective power shift from the legislature.

Before elaborating on crucial differences between the two branches of government, I identify the two key properties of financial crises for policymaking. When the financial system freezes, as in the fall of 2008, banks can fall like dominoes. The insurance giant AIG failed only one day after Lehman Brothers, prompting the US government inject \$85bn after it had just refused to use public money to rescue Lehman. From that moment on, financial markets continued to deteriorate causing runs on money market funds later that week and, eventually, on other banks. Hence, one defining characteristic of financial crises is the speed of events which translates for policymakers into an urgency to act.

The second property of crises is that they pose a large economic threat. Failing banks put the economy at risk and jeopardize people’s savings and investments (see also Chapter 2). Restoring confidence in financial markets is a difficult and

delicate task. Decisive action may turn the crisis around, but policymakers may also fail and cause instead a financial heart attack. For instance, the debt guarantees by the Irish government seemed to calm markets at first, but they soon flopped and wrecked the state alongside banks. Thus, the second key feature of bank crises is their threat to the economy. There is the risk that banking crisis entail not merely a downturn, but a depression.

These features of financial crises, threat and urgency, privilege the executive over the legislature. The executive differs by design from the legislature. To execute the laws passed by the legislature, the executive has a large expert civil service. The executive controls the state bureaucracy and employs specialized staff which provides expertise and up-to-date information. And its expertise proves insufficient, it has the necessary resources to recruit outside advisors. As Gailmard and Patty (2013, 1) put it, “information is the lifeblood of executive branch action.”

Legislatures have their ways, too, to cope with complex issues. Lawmakers can produce detailed policies that solve intricate problems. But for that, they need time. They must assign reports, consult interest groups, and hear experts. With this work done, they force the executive’s hand. During financial crises, however, there is not enough time for this process. For legislatures, time is always in short supply (Döring, 1995), but days or a few weeks exceed legislative capacity to decipher the crisis and fabricate a response. Thus, the crisis accentuates the relative advantage of the executive vis-à-vis the legislature. This advantage depends generally, as Laver and Shepsle (1996, 280) put it in their study of parliamentary systems, on “the ability of parliament to bring independent judgment to bear upon the government’s proposal.” And the crisis curbs its ability to make that judgment.

The decisive factor, however, is the crisis threat. With the chance that wrong decisions wipe out savings and devastate the economy, expertise and information become paramount. Market expertise and information help to get it right. If policymaking were a guessing game, banking crisis would turn it into Russian Roulette. Normally, getting it wrong is no big deal. During banking crisis, it makes all the difference.

The executive with a large civil service at its disposal can make up for lacking knowledge, but legislators do not have this option. The urgency and threat of banking crises pose a dilemma for legislators. The stakes are high, but they don’t have the time to gather information and develop expertise. Therefore, legislators have to choose between devising new policy anyway—playing Russian Roulette—

or deferring to the executive. Given the appeal of Russian Roulette, legislators prefer to delegate the crisis management to the executive.

There is no aromaticity that lawmakers defer during banking crises. Devising new policy to counter large risks is unattractive in little time, but lawmakers may have an adequate policy ready. When they trust a policy to work, they face no dilemma, and they can specify policy against the preferences of the executive. But the limits for this case are narrow. Lawmakers trust policy when they have used it with success in comparable circumstance before, but they are unlikely to put faith in a policy only because it worked elsewhere.

In short, I argue that the urgency of banking crises prevents lawmakers from collecting information and developing expertise, and that the threat dissuades them from making policy without the conviction that it will work. So unless lawmakers have tried-and-tested policies available, they defer to the executive. Deferring to the executive means here letting the executive decide on policy. One way for the legislature to do this is implement the executive's suggestions. Another way is to leave policy open and let the executive decide later. Either way implies that the legislature abstains from specifying its own policies. Banking crises essentially efface the legislature as a veto player, and level the difference between the gridlocked American political system and the British unitary one. Laver and Shepsle (1996, 280) pointedly conclude that "parliamentary democracy is not rule by legislature." During banking crises, no democracy is rule by legislature.

In this way, policymaking during banking crises exhibits a shift of power to the presidency similar to a time of war. However, the mechanisms of this shift differ. Howell, Jackman and Rogowski (2013), for instance, argue that lawmakers defer to the executive in times of war because they become more concerned about national interests over which the executive has an informational advantage. Thus, they pass over their parochial considerations because they place a higher value on national outcomes and acknowledge that the president can better discern what is best for the country.

The authors emphasize the crucial role of informational advantage of the executive. The difference in the argument here is that the authors assume that this advantage remains constant. I assume merely that lawmakers are slower than the executive to gather information and to develop expertise. Accordingly, I argue that, with time, lawmakers can catch up. Thus, if another banking crisis erupted in the next few years, lawmakers would be less likely to defer.

Another difference between the two arguments is their scope. Howell, Jackman and Rogowski (2013)) try to explain a shift of power to the president across all policy areas, but that their “nationalization of politics” is likely to be limited to large-scale wars. Banking crises don’t have the broad effects of war. For that they pose too narrow a threat. Just because the executive is in a better position to solve the banking crisis, lawmakers will not yield power to the executive in other areas, like security, tax or social policy.

5.3 Urgency and threat

In the remainder of the chapter, I support the argument with evidence from the passage of the American banking bailout. I start by recapitulating the adoption of the bailout bill and show that the banking crisis did indeed create the conditions of urgency and threat. Next, I identify the preferences of legislators and present evidence from various sources, including polls, actors’ public statements and policy proposals. Using actors’ preferences, I develop the argument’s predictions about policy outputs and compare these with the final policies.

Devising and enacting the banking rescue plan passed swiftly. It took less than two weeks from Paulson proposing TARP to the president signing it into law. Because of the financial turmoil after Lehman collapsed, Secretary of the Treasury Paulson wanted to intervene broadly to restore financial stability. To that end, he presented a three-page proposal to Congress on September 20, only five days after Lehman’s failure. In this proposal, he asked Congress for \$700bn to purchase “troubled” assets. This intervention was intended to restore confidence because it would take uncertainty off banks’ balance sheets.

After Paulson submitted his proposal, the two chairmen of the relevant committees in the House and the Senate, Barney Frank and Chris Dodd, devised and agreed upon a counter-proposal.² A week later, on Monday, September 29, the House voted on the bill and let it fail. It passed the bill in its second vote that same week, on Friday, October 3, after the Senate had already adopted the bill. The president signed it into law later that day (Financial Crisis Inquiry Commission, 2011, 372f). And another week later, on Monday, October 13, Secretary Paulson

2. Herszenhort, David M. “Stocks Fall as Rescue Plan Is Negotiated,” *New York Times*, 22 September 2008.

summoned the chief executives of the nine major banks to Washington, DC, and compelled them to accept \$125bn of state capital (Financial Crisis Inquiry Commission, 2011, 373f). The Treasury announced a broad and voluntary recapitalization program for smaller banks the next day, on October 14.³ Thus, he reversed course and did not purchase troubled assets, as he had proposed to Congress, but recapitalized banks directly with government money.

The final bill differed from Paulson's initial draft, but these changes did not include the recapitalization of all major banks. This plan emerged solely in the Treasury. The differences covered instead four main issues: oversight, relief for homeowners, restrictions on pay for rescued bankers and warrants in exchange for government aid. The bill also includes a lengthy section with various tax provisions, including tax incentives for renewable energy.⁴ But the bailout provisions themselves remained, contrary to some accounts, rather short. The parts of the bill that concern the bailout and its oversight cover merely 38 pages.

5.4 Lawmakers facing depression

Congress passed the bill only two weeks after Paulson proposed his plan. During this time, lawmakers met with Paulson and Bernanke several times, but it was too little time to hold the usual hearings with experts and affected interest groups. This hurry alone does not prove that it was the crisis that created this urgency for lawmakers. It could also have been that the executive imposed time pressure on lawmakers as a strategy to get its proposal passed. However, there are two reasons why the urgency was not mere strategy. First, the American president does not have the formal powers to impose a tight schedule on Congress, and he fails at other times to elbow lawmakers to pass legislation quickly. During the Bush presidency, the average time it took Congress to pass a law was seven months, and only six percent of all laws were signed into law within 14 days.⁵

3. U.S. Department of the Treasury, "Press Release: Treasury Announces TARP Capital Purchase Program Description," 14 October 2008. Available online: <http://www.treasury.gov/press-center/press-releases/Pages/hp1207.aspx>. Accessed: 5 March 2014.

4. Siegel Bernard, Tara and Kate Galbraith, "Bailout brings With it Diverse Perks," *New York Times*, 4 October 2008.

5. The bailout bill passed after 14 days, but the official time stamp for this bill is 574 days because the House used a procedural trick to speed up the date of the vote; it put the bailout

Second, the crisis in the fall of 2008 occurred in a rapid pace that lay beyond the control of the administration. Lehman Brothers failed one day, AIG came down the next, and money market funds “broke the buck” that same week. In general, funding markets dried up quickly (see Chapter 2). To avoid panic, the Treasury prevented the failure of both AIG and money market funds.

This rapid deterioration of banks is typical for banking crises. For a bank, bankruptcy in times of crisis arrives within days; its deposits drain, its interest rates spike, and its shares drop. The case of Northern Rock has shown that even ordinary savers, worried about their savings, can push a bank into illiquidity within days. Thus, the events supported the claims by the executive that it needed the authority for a bailout quickly. The time pressure that determined the passage of TARP was not merely strategy from the executive’s toolbox, but stemmed from the crisis itself.

