Insuring Rents*

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Abstract

Economists have long recognized the need for durability-enhancing mechanisms to facilitate political exchange, but the focus has been almost entirely on mechanisms that raise the cost of reneging on bargains once they have been struck. What happens if these mechanisms fail? This paper argues that politicians have an incentive to establish an insurance-like mechanism that indemnifies interest groups whose legislatively-created benefits have been reduced. I consider the role of the Department of Justice's settlement authority in facilitating this type of transfer, and illustrate my argument by examining two recent settlements involving Citigroup and Bank of America. These settlements are notable not only because they involved the allocation of money to third-party groups who were not directly harmed by the alleged violations of federal law, but because both corporations were required to donate millions of dollars to housing counseling organizations whose subsidies Congress reduced following the 2010 midterm elections.

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> Transactions that are subject to *ex post* opportunism will benefit if appropriate safeguards can be devised *ex ante*.
>
> - Oliver E. Williamson (1985, p. 48)

1 Introduction

When the Framers set out to design the system of checks and balances found in the United States' constitution, they deliberately vested authority over the government's finances with Congress.[1] This power - known as the "power of the purse" - is supposed to be the primary means by which Congress controls the administrative state. However, regulatory agencies have become increasingly able to circumvent Congress' appropriations power by raising and allocating revenue without congressional approval, which is puzzling because much of the legal authority that undergirds these agencies' ability to self-finance Congress authorized.

The rise of agency finance is not a new phenomenon, although it has only been in the past ten years that it has received attention from legal scholars. The analysis found in this literature tends to be focused on what legal scholars view as the problems with agency finance - namely the weakening of the separation of powers - rather than explaining its causes (Peterson, 2009; Wilt, 2017). There are, of course, exceptions. DeMuth & Greve (2016), for example, speculate that the rise of agency finance is part of a broader trend towards executive government, but fall short of providing an economic theory of why this is the case.[2]

Why would Congress relinquish its control over agencies that could potentially impose substantial burdens on their constituents? In this paper, I argue that the answer lies in the peculiar nature of political exchange. Like private transactions, political exchanges require assurance that each party will live up to their end of the bargain. Unlike private transactions, however, political exchanges lack legal sanctions to ensure compliance. The absence of such sanctions

[1] See Federalist No. 58 (1788).

[2] They acknowledge that "public-choice" factors - such as budget maximization á la Niskanen (2007) - have likely contributed to this phenomenon, they brush these aside as being proximate rather than fundamental causes of agency finance.

creates uncertainty about the durability of the bargains between interest groups and the legislature, thereby reducing the value of special interest legislation. If political exchange is to be feasible, therefore, some mechanism, or set of mechanisms must exist to enforce agreements between interest groups and politicians.

Landes & Posner (1975) were the first to draw attention to the durability problem inherent to political transactions. They identified two types of institutional mechanisms that exist to increase the durability of special-interest legislation. The first is the structure of the legislature itself; majority-voting rules, the committee system, and bicameralism, for example, all increase the cost of repealing legislation once its been passed.[3] The second is the independent judiciary, which, in their view, acts as a third-party enforcer of bargains struck between interest groups and the legislature.[4] Subsequent research along these lines identified an array of political institutions that possessed durability-enhancing characteristics, such as constitutional amendments (Crain & Tollison, 1979a), the executive veto (Crain & Tollison, 1979b), and the size of legislative majorities (Crain et al., 1988).[5]

While these mechanisms can reduce the probability that future politicians will renege on the bargains reached between interest groups and politicians today, there is no guarantee that they will always be effective. What recourse do interest groups have if these mechanisms fail? One answer is that they simply incur the loss. But this answer is unsatisfying for two reasons. First, it is not unreasonable to think that interest groups would demand assurances from the legislature that they will be compensated should their legislatively-created benefits be terminated, especially given the transitional losses that such a termination would entail (Tullock, 1975). The second, and in my view, more compelling reason is that if politicians could devise a mechanism that indemnifies interest groups for the loss ex post, they could charge a higher price for legislation

[3]These mechanisms also increase the costs of enacting legislation in the first place. Nonetheless, if the benefits from increased durability exceed the additional costs of enacting legislation, the net value of legislation will be increasing. Thus, politicians will adopt durability-enhancing mechanisms up to the point where the marginal value of additional durability is just offset by the costs associated with enacting new legislation. See also: Crain (1977) and Shepsle & Weingast (1981).

[4]For an analysis of the incentives of judges to enforce wealth transfers, see Anderson et al. (1989) and Toma (1991).

[5]See Shughart & Tollison (1998) for a survey of this literature.

ex ante.[6]

Scholars working on the rise of agency finance have identified a number of mechanisms through which regulatory agencies, and the executive branch more broadly have been able to raise and allocate revenue independent of Congress. This paper considers one of these mechanisms: the Department of Justice's settlement authority. I argue that the broad discretion the Department of Justice has over the terms of the settlements reached between itself and private organizations enables it to extract substantial amounts of financial resources that it can then direct to politically-important groups, including those whose legislatively-created benefits have been terminated.[7]

As others have noted, data on both the sources and recipients of the funds allocated by the executive branch are difficult to find, which is itself telling. That said, two recent settlements involving Citigroup and Bank of America are illustrative of the sort of behavior I describe in this paper. These settlements are notable not only because they involved the allocation of money to third-party groups who were not directly harmed by the alleged violations of federal law, but because both corporations were required to donate millions of dollars to housing counseling organizations whose subsidies Congress reduced following the 2010 midterm elections