I argue that banking crises change policymaking not only by imposing urgency, but also by creating a sense of threat. Since “threat” implies the “*possibility* of trouble, danger, or ruin” (Oxford Dictionary, emphasis added) it is necessarily subjective. The history of banking crises demonstrates clearly that failing banks cause severe recessions (Cassis, 2011; Reinhart and Rogoff, 2009), but what the specific damage will be is unclear. With little time at hand, lawmakers are left to trust the assessments of the executive and other experts. Among them, the Fed Chairman Ben Bernanke was the most important. His evaluation was particularly credible for two reasons. First, Bernanke and the Fed have a lot of economic expertise and very good access to market information. Thus, it’s likely that he can observe the relevant events and interpret them correctly. The second reason is that the Fed is independent and non-partisan. Bernanke has thus little incentive to add a partisan bias. For sure, Bernanke as Fed Chairman has his own institutional motivations, but they are not systematically against either Democrats or Republicans. For legislators, the Fed is as close to a disinterested expert as they can find. And Chairman Ben Bernanke pronounced a dire assessment of the looming threat.

Bernanke supported Paulson to demand that Congress pass a bill granting the administration the authority to stabilize markets. He told Congressional leaders,

into an amendment to a proposal that was introduced 19 months before. These data are taken from the Policy Agendas Project, available at <http://www.policyagendas.org/>.

“If we don’t get this, it will be nothing short of a disaster for our markets.”⁶ Later, when the proposed bill failed in the House, Bernanke phrased his assessment even clearer, “I spent a lot of time as an academic studying the Great Depression. If we don’t act in a very huge way, you can expect another Great Depression, and this is going to be worse,” (Wessel, 2009, 203) and “If we don’t do this, we may not have an economy on Monday.”⁷

The sense of urgency was transferred to legislators. Briefed by Paulson and Bernanke on Thursday, 19 September 2008, the House Speaker Nancy Pelosi said, “We hope to move very quickly. Time is of the essence.”⁸ The extraordinary speed to pass the bailout caused some reluctant representatives to complain. Representative Mike Pence, the Chairman of the House Republican Conference said, “This is going way too fast. The American people don’t want Congress to make haste with the financial recovery legislation; they want us to make sense.”⁹

The legislators also adopted the sense of threat. Some focused on potential unemployment, others worried about people’s retirement security and savings. Senator Kent Conrad said in a Senate debate, “It’s not just going to be Wall Street. The chairman of the Federal Reserve has told us if the credit lockup continues, three million to four million Americans will lose their jobs in the next six months.”¹⁰ And Republican House Minority Leader John A. Boehner stated, “Nobody wants to do this; nobody wants to be involved in this. But I am going to argue that if we do nothing, we are jeopardizing our economy, jobs, people’s retirement security. Congress has to act and we have to act quickly.”¹¹ The *New York Times* accurately predicted the behavior of legislators: “Given the circumstances and dire warnings of economic doom, the expectation remained that enough lawmakers would grit their teeth, hold their noses, screw up their courage and back

6. Carl Hulse and David M. Herszenhorn, “Behind Closed Doors, Warnings of Calamity.” *New York Times*, 20 September 2008.

7. Andrew Ross Sorkin, Diana B. Henriques, Edmund L. Andrews and Joe Nocera, “36 Hours of Alarm and Action as Crisis Spiraled.” *New York Times*, 2 October 2008.

8. Jeannine Aversa and Julie Hirschfeld Davis, “Congress Promises Quick Action on Bailout Package.” *Associated Press*, 19 September 2008.

9. David M. Herszenhorn, “Talks on Bailout Plan Advance; Congress is Angry and Skeptical.” *New York Times*, 24 September 2008.

10. Carl Hulse and David M. Herszenhorn, “Breakthrough Reached in Negotiations on Bailout” *New York Times*, 27 September 2008.

11. Carl Hulse, “Faced With Financial Upset and an Election, Lawmakers Lash Out.” *New York Times*, 24 September 2008.

some variation of the administration plan¹² (Representative John Shadegg, R-Arizona, later said “I’m inclined to hold my nose and vote yes.”¹³). Legislators recognized the dire state of the financial system and the need for government action, and so the need to pass a bailout bill.

5.5 Preferences

In the last section, I outlined the quick journey from bailout proposal to law. In this section, I focus on what the administration and lawmakers wanted. Identifying their preferences allows assessing to which extent either side attained its goals.

What the Treasury wanted after Lehman collapsed is straightforward and is well reflected in Paulson’s initial proposal. The Treasury wanted Congress to grant extensive authority to restore financial stability. It wanted \$700bn, and it wanted no strings attached. The law shouldn’t specify a course of action, earmark money to homeowners, restrict executive pay, or put the Treasury under the close watch of oversight committees. Paulson’s proposal specified this large sum, but assigned further decisions to the Secretary’s discretion. Importantly, it stipulated that he would not be accountable to any oversight. Because Lehman had demonstrated that letting banks fail caused financial havoc, Paulson wanted to avoid further failures and put the faith of the United States government behind banks. And for this guarantee, he wanted broad authority without hassle. As he put it succinctly in a Senate hearing, “We need flexibility.”

Establishing lawmakers’ preferences is harder, because they are many and are usually not of one mind. But the debates among lawmakers point towards a few common issues. Lawmakers repeatedly emphasized restricting bankers’ pay, helping struggling homeowners, and establishing oversight for the bailout program. Members of Congress had a strong incentive to reflect the preferences of voters, in particular when facing elections in the coming weeks. In general, they are more populist and responsive to voters. For this reason, public opinion polls speak to which issues lawmakers should care about. And as I show below, polls support

12. Carl Hulse, “Those Selling a Bailout Find a Skeptical Audience in Lawmakers.” *New York Times*, 24 September 2008.

13. Jonathan Weisman, “Obama, McCain Stand United In Pressing Hard for Rescue.” *Washington Post*, 2 October 2008.

these three issues. The polls also show that people were skeptical about Paulson's plan. They had the impression that it privileged bankers and rewarded them for failure. Lawmakers also shared this worry and questioned Paulson's plan to buy up bad assets.

In normal times, Americans want the government to stay out of banks and let them run privately. Even after the first clear signs of the crisis the public remained skeptical. After the failure of Bear Stearns in March 2008, 60 percent of respondents to a Gallup poll said they opposed government steps to prevent Wall Street firms from failing. Figure 5.1 shows that Americans agreed on this reluctance for government action, regardless of their income or their partisan affiliation.

Do you favor or oppose the federal government taking steps to help prevent major Wall Street investment companies from failing?

March 24-27, 2008

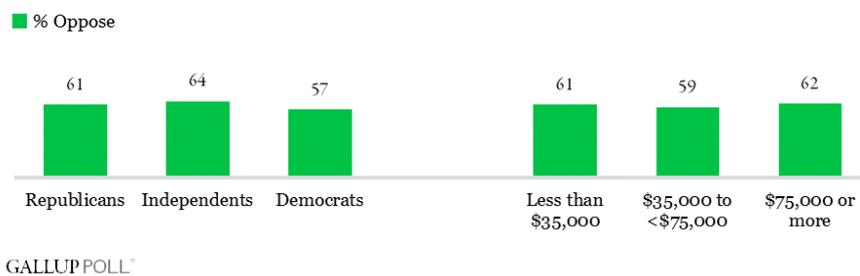


FIGURE 5.1: Public opinion on government intervention in March 2008

This attitude changed when the crisis became systemic and put people's savings and jobs at risk. After the failure of Lehman Brothers, the financial turmoil began to occupy the minds of the general public. The news reported failing banks, jittery investors, and fickle stock markets. Even though modern finance hides successfully behind technical language and complex creations—think of CDOs, MBS, or SPVs—the public saw the impending crisis and the potential downsides. Besides the fear of a financial meltdown, people worried about the economy and their savings. Figure 5.2 plots the percentage of Americans that viewed the state of the economy as poor, and the percentage that worried about their personal finances. Both lines jump markedly between the week of the Lehman collapse and the week Congress passed TARP (represented by the two vertical lines). By then, almost 60 percent said that the state of the economy was poor, and about 45 per-

cent of Americans worried about their finances. And by October 12, two-thirds said that “their financial situation has been harmed.”¹⁴

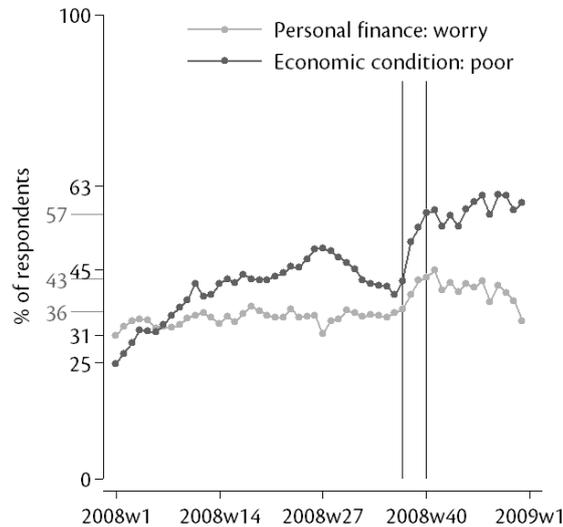


FIGURE 5.2: Concerns about personal finance and the economy

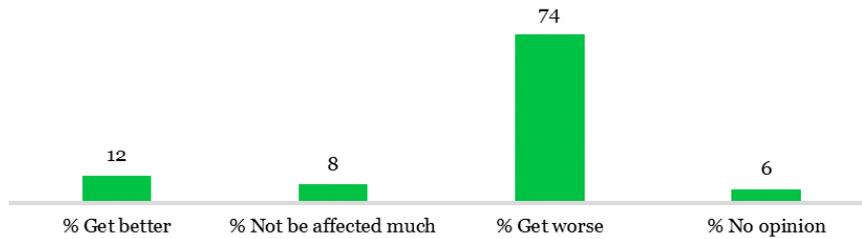
People not only recognized the crisis, but they also acknowledged that solving the crisis needed government intervention. Consider Figures 5.3 and 5.4. Three out of four Americans said that if Congress didn’t intervene, the economy would get worse over the next few years (Figure 5.3). And four out of five said they would like to see Congress pass a rescue plan (Figure 5.4). Within half a year (from March to September), people reversed their opinion on government aid to the banking sector. After the failure of Bear Stearns, a majority opposed government action; after the failure of Lehman Brothers, almost everybody—80 percent—wanted the government to step in.

Figure 5.4 shows that most Americans wanted Congress to take action, but it also shows that the majority (56 percent) was against the TARP proposal. Congressmen and -women heard that opinion loud and clear. The New York Times reported on the broad opposition to the TARP bill, and cited figures of calls and emails to Senator Barbara Boxer, a Democrat Senator from California: She “received nearly 17,000 e-mail messages, nearly all opposed to the bailout.” In a single day, on Tuesday, 23 September 2008, “[m]ore than 2,000 constituents called

14. Jacobe, Dennis, “Two-Thirds of Americans Financially Hurt by Crisis.” Gallup, 15 October 2008.

Suppose Congress takes no action on this issue. Over the next few years, do you think the U.S. economy would -- [ROTATED: get better, not be affected much, or get worse]?

Based on national adults



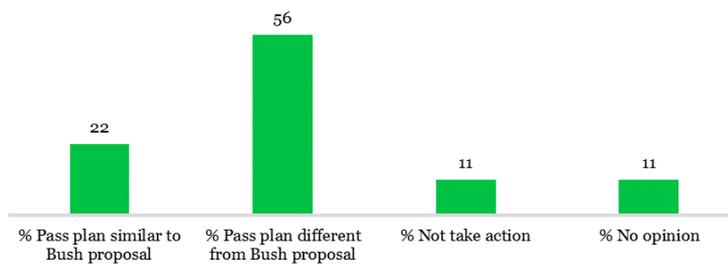
USA Today/Gallup poll, Sept. 24, 2008

GALLUP POLL®

FIGURE 5.3: Perceived consequences of Congressional inaction, 24 September 2008

As you may know, the Bush administration has proposed a plan that would allow the Treasury Department to buy and re-sell up to \$700 billion of distressed assets from financial companies. What would you like to see Congress do?

Based on national adults



USA Today/Gallup poll, Sept. 24, 2008

GALLUP POLL®

FIGURE 5.4: Public opinion on Congressional action, 24 September 2008

Ms. Boxer's California office on Tuesday alone; just 40 favored the bailout. Her Washington office received 918 calls. Just one supported the rescue plan."¹⁵

The overwhelming opposition against the specific policy is astonishing considering the overwhelming support for Congressional action. At the heart of this contrast lies the dilemma of banking bailouts: To solve the banking crisis means to rescue those that caused the crisis, the banks. It appears that crisis management rewards bankers for messing up. Thus, everybody likes to solve the crisis, but nobody likes to save bankers. Economists justify this dislike with "moral hazard," the notion that saving failing banks eliminates market discipline and encourages risk-taking in the future. The dislike by the general public is spurred by bankers' enormous pay, despite their apparent inability to manage their banks. Save the banking system without savings banks (and bankers) is a dilemma which is hard to resolve. In this light it is easy to see that the people's most common emotional response to the crisis management at the end of September was not fear, but anger. A Gallup poll found that 53 percent of respondents said they felt anger, and only 41 percent felt fear.¹⁶

One way to overcome this dilemma is to save banks, but punish the bankers by limiting their pay. Executive pay has been a hot topic in the United States since the accounting scandal of Enron in 2001 (Culpepper, 2013). Demanding to cut bankers' bonuses—especially of those that caused their firms to fail—fit right into the general debate. The term "fat cat" was entrenched in this discussion; commentators (and cartoonists) now depicted the fat cats (in boats) as being bailed out. As Figure 5.5 shows, 63 percent of Americans said they find it "very important" that the government should limit compensation for the executives of rescued banks.

Another way of trying to crack the conundrum of restoring financial stability without rewarding bankers is for the government to help struggling homeowners. Advocates succinctly described this as "saving Main Street, not Wall Street" (e.g. Bair, 2012; Barofsky, 2012). The aim of such a program is to help restructure the mortgage contracts to allow people to stay in their homes. The same poll that asked Americans about the importance of limits on compensation, asked about mortgage relief: Half of the respondents said they find it "very important" that a

15. Sheryl Gay Stolberg, "Lawmakers' Constituents Make Their Bailout Views Loud and Clear," *New York Times*, 25 September 2008.

16. Jeffrey M. Jones, "Majority of Americans Angry About Financial Crisis", 2 October 2008, Gallup.

government plan help homeowners who cannot pay their mortgages (see Figure 5.6). Another 30 percent found this help “somewhat important.” Overall, people preferred to help struggling homeowners, but some voiced the criticism that this, too, rewarded irresponsible behavior by people who bought houses they could not afford.

The crisis not only changed the preferences of the public, but also those of lawmakers. As lawmakers depend on their constituents for reelection, they react to the changed preferences of their constituents. The starting point for the legislators, as for the general public, was the irritation that banks needed a bailout. Like Senator Sherrod Brown said, “The sentiment from Ohioans about this proposal is universally negative. I count myself among the Ohioans who are angry.”¹⁷ But eventually, lawmakers want to solve the crisis and to defuse its threat to the jobs and to the savings of their constituents. Ellen Tauscher, Democrat Representative from California, said “The tide has changed. While this was initially unpopular, events are overtaking us.”¹⁸

As shown above, the public wants to cut bankers’ pay and help homeowners. Again, this should motivate lawmakers in their efforts to pass a bill—in particular for those whose constituents find them particularly important. The constituencies differ on these two issues, on mortgage relief in particular. Democrat voters overwhelmingly favor mortgage relief, whereas Republican voters oppose it. Figure 5.7 reports polling data showing that 71 percent of Democrats wanted the government “to help prevent people from losing their homes because they can’t pay their mortgage,” while only 40 percent of Republicans wanted this, and 58 percent opposed it. Limiting pay was more important for Democrats, but it was less partisan because it also found a majority among Republicans. For instance, voters of both parties wanted to block the bonuses of AIG executives (83 percent of Democrats, 67 percent of Republicans, see Figure 5.8). Thus we could expect these elements—preferred policy instrument, restrictions on bankers’ pay and mortgage relief—to be part of bailout legislation.

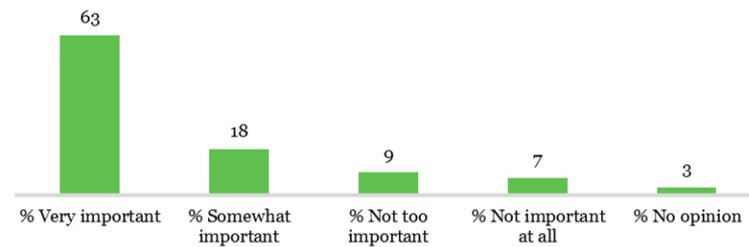
Debating TARP, members of Congress brought up these topics. The Democrats demanded restricting executive pay and supporting homeowners. These

17. Carl Hulse, “Faced With Financial Upset and an Election, Lawmakers Lash Out.” *New York Times*, 24 September 2008.

18. Jim Puzzanghera, Tom Hamburger and Richard Simon, “Financial Crisis: Capital Hill; 11th-hour scramble for votes on bailout.” *Los Angeles Times*, 3 October 2008.

How important is it to you that any government plan to deal with the financial problems ...

A. Set limits on compensation for executives at corporations that participate in the plan



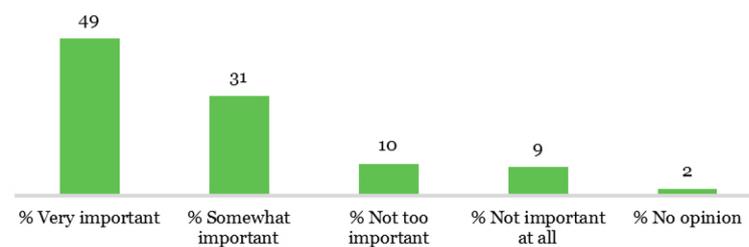
USA Today/Gallup poll, Sept. 24, 2008

GALLUP POLL®

FIGURE 5.5: Public opinion on limiting executive compensation

How important is it to you that any government plan to deal with the financial problems ...

B. Include provisions to help homeowners who cannot pay their mortgages



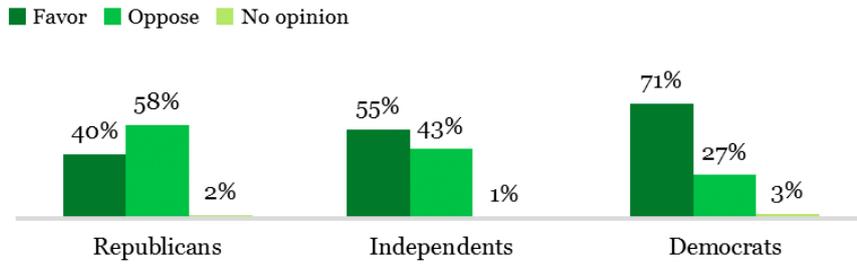
USA Today/Gallup poll, Sept. 24, 2008

GALLUP POLL®

FIGURE 5.6: Public opinion on mortgage relief

Do you favor or oppose the federal government taking steps to help prevent people from losing their homes because they can't pay their mortgage?

March 24-27, 2008

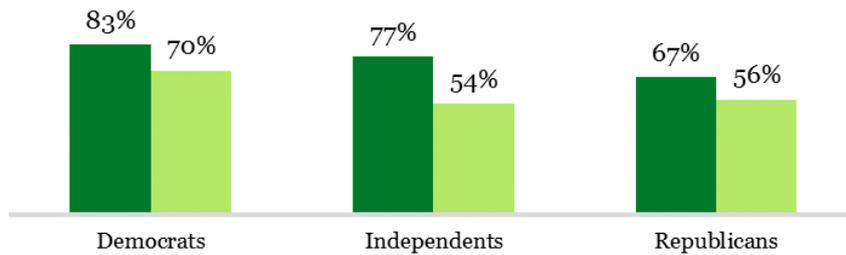


GALLUP POLL®

FIGURE 5.7: Public opinion on mortgage relief by party affiliation

Views on AIG Bonues, by Party Affiliation

■ % Who say government should try to block/recover ■ % Outraged



Gallup Poll, March 17, 2009

GALLUP POLL®

FIGURE 5.8: Public opinion on AIG bonus by party affiliation

were the two most important topics for Democrats to add to the bailout plan. For instance, Senator Christopher Dodd argued for a proposal that bankruptcy court judges could change loan contracts to allow bankrupt borrowers to keep their homes.¹⁹ Speaker Nancy Pelosi followed the public's call for limits to executive compensation: "The party is over for this compensation for C.E.O.'s who take golden parachutes as they drive their companies into the ground."²⁰ But this was not limited to Democrats. Both presidential candidates, Senators John McCain and Barack Obama, said they endorsed support for homeowners, strict oversight, and restrictions on pay for executives whose firms were bailed out.²¹

Members of Congress debated two further topics. The first was on oversight over the implementation of TARP. Secretary Paulson preferred no oversight, but by categorically barring any type of accountability in his initial proposal, he inadvertently piqued Congress to demand more. Accordingly, lawmakers demanded strict oversight and brought it up repeatedly. In the hearing of Paulson and Bernanke, Senator Dodd raised oversight as a major topic in the hearing's opening remarks, and after extensive back and forth, concluded: "I think there's general consensus here about oversight, accountability."

Another important topic was the return for taxpayers and how to best support banks. Before TARP passed in Congress, Paulson argued that the best way to help banks was to buy up bad assets. For that, he suggested using a "reverse auction," in which banks compete for the lowest price to sell these assets to the Treasury. Lawmakers doubted the auction's effectiveness and worried that it would give large subsidies to banks without strings attached and no possibility for the taxpayer to make up the costs. For this reason, lawmakers suggested different mechanisms, like directly injecting capital. To this end, Harry Reid asked in the hearing with Bernanke and Paulson: "Why wouldn't equity participation rights work in this arrangement to protect the taxpayers and reimburse the taxpayers, particularly with the difficult problems of pricing these securities...?" In the same hearing, Reid also argued for the use of warrants. The warrants would allow the state to buy shares later at a fixed price and to reap some gains when the banks recovered.

19. Ylan Q. Mui and Dina El Boghdady, "The Crisis and Your Pocketbook." *Washington Post*, 23 September 2008.

20. Mark Landler and David M. Herszenhort, "Lawmakers Challenge Lack of Help Aimed At U.S. Homeowners." *New York Times*, 24 September 2008.

21. Michael Cooper and Patrick Healy, "McCain, More Critical of Bailout Plan, Faults Oversight." *New York Times*, 23 September 2008.

Overall, Congress cared about several issues. Following public opinion, lawmakers wanted to restrict pay of bailed-out bankers, and they wanted to help not only banks but also struggling homeowners. This broadening of the plan to include homeowners was particularly important to Democrats. But both Democrats and Republicans wanted to lace close scrutiny on the Treasury. How to best intervene was too intricate for the public to have a clear opinion about. However, lawmakers still questioned Paulson's plan and suggested alternatives, in particular injecting capital directly into banks and obtaining warrants from rescued banks.

These issues, helping homeowners, curbing pay for rescued bankers, and the design of the policy and oversight, were important to lawmakers and one could, in general, expect lawmakers to include them in the bailout bill. I argue, however, that during the banking crisis lawmakers lack the time to develop the expertise to devise new policy. They fear an economic collapse, so they shy away from constraining the executive with clumsy policy prescriptions. Lawmakers essentially defer to the executive. This argument, however, points to two instances that allow lawmakers to still specify their preferences in the law. The first instance is when lawmakers trust in the success of a policy element. And the second is when they can specify policy that does not constrain the flexibility of the executive to solve the crisis. Both instances occurred in the American crisis management and led to strict constraints set by Congress. Congress trusted warrants because it had used them in the past. And Congress enforced oversight because it would limit abuse of executive power, but would not constrain the flexibility of the administration to solve the crisis. Regarding the other parts of the bailout, including its design, Congress delegated policymaking to the executive. In the next section, I examine policies and their characteristics as well as to what extent Congress specified them in the law.

Policy design

The most important question about the bailout was how to rescue banks and on which scale. Secretary Paulson wanted \$700bn to buy up toxic assets in an auction. Congress didn't meddle with this plan. First, it adopted the proposed size of the bailout. This is remarkable because Paulson gave little justification for this amount, and lawmakers usually don't hesitate to haggle over the cost of government programs. Paulson maintains that he arrived at the figure by considering how much would instill market confidence, given that the residential mortgage

market amounted to \$11 trillion (Paulson, 2010, 265), and how much the public and Congress would accept. Essentially, as Sorkin (2009) puts it, “the numbers were, at best, guesstimates.” Yet, it was a massive program. It amounted to almost a quarter of the federal budget and was more than the annual costs of Medicare and Medicaid or Social Security. Even though only a small share of the program would have funded many local pet projects, lawmakers refrained from bargaining about the overall figure. The only restriction that lawmakers required was a sequential payout. Enacting the bill granted the administration the initial \$350 billion. For the second tranche, another \$350 billion, the president would have to submit a report to Congress on the necessity of the additional funds. But he would be granted the second tranche unless both Houses of Congress passed a joint resolution to withhold the money—and overrode the president’s possible veto (EESA, Sect. 115). This put the bar for limiting the funds very high, and the president obtained them without further ado in January 2009.

Second, legislators were not convinced with the treasury’s plan, but they still agreed to it. They supposed the plan would be expensive and fragile. A Senate staffer involved in the negotiations confirmed this, saying, “I think the majority of the Democratic Caucus, and a lot of the Republican Caucus never got that auctions would work. We never saw the path for it to work,” but at the same time, stating “I certainly didn’t want to preclude Treasury from doing their auctions.”²² Asked whether Senators agreed to this, even though they didn’t think auctions would work, he summed up lawmakers’ ultimate response to the Treasury’s proposal: “we finally said: ‘Listen, you guys [i.e. the Treasury], we are giving you the check. We are going to put a lot of oversight, we’re going to put a lot of strings attached here and there, but ultimately, we are giving you the flexibility to decide what system works best.’ ”²³

Not only did Congress grant the Treasury flexibility to act, but the Treasury used it. How the Treasury intervened differed starkly from what it had proposed to Congress and from the main intention of the law. The Treasury had stated it wanted to buy up assets, as the name *Troubled Asset Relief Program* implied. It ended up, however, injecting capital into banks, which provided money to banks in return for an equity stake. Importantly, the decision to include all major banks in this program, to essentially force relatively healthy banks to accept the govern-

22. Interview, Washington, DC, 14 November 2012.

23. Interview, Washington, DC, 14 November 2012.

ment as a shareholder is nowhere in the law. That was entirely at the discretion of the Treasury. Asked about the mandatory participation, Barney Frank confirmed the Treasury's authorship: "That was Hank Paulson's decision ... So he did call them [the bankers] in and say, 'you're doing this, you're taking it.' ... 'you're going to do this.' And that was it."²⁴

Why did the Treasury change its course and inject capital rather than buy toxic assets? One reason might be that the Treasury wanted to inject capital in banks all along, but thought that an intervention at arms length would stand a better chance to find approval in Congress than a program that would make the state a partial owner of banks. Hank Paulson and Treasury staff maintain, however, that they planned to buy assets, but changed course because the crisis deteriorated (Paulson, 2010; Swagel, 2009). Capital injections would be faster to implement and would have a larger impact than an asset program (Swagel, 2009, p. 39). An additional motivation might have been that the British government launched a recapitalization program, and markets reacted positively. However, injecting capital is a standard way to support banks, and the Treasury had debated about this option before Brown and Darling announced their program. Crucially, the British program did not include all major banks, indicating that it was not the blueprint for the American bailout.

Bankers' pay and mortgage relief

In terms of substance, the bailout's design is the key part of the program, but for lawmakers, who have to stand for re-election, restricting bankers' pay and helping homeowners may have been more important. Bankers' bonuses and mortgage relief were salient, and the public was in favor of cutting down bankers' bonuses and of supporting homeowners. As banks were a major contributor to the crisis, it was the common sentiment that the bailout should not finance big bonuses for those that ran down their banks. Instead, the government should help those that suffer from the crisis, in particular households who struggle to pay their mortgage. EESA, the TARP law, includes these issues. Sections 109 and 110 aim at helping homeowners ("Foreclosure mitigation efforts," "Assistance to homeowners"); Section 111 covers executive compensation ("Executive compensation and corporate governance"). These provisions, however, were vague and did little to

24. Barney Frank, interview, Washington, DC, 16 November 2012.

bind the executive to enforce strict limits on pay or to substantially help homeowners.

For the Treasury, it was important that TARP provided the Treasury with a lot of latitude for crisis management. It feared being too constrained to adapt to market developments. Strict rules on mortgage relief and executive pay would have, in the Treasury's view, significantly constrained its latitude to act. Restrictions on executive pay could deter banks from participating in a bailout program. Paulson stated this when he proposed his program, "Pay should be for performance, not for failure," he said. "But we need the system to work, so the reforms need to come afterward."²⁵ And mortgage relief would tie up large sums of money which would not be available to bail out banks. Thus, the Treasury resisted strict rules for both aims, and Congress, aiming to provide the Treasury with the tools it wanted, shied away from overriding the Treasury's objections.

Lawmakers acknowledged that they wanted restrictions, but given the crisis, preferred to defer to the executive. For instance, Senator Mitch McConnell of Kentucky, the Republican leader, stated this rationale clearly on the Senate floor when debating TARP:

When there's a fire in your kitchen threatening to burn down your home, you don't want someone stopping the firefighters on the way and demanding they hand out smoke detectors first or lecturing you about the hazards of keeping paint in the basement, you want them to put out the fire before it burns down your home and everything you've saved for your whole life. The same is true of our current economic situation. We know that there is a serious threat to our economy, and we know that we must take action to try and head off a serious blow to Main Street.²⁶

On bankers' pay, Barney Frank wanted restrictions, but ultimately settled for loose rules because Paulson resisted. Barney Frank pointed this out when recounting his interaction with Paulson on executive compensation: "Hank, what are you telling me about these people? That they will be so upset at any restrictions on their enormous compensation that they will let the country fail?' And

25. Brian Knowlton and David M. Herszenhorn, "Bipartisan Support for Wall St. Rescue Plan Emerges." *New York Times*, 21 September 2008.

26. David M. Herszenhorn, "Talks on Bailout Plan Advance; Congress is Angry and Skeptical." *New York Times*, 24 September 2008.

he said, ‘yes.’ He was afraid if we had any compensation restrictions, they would walk away. But we insisted on writing some in.”²⁷ These restrictions, however, merely prohibited golden parachutes. They did not prevent Merrill Lynch, for instance, from paying more than \$3.6bn in bonuses, even though they incurred \$15bn in losses in the fourth quarter of 2008 (Congressional Oversight Panel, 2011, 7). Congress tightened these restrictions, but only later, in 2009, when the systemic banking crisis had passed.

Much in the same vein, Frank described the lack of effective rules on mortgage relief: “There are people who have mortgage applications they cannot pay. To avoid them being foreclosed on, either the banks take a hit by reducing what they are owed, or the taxpayers bail them out. Or, where does the money come from? The only source of the money would have been the TARP funds. And that’s how we lost it.”²⁸ In other words, mortgage relief would have required substantial funds, which the Treasury wanted for banking support, and Congress did not want to deny the Treasury these means.

Democrats, who had the majority in the House made sure to include what they cared about, restrictions on executive compensation and mortgage relief, clearly in the hope of nudging the Treasury towards their preferences. Compared with the main goal of the program, stopping the financial crisis, the Democrats found their preferences less important and refrained from hardwiring them into the law. In other words, they waived the issues legislators cared deeply about in favor of granting the Treasury the authority it wanted.

Oversight

In two respects, Congress held its line. It demanded strict oversights and it requested that banks that gained from the asset purchases needed to provide the government with warrants. That was intended to ensure that the government would participate in the up-side risk when the banks fared better after the crisis. Neither element stands against the fact that Congress deferred to the executive both on the essential policy design (e.g. capital injections or asset purchases) and what it cared most about (executive compensation and mortgage relief). It does, however, shed light on the conditions of Congress’s deferral to the executive. Congress could demand strict rules on oversight because they would not

27. Barney Frank, interview, Washington, DC, 16 November 2012

28. Barney Frank, interview, Washington, DC, 16 November 2012

restrain the executive in its crisis management. Oversight merely ensures that the executive adheres to the rules.

Congress charged three institutions with overseeing the implementation of the TARP programs. First, Congress stipulated that the Government Accountability Office (GAO) oversee TARP; second, it established the Congressional Oversight Panel (COP); and third, it created the Special Inspector General for the Troubled Asset Relief Program (SIGTARP). The GAO should monitor the Treasury for the duration of the authority (EESA, Sect. 116). The COP was to oversee the program six months after the rescue authority expired (EESA, Sect. 125). And SIGTARP was to continue oversight until the Treasury sold the last troubled asset or ended the last guarantee (EESA, Sect. 121). Thus, Congress demanded heavy oversight, above and beyond of the norm.

Since the TARP oversight started during the life of the program, it was more than mere *ex-post* oversight. The oversight reports prompted the Treasury to implement changes during the life of the program. For instance, SIGTARP and the Congressional Oversight Panel criticized how the Treasury sold the warrants it had received from banks, and the Treasury subsequently changed its procedure (Congressional Oversight Panel, 2011, 11). But this hardly limited the Treasury's flexibility. The Treasury itself made the policy decisions. It did not have to consult with its overseers about how to implement policy. Only after the Treasury decided on a course of action and implemented the policy could the oversight bodies form an opinion and suggest changes. Overall, the oversight was tight, and the oversight bodies have made a convincing case that they improved implementation of TARP, even if the Treasury did not heed all of their recommendations (Congressional Oversight Panel, 2011; Barofsky, 2012).

Warrants

Congress was tough not only on oversight, but also on warrants. It required the Treasury to demand warrants in exchange for support (EESA, Sect. 113). This requirement is very specific and differs in this respect with the rest of the law. It emphasizes the mechanism of when and why Congress defers to the executive. The starting point for deferment is the need to decide quickly. The available time during crisis is insufficient for lawmakers to develop the expertise to formulate specific policies (e.g. with its usual hearings). Between specifying a certain policy that is in line with their preferences and risking the failure of the crisis manage-

ment (because the policy is too clumsy), lawmakers prefer to defer to the executive and not specify the policy. Lawmakers, however, may be already have expertise on a policy element, because they have used it in the past. In this case, they are confident that the specified policy element works and will not cause a financial meltdown. Thus, there is no either-or choice between specifying a policy and risking stability.

Congress had required warrants before, and they had been successful. In 1979, the government bailed out Chrysler and received warrants in return for guaranteeing a loan to the auto company. Three years later, the government auctioned off the warrants and received \$311 million (\$622 million today). And just before Lehman's failed, the government received warrants in the bailout of Fannie Mae and Freddie Mac. Thus, lawmakers, in particular Harry Reid, who was the strongest advocate for warrants, was confident that requiring warrants was an apt method for bank bailouts. They very likely increased the return for taxpayers, as warrants imply a cross-subsidy across time, in which the bailout today is financed by the companies in the future once they recover (see Chapter 2). In other words, warrants offered a specific policy element which would further the preferences of Congress, namely limit costs to taxpayers, but not add uncertainty about the success of government crisis management. This allowed lawmakers to be firm on their request about warrants, while it put the rest of the bailout decisions in the hands of the executive.

The case of warrants shows that financial crises do not shift power automatically and absolutely from the legislature to the executive. It is not the case that lawmakers hand everything over once banks fail. Rather, financial crises change the conditions of policymaking, and these determine the choices lawmakers face. Crisis reduces the available time, and therefore impede lawmakers to obtain expertise and develop new policies. But if they have working policies at hand, they can use them and set the course for the crisis management.

By selling the warrants, the governments recouped its investments and generated profits. That Congress required these warrants begs the question, whether Congress was ultimately the reason why the crisis management was successful? The answer is similar to one concerning oversight. Warrants improved TARP's success for the taxpayer. However, warrants by themselves would not have sufficed. Warrants were successful because the Treasury got the strong banks to participate in the program. The large gains from the warrants did not come from

the banks that needed government support, like Citi. They came from those that were relatively healthy, like Wells Fargo and JP Morgan. And Congress was not part of the decision to include these healthy banks. To illustrate this point further, had the British government added warrants in their bailout, it would have fared hardly any better. The two banks that received government capital, RBS and Lloyds/HBOS, are still struggling, and the government owns most of the shares (especially in RBS). Warrants would not have limited the losses. As with oversight, that Congress demanded warrants helped limit losses to the taxpayer, but it alone (or both in combination) cannot explain the success of the bailout. That comes from the interaction between the Treasury and the banks.

5.6 Nationalized politics

Although the evidence supports the proposed argument of crisis politics, critics may argue that bailouts conform to presidential politics as usual. In his model of presidential power, Beckmann (2010) explains the legislative success of presidents using the location of the status quo, the preferences of supporting and opposing congressional leaders, the pivotal voters and the broader political context. In that perspective, the crisis creates a gap between the status quo and preferences of the president and the lawmakers. Doing nothing isn't an option for anybody. If congressional leaders have different preferences, the negotiation turns to pivotal voters in Congress who can be accommodated by policy adjustments. These adjustments also apply to TARP. Legislators added a number of provisions, including oversight, warrants and the various tax breaks. There are two objections to this account. First, Beckmann (2010) also stresses that the context plays a role, like the president's political capital. As pointed out above, the president's capital was exhausted by the time of the crisis. His approval rating was at a historic low, and he was at the end of his second term. Second, Beckmann's account is vague. The status-quo gap predicts legislative action, but it does not suggest that Congress defers to the executive and grants these broad powers to the president. Overall, Beckmann's model explains well the strategies presidents employ to nudge lawmakers into passing bills. But as he concedes, "real world events" may trump influencing the power balance between Congress and the president, and these are outside of his account.

There is another account of presidential power that predicts a shift of power to the president during crises. Howell, Jackman and Rogowski (2013) argue that national crises—especially war, but potentially banking crises as well—“nationalize politics” and shift power to the president. In this account, the banking crises shift lawmakers’ focus on national interests. Lawmakers defer to him, because the president is better informed about what is best for the country as a whole. The authors argue that for war, lawmakers give more leeway in all policy fields. But they suggest that for other types of crises, the effect may be more localized. Thus, they argue that banking crises shift power only in the area connected to crisis management. This conforms well to the experience of 2008. Although Congress passed the bailout, it stifled other presidential initiatives. This account, however, implies that the shift occurs equally within the policy field. Thus, it cannot explain why lawmakers insisted on warrants and oversight.

5.7 Conclusion

Strong legislatures, like the US Congress, are veto players that can shape or stifle the executive’s initiatives. Bailouts, too, depend on their approval. Legislatures, thus, can place tough checks on the way governments bail out banks (Keefer, 2007). In this chapter I have argued that banking crises essentially eliminate the legislature as a veto point. Lawmakers fear that a wrong policy choice leads to economic disaster, and they don’t have the time to develop expertise and devise new policy. Lawmakers, therefore, recognize the executive’s advantages in expertise and information and grant broad authority to let the executive manage the crisis. Lawmakers can only enforce their own preferences for policies that either don’t reduce the executive’s flexibility or for policies which they have used before and trust to work.

In the United States, lawmakers approved the administration’s plan to buy up assets for \$700 billion. They didn’t enforce their preferred bailout plan and they shied away from enforcing highly popular measures: cutting bankers’ pay and dedicating parts of the bailout to struggling homeowners. They only required the Treasury to demand warrants from banks in return for government support and put heavy oversight in place. The American bailout, which stabilized markets and

generated a return for the government, was not designed by Congress, but by the Treasury. And the Treasury had extraordinary latitude to resolve the crisis.

Restricting executive pay would have been painful for top bankers, so the absence of these restrictions raises the question whether the business power of US banks was strong (against the argument in Chapter 4): The bankers got the rescue on their terms, without cuts in their compensation (c.f. Woll, 2014, ch. 5). Undoubtedly, letting the banks determine the pay of executives was in their interest, and this outcome points to their privileged position in general, in line with broader privilege of being rescued. But does this attest the superior position of American banks compared to British banks which had to accept pay restrictions? I argue not. For the British and the American governments, it was more important to get banks to accept state capital. That would bolster their balance sheets and restore stability. Restricting the pay of “fat cats” which wrecked the economy had popular appeal and suggested electoral gains, but it wouldn’t solve the crisis. Both governments ranked restricting pay lower in their preferences. That the American government didn’t enforce pay restrictions does therefore not indicate that American banks won the day, while the British banks lost against their government. American banks, even the healthy ones, had to pay dearly by accepting state capital and provide valuable warrants.

That the authorship of the bailout lies with the Treasury puts the studies on Congressional voting on TARP in a new light. These studies found that members of Congress, who received financial contributions from banks, are more likely to vote for the bailout. The insights from this chapter do not contest this finding. But I still maintain that these findings have little import. Congress hardly shaped the bailout. Explaining the vote in Congress says nothing about how the government bailed out banks. And the starkly different bailout programs in the United Kingdom and the United States show that this variation counts for the outcome of the bailout.

Critics may retort that without the approval by Congress, the bailout may not have occurred in the first place, and for this reason, banks’ financial contributions are crucial. The flaw in this response is that the studies of congressional voting on TARP do not speak to this point. These studies merely show that a representative with the banks’ support was more likely to vote for the bailout than a representative without. But this is no surprise, given the widespread criticism of TARP. Voting “aye” put every member of Congress into the uncomfortable po-

sition of justifying to voters why (s)he gave their tax-dollars to bankers. Enduring this encounter may be easier for those representatives who received money from banks. Still, these studies do not show that lawmakers would have derailed the bailout bill without banks' campaign contributions. And given the experts' predictions about impending collapse of the economy, it is hard to conceive that lawmakers would have prohibited the executive from supporting banks. In other words, banks' financial contributions probably nudged some representatives to vote for the bailout, but its highly unlikely that they were the decisive factor for Congress as a whole to pass the bailout bill.

Conclusion

In this thesis, I have shown that governments bail out banks because banks are critical to capitalist democracies. Banks enjoy a public safety net. Governments, however, can make banks pay for this protection. Two of this dissertation's conclusions stand out. The first is that the influence of business through lobbying and other channels of instrumental power is exaggerated. Banks cannot secure sweetheart deals by pointing to their track record of campaign contributions. Bailouts are not for sale. During crises, governments can use banks' dependence on the domestic market to force them to bear the bailout costs. Only highly international banks, can parry this threat by using their structural power strategically.

The second conclusion is that financial crises remove veto points. They create a large threat and leave little time for deliberation, which prompts lawmakers defer to the executive branch. Thus, financial crises shift power from legislatures—even strong ones, like the US Congress—to the head of government. In this chapter, I elaborate on these conclusions, summarize the findings and discuss my contributions to the literature.

6.1 The crisis aftermath

The financial crisis that started with the suspension of a few French investment funds in 2007 became the largest crisis since the Great Depression. A number

of banks failed, and governments around the world intervened forcefully to save their banking sectors. Nevertheless, the crisis has derailed growth in Europe and the United States (?, 20). In the OECD, the economy contracted by 3.5 percent and has since grown annually by merely 1.8 percent. Thus, the economy has not yet recovered from the crisis, and it is doubtful it will make up for the crisis set-back.

Unemployment mirrors this dreary picture. In the member countries of the OECD, unemployment rose from 5.6 percent before the crisis to 8.4 in 2010 and has stubbornly remained at this high level (7.9 percent in 2013). American workers suffered even more. In the United States, unemployment jumped from 3.6 to 9.6 percent in 2010 (and recovered somewhat to 7.4 percent in 2013). This has greatly affected the poor. In the last few years, the income of the bottom ten percent has stagnated in the OECD and has fallen in the United States.

Pension investments, too, still suffer from the crisis shock. The crisis reduced pension wealth in the member states of the OECD by 23 percent. The impact was even stronger in the United States. There, pension wealth dropped by 27 percent (OECD, 2009c). Since then, pension assets have recovered somewhat, but the returns are—as of 2011—still negative.¹ Despite the government's interventions, the crisis tore a hole in people's retirement savings, and the economy is still ailing. But how have banks fared since the crisis?

Banks' profitability has recovered. As a share of their assets, American banks made annual profits of 1.7 percent before the crisis. From 2008 to 2012, this figure dropped to 0.53. In 2013, profitability increased to 1.24 (OECD). Many banks have fired staff to reduce costs. The number of employees has declined since the heyday in the mid-2000s. But bankers' pay has bounced back for those that stayed on. The average chief-executive pay at the "15 leading US and European banks" dropped from \$14m in 2008 to \$6m in 2009 but has steadily increased—\$9.7m, \$12.8m, \$11.5m—to \$13m in 2013.² This pattern is the same for bank employees. In

1. The annual real net investment return of pension funds in the OECD (weighted average) is -1.6 since the crisis (December 2007 to June 2011) and 0.1 for the decade (December 2001 to December 2010). For the United States these figures are still lower, -1.7 and -1.3 (OECD, 2012, 21)

2. Megan Murphy, "Bonuses furore hits banking chiefs' pay." *Financial Times*, 22 August 2010; Megan Murphy and Sharlene Goff, "Bank chiefs' pay rises by 36%." *Financial Times*, 14 June 2011; Daniel Schäfer, "No stop to bankers' pay rises, data reveal." *Financial Times*, 24 June 2012; Daniel Schäfer, "Average pay of top bankers drops 10%." *Financial Times*, 23 June 2013; Daniel Schäfer, "Pay rises for senior bankers hit 10%." *Financial Times*, 2 June 2014.

2010, the average remuneration at large American banks—Citi, Bank of America, Goldman Sachs, JP Morgan Chase—was back to the levels of 2004-05 (but not quite to record highs in 2007).³

This rebound of bankers' pay as well as a series of bank scandals have fueled the debate on bank regulation and restricting bonuses. Policymakers have started to tighten regulation, and the banks' own safety nets—their equity levels—have strengthened. But some observers liken these instances of success to winning battles while losing the war and conclude that the next crisis is already in the making (Bell and Hindmoor, 2014*b*). Overall, the consequences of the crisis appear much lighter for banks than for workers.

6.2 Business power and bailouts across countries

When banks slid into trouble in the fall of 2008, politicians ran to save them. Their efforts put billions of taxpayers' money at risk, in some countries even the solvency of the state. But what is particular about this instance of policymaking? Bailouts differ from other policies because they are a response to a crisis. And crises change politics. Financial crises pose a large economic threat. They propagate within weeks and erupt in sudden bursts, spreading the troubles from one moment to the next. This fast pace creates a sense of urgency. Threat and urgency is an unpleasant combination. Disarming the threat requires developing good and decisive policy, but for that, there is little time. Gathering information, building expertise, deliberating options and consequences all have to take place within weeks—or before Asian markets open on Monday morning. Policymakers in this situation extend their working time by getting less sleep, but this, too, has its limits. Financial crises leave not enough time.

Policymaking on the fast track is different. It narrows policymakers, limits the number of people involved and excludes those with fewer resources. Most importantly, it sidelines the legislature. Lawmakers lack a bureaucratic apparatus that supplies them with the latest information and expertise. Unless, lawmakers have a tried and tested policy ready, they defer to the executive to solve the crisis.

3. Financial Times, "Banks' earnings: How pay relates to performance." Available at <http://www.ft.com/intl/cms/s/0/4ce7a094-1c9e-11df-8456-00144feab49a.html>, accessed 14 July 2014

The time pressure precludes them from developing policies they trust will work, and the large potential damage prevents them from experimenting and muddling through. Thus, the crisis shifts power to the executive branch, even in systems with strong legislatures.

During crises, decision-making moves up the hierarchy. The terms of bailouts often emerge from the negotiations of bank CEOs and the top regulators and the finance minister. This seems like an open invitation for politicians to embezzle funds and to collect favors from bankers. But cronyism is not what drives bailouts. That governments bail out banks is not because banks lobbied for it or because they have a standing line to the finance ministry. Rather they do so because letting banks fail wrecks the economy with devastating effects for ordinary people. Financial turmoil threatens their jobs, savings and pensions.

And banks' instrumental power—like earlier campaign contributions or lobbying efforts—grants them few advantages. The stakes in bailouts are too high for politicians to sell out to bankers. The management of the crisis is important to people, and politicians know they are facing high scrutiny. The topic is on newspapers' front pages, and lawmakers follow up with oversight investigations. The negotiations between the government and the banks bears little resemblance to the back-room dealings of the arcane issue of regulating banks. There is another circumstance that plays into policymakers' hands. In a banking crisis, everybody stands to lose a lot, but banks, too, have to fear for their existence. The banks that run out of liquidity have no other resort than the state. Struggling banks depend on the state and cannot make demands. The government can dictate the terms.

However, banks are not entirely at the mercy of the government. Although the usual influence through instrumental power is stalled, banks' structural power can thwart the government's plans. In bailout negotiations, much is at stake for both banks and the government. The best option for the government is to shift the bailout costs to healthy banks. Those banks, however, prefer not to pay. The resolution depends on banks' outside options. Banks that depend on the domestic market are vulnerable to regulatory sanctions. If they don't acquiesce, they face steep costs after the crisis. Thus their outside option is grim. But for highly international banks, regulatory threats from the domestic regulator may be unpleasant but they are surmountable. No profits from that country does not threaten their overall business. International banks thus have a possible outside option which they can use strategically in the negotiations with the government. With

this strategic structural power, banks can foil governments efforts to distribute the costs of restoring stability.

How does this situation translate into policy? If there is a large bank that is both healthy and does not depend on the domestic market, it can thwart government efforts and refuse to share bearing the bailout costs. In that case, the government has to rescue the failing banks without help from the healthier ones. But either way, governments resort to bailouts. The disruptions that bank failures would cause governments to rescue banks. Policymakers also want to restore financial stability because steering the country into a full-blown crisis is a sure way to lose elections.

The findings of this thesis contribute to a number of debates. The thesis speaks to the debate on banking bailouts, but it also has implications for the study of business power, executive-legislative relations and the relative power of the American presidency. In the remainder of the chapter, I point to the contributions made in this thesis, starting with the discussion on banking bailouts.

6.3 Bailouts between cronyism and collective action

Scholars have theorized which factors determine how governments manage crises. The recent bailouts prompted several new contributions to this debate, and this thesis responds to this emerging literature. I argue against the view that bailouts stem from “crony capitalism” (Maxfield, 2003; Rosas, 2006; Keefer, 2007), banks’ campaign contributions or gifts to politicians (Blau, Brough and Thomas, 2013; Jabko and Massoc, 2012). In Chapter 3, I have shown that electoral accountability does not explain the varying sizes of bailouts, as the crony capitalism view claims. Instead, this variation can be explained by the crisis impact and people’s holdings of pension assets. These results indicate that bailouts are not gifts to politicians’ friends, but the response to the median voter. The analysis in Chapter 4 shows that instrumental power fails to explain the bailout designs and costs. Additionally, I have demonstrated in Chapter 5 that banks’ influence due to donating to legislators is limited because Congress itself hardly shaped the bailout. These results mirror Grossman and Woll’s conclusion that “‘crony capitalism’ accounts overstate the role of bank lobbying” (Grossman and Woll, 2014, 574).

Cornelia Woll (2014) and Emiliano Grossman (2014) also greatly advanced the discussions on bailouts in other ways. They show that not all bailouts are alike, as others had argued, but that their risks and costs vary. Woll (2014) argues that financial crisis management resembles a game of chicken. The party that doesn't act wins. She turns Olson's logic of collective action around and argues that business power stems from the unwillingness or incapacity to act collectively. In countries where banks are used to coordinate amongst each other, they also cooperate in times of crisis and bear some of the crisis costs. Where banks fail to cooperate, the government has to act and shoulder the costs alone. My findings support one aspect of this argument, namely that the highest costs "arose where the financial industry was capable of refusing to participate" (Woll, 2014, p.~14, loc. 208).⁴ HSBC's ability to stay out of Darling's rescue plan forced the government to only save the weakest banks, and this restriction created large losses for the taxpayer.

Nevertheless, Cornelia Woll's "power of in-action" misreads the source of business power. Non-cooperation *is* important to explain the failure of the government, but it doesn't follow from banks' in-action. Non-cooperation is the result of individual banks' deliberate *action*. HSBC and Deutsche Bank intentionally obstructed their governments' efforts. Thus, business power doesn't flow from banks collectively, but from individual banks.

Woll argues that when banks are well-organized, they agree to chip in. This argument prompts the question of why a well-organized banking sector would agree to an unfavorable policy outcome? Why is it better for banks to be at odds with each other than to be of one mind? Woll's answer is that no reasonable actor—not even banks—would risk a financial meltdown. Because banks know the danger, they agree to cooperate. But this argument assumes that bailouts are only all-or-nothing. Her metaphor allows only two options: to yield or not to yield. And this stark choice implies a simplification that stands in contrast to the different options open to banks. If the metaphor were true, HSBC and other British banks would either have had the choice to accept the government's proposal to a collective arrangement (yield) or to obstruct the bailout and risk economic disaster (not yield). But in fact, HSBC never obstructed the overall bailout; it wanted the government to restore stability. It only rejected the government's proposal to accept state capital.

4. The citations for Woll (2014) refer to the e-book edition (location reference), the page numbers for print edition are approximate.

If financial crises offer banks not only two bad options (pay for the bailout or catastrophe) but also a good one (let the government pay for the bailout), why would a well-organized banking sector pick the bad option and pay? The answer that emerges from this dissertation is that banks don't have this choice. In a financial crisis, banks depend on the state to restore stability. They are also subject to regulatory costs. If the government proposes a rescue program, banks must play along and accept the government's terms. Only if a bank is financially healthy and can cope with potential regulatory costs, can it refuse to participate.

This distribution of power stands against Woll's power of inaction. Woll argues that the source of power is the heterogeneity of the banking sector. In her view, the structure of the collective determines whether banks chicken out and lose. Thereby, she underestimates the power of both the government and individual banks. In her account, the government is passive and merely responds to banks' decisions. However, the government has its own power over banks, rooted in its role as regulator and lender of last resort. It can withhold support and impose regulatory costs. Weak banks must accept; large and healthy banks with an international footing may escape the government's control. Rather than a game of chicken, bank bailouts resemble a game of poker. That banks win does not depend on whether they decide to stay in the game or throw in the cards. It depends on whether a bank holds a better hand.

How can we know which account better captures the bailouts of 2008? This question warrants a close look at Woll's main argument:

When the banking sector is capable of organizing collectively and contributing to its own rescue, this helps to contain costs and manage banking crises in a manner least painful to the public budget. However, the inverse is not true: a banking sector refusing or failing to organize collectively can lead to high costs for the public budget, but the government can also get out of the situation rather well. In fact, when the banking sector relies on the government for its own rescue, the final fiscal costs are a gamble: they can be rather low, as will probably be the case in the United States, dramatically high, as was the case in Ireland, or somewhere in the middle, as in Germany and the United Kingdom." (Woll, 2014, p. 65, loc. 1418)

The first part corresponds to the argument made in this thesis: When healthy banks participate in the rescue scheme, they share the bailout costs (see Chapter 4). One smaller difference is the motivation for banks to participate. In Woll's account, banks cooperate because of their "collective action capacity." I argue in contrast that the banks had little structural power and had no choice but to conform to the government's push for a collective solution. The more important difference between the two accounts comes from the second part. She states that the failure of collective action allows any type of outcome. Collective inaction may be cheap as in the United States or costly as in Ireland or the United Kingdom.

The comparison of the United States and the United Kingdom shows, however, that "voluntary" participation (i.e. capacity for collective action) is not the crucial determinant for the distributions of costs. What counts is instead whether all banks participate in the scheme. In the United States, all the major banks took part in the government's program and accepted state capital. This broad solution distributed costs onto healthy banks. This had nothing to do with banks being "incapable" of collective action.

Woll does talk about coercion by the government. She adds to her first main argument "a second, more normative argument: When a collective commitment from the financial industry is lacking, it is best to act unilaterally and impose a government solution" (Woll, 2014, p.~66, 1436). But in this sense, coercion doesn't refer to mandatory programs like the one in the United States. Woll means more generally a punitive bailout in which the government demands high fees and restricts bonuses to limit "moral hazard" (Woll, 2014, p.~66, 1436). Thus, the "more normative" aspect of her argument speaks to the fact that these punitive features supposedly limit dangerous risk-taking in the future. It does not relate to the immediate burden-sharing of the bailout between banks and the state. And it does not predict that the American government would win against banks.

6.4 Business power

This thesis speaks to the power of banks during bailouts, but it contributes to the wider debates on business power. It emphasizes the importance of structural power relative to instrumental power, and it recasts the boundaries between these two types of business power. This emphasis on structural power changes the ex-

pectation that business power shrivels when voters care and pay attention. Finally, the argument addresses recent accounts of business power that emphasize ideas.

Does capital determine public policy? This is the crucial question for the legitimacy of capitalist democracies. Many scholars have concluded that business skews policy in its favor because of its superior resources. Business can extract concessions from the democratic process because it occupies a central position in the economy and because it can spend tons of money to cajole politicians. In the last two decades, scholars have increasingly emphasized instrumental over structural business power. They have criticized that markets don't imprison the state all the time. Business sometimes loses (Smith, 2000; Baumgartner et al., 2009; Culpepper, 2013). And although Hacker and Pierson (2002) have pointed out that structural power varies, they too relegate structural power to a secondary role: "The prospect or actuality of disinvestment can set the agenda for governments and help to define (or rule out) alternatives, but this signal cannot tell governments what do. The extent to which business influences specific policy choices will be a function of instrumental rather than structural power." Explaining the variations of policies would then rely on business's instrumental power. But the different banking bailouts show that structural power does not merely sit in the background. If firms invoke their structural power strategically, it can determine specific policy outcomes.

The recent crisis prompted a rediscovery of structural power (Bell, 2012; Bell and Hindmoor, 2014*b,c*; Marsh and Lewis, 2013). One reason for this rediscovery is that banks being "too-big-to-fail" is clearly a form of structural power. Instrumental power may have helped make banks grow before the crisis, but in the moment of crisis, it is not instrumental power that made banks too big to fail (Hindmoor and McGeechan, 2012). But the structural power in these accounts is general and does not vary across countries. It is thus insufficient to explain the differences among countries.

This thesis addresses the recent and the earlier debates on instrumental and structural power. It stresses structural power, but not merely the general and automatic kind that has received widespread criticism. Chapter 4 provides a different way of classifying business power. The recent classification understood business power to be structural if it worked "apolitically and automatically" (Hacker and Pierson, 2002, 281). Yet this distinction neglects the forms of power that the firm can invoke intentionally and flow from the structural position of the firm. A bet-

ter criterion to separate instrumental from structural power is thus its source. It is structural power if it stems from the firm's position in the economy, that is, if it is innate to the function of the firm. On the other hand, it is instrumental power when it springs from activities beyond producing and investing. This definition builds on the understanding of business power before Lindblom's "privileged position" came to dominate the debate (Block, 1977; Ward, 1987; Bowles and Gintis, 1986). Whether either form works automatically or not is a fruitful, but different question.

This alternative classification of business power is not merely a semantic quibble. It provides a number of advantages. First, it opens up new perspectives. There are two typical forms of business power that have been subject to many studies. One is structural power that works automatically. This kind of power is Lindblom's privileged position. The other is instrumental power that firms use intentionally. This category includes firms' lobbying efforts and their contributions to political campaigns. A new perspective of business power emerges for two further types of business power. These are structural power that firms invoke strategically and instrumental power that functions automatically. For instance, this classification suggests a reevaluation of instances when firms use their capacity to invest (or withhold investment) strategically (Fairfield, 2011, forthcoming). Second, the view on these less common types of business power guards against exaggerations. In this thesis, I have argued that scholars overstated banks' instrumental power. The ties between banks and governments via personnel or financial contributions fail to explain the variation in banking bailouts. Other policy fields may suffer from a similarly skewed perspective. Another advantage is methodological. Strategic structural power requires action by firms. For this reason, researchers can observe the use of structural power; it does not merely take place in the heads of policymakers. Finally, re-classifying business power changes the implications of other theories of business power, for instance the effect of salience.

High salience curbs the influence of business (Culpepper, 2013). When voters care and pay close attention, politicians get punished for giving way to business. And in the fall of 2008, the banking crisis was the hottest topic in politics and the news. This high scrutiny should have expunged business' influence. But in countries like the United Kingdom, banks determined the crisis response. They succeeded in thwarting the government's plan to make them bear the bailout costs. Considering the different kinds of business power resolves this puzzle. What fades

in the glare of media attention is instrumental power. Voters punish politicians in polls when they see that politicians favor business in connection with campaign contributions or lucrative job offers. This electoral threat makes politicians less responsive to business demands when salience is high. They choose votes over kickbacks. But with structural power, politicians don't have this choice. In the poker game of bailouts, politicians with a poor hand lose. They can't trump banks just because they would like to please voters. The same mechanism works for business's privileged position. When a proposal threatens investment and employment, high salience does not reduce the structural power of business. If anything, it strengthens business position because it ensures that voters understand politicians are putting jobs at risk.

Critics may doubt the value of separating strategic instrumental power from strategic structural power. Why is invoking structural power not the same as plain lobbying? Both require business to take action and address policymakers. The difference is that instrumental power grows out of lobbying itself, while structural power stems from the firm's position in the economy. The implication is that instrumental power increases with lobbying activity. Fiercer lobbying, closer political connections and more donations mean greater instrumental power. This payoff does not exist with structural power. A firm can threaten the government over and over again, but this effort doesn't change the firm's position in the economy, and its structural power remains the same. Thus, the strategic structural power requires actions, but it doesn't expand because of additional activity. It is constant and tied to the firm's position.

One source of structural power that scholars have recently emphasized is economic ideology. Ideas shapes the magnitude of business power (Bell, 2012). Bell and Hindmoor (2014a) argue that politicians' ideas led them to bail out banks. I agree that the policymakers act depending on how they understand the impact failing banks have on the economy. Had policymakers thought that banks were irrelevant, they would have let them fail. The problem of trying to explain bailouts with ideas, however, is that they hardly vary. Policymakers have for a long time understood that letting banks fail causes economic disaster. As Cassis (2011) shows, policymakers have rescued big banks since the Baring Crisis in 1890. In particular during the recent crisis, all policymakers understood the dangers of bank failures. Thus, ideas could explain that bailouts occurred in all affected countries, but they cannot explain the variations across countries. Thus, ideational explana-

tions add little explanatory value; they cannot explain why bailouts were bigger in some countries than in others, or why some countries forced all banks to accept state capital and others did not.⁵ Ideational explanations better explain policies when policymakers have different ways to think about a policy, for instance when choosing between stimulus and austerity or between economic integration or autarky (Darden, 2009).

6.5 The American Presidency

Sometimes, the president gets what he wants from Congress; sometimes he fails. There are a number of theories that aim to explain the wavering power balance between the executive and the legislature. Compared to other political systems, the American president faces a particularly powerful legislature. Given this setting, the president is more likely to succeed when he is at the beginning of his term, when his party holds the majority in the Senate and the House, and with issues that concern foreign, not domestic politics. In the fall of 2008, judging from all of these theories, President Bush and his administration should have been weak. But with the banking bailout they got what they wanted, and Congress proved to be the weaker branch of government.

The reason for the strength of the president against Congress is the crisis itself. Crises require fast decisions and create a large threat—the meltdown of the financial system. Because the lawmakers cannot acquire the necessary information and expertise quickly, they defer to the executive branch.

This argument builds on explanations that rarely receive further attention. Scholars of executive-legislative relations usually acknowledge that external, real-world events affect the institutional power balance, but treat them as random and without systemic impact. This lack of attention is different only for one type of event, war. A number of scholars argue that war allows the president to act with greater autonomy. Howell, Jackman and Rogowski (2013) argue that war increases the importance of the national interest, and Members of Congress defer to the

5. Bell and Hindmoor (2014a) claim that ideas can explain that the American bailout was different from the British bailout. As evidence they cite that the American government purchased assets because of their “deep-seated aversion to public ownership.” However, purchasing assets was merely an interim solution; the American government dropped this plan and ended up injecting capital.

president because they recognize that the president knows more about national interests.

In this thesis, I argue that banking crises create a similar effect. Crises essentially eliminate legislatures as veto points. In contrast to Howell, Jackman and Rogowski (2013), however, I don't assume that lawmakers have a (constant) informational disadvantage compared to the president. Rather, I assume that their disadvantage is based solely on the speed of gathering information. They can learn and catch up with the president, but they need time. Thus, with time, Congress can catch up with the administration. The re-occurrence of issues builds up legislators' expertise, which reduces their disadvantage and their need to defer to the president.

The findings in this thesis thus suggest that external events beyond war affect the relation between the executive and the legislative branches. Financial crises occur frequently and they shift power systematically from the legislature to the executive. Other types of crises may work in a similar way. Crises thus merit much closer attention.

6.6 Politics and markets: Escaping the prison

Charles E. Lindblom (1982) has argued that the market imprisons policymaking. Because politicians depend on business to invest, they need to make policy in the interests of business. He added, however, that "where there are prisons... there are also jailbreaks" (Lindblom, 1982, 330). But when can the state break free? Responding to the crisis of 2008-09, some governments had to give way to banks, others prevailed. Studying the banking bailouts helps us understand the weaknesses of the market prison.

At first sight, the recent banking bailouts come across as a dismal case of policymaking. Politicians channeled billions of dollars into failing banks, which many observers have taken as evidence of a rigged political system: Bankers receive favors because they have donated money to political campaigns, because Goldman-Sachs bankers are in government, or because the banks have become too big to fail. Thus, financial markets look like well-guarded prisons, and bailouts seem to fit well into the overall rise of winner-take-all politics (Hacker and Pierson, 2010).

I don't contend the rise of inequality or the advantages the rich enjoy in capitalist democracies, particularly in the United States. But I argue that bailouts are different and show an instance when business failed to get what it wanted. Bailouts are not side-payments to banks at the expense of the public. They benefit banks as well as the average Jane. Especially where pensions are invested in financial markets, politicians have the incentive to absorb stock market shocks. The most reliable voters—those older than 40—hold pension assets for their old-age income. If they lose their pensions, they will vote for the opposition and throw the government out of office. The prospects of elections impels politicians to protect pensions. Banks donate to political campaigns and often have access to the government, but even if they didn't, governments would rescue banks. People's votes prompt governments to restore financial stability.

Hence, a privatized pension system ties financial markets closer to the state. In unfunded pension systems, the state tends to people's old-age income; in privatized systems, this falls to financial markets. People save while they work, invest the savings in stocks and bonds, and withdraw them when they retire. But if the financial markets fail, democratic governments must intervene because the majority of people views income for the elderly as essential. Ceding pensioners to market fate is no route to re-election. Thus, the failure of markets brings back the state.

This ultimate responsibility is not confined to pensions, but occurs always when the state relies on markets to supply public services. This can include public transport, health or (nuclear) energy. A collapse of these markets turns consumers into voters, and they demand the state to fill the gap. The state, as David Moss (2002) has put it, is thus "the ultimate risk manager." In consequence, public services are never fully privatized. When markets collapse, the provisioning of public services falls back onto the state. This ultimate responsibility puts another constraint on the state; it reinforces Lindblom's (1982) prison. The state does not only need to keep business happy to ensure investment, it also needs to jump in when markets fail.

The recent bailouts show, however, that the market prison has weaknesses. For Lindblom (1982), the constraint through markets on policymakers is a "mechanism." It appears, like gravity in physics, as the natural law of the market system.

The decisions of thousands of businesses, which together make up the market, build the prison for the state. A single firm is irrelevant. But in banking, as in

many other sectors, the market doesn't consist of thousands of firms. Big banks make up large parts of the banking sector. Hence, the state doesn't face an anonymous mechanism, but a few big banks, and the government can negotiate with them, and they can lose. Focusing on individual firms rather than on almighty markets opens up the focus from the state to the interaction between the state and firms. And it is not necessarily the state who draws the short straw.

Lindblom is right to point out that the combination of democracy and capitalism confers a huge advantage to business. Policymakers depend on firms to invest, grow and hire people. And when big firms, they receive state support because consumers vote, and in democracies, votes matter. Still, the state is not a convict in Alcatraz. Rather than the market prison, the state confronts individual firms. And even giants like Goldman Sachs cannot ignore the threats of the government. The state has its own power over firms.

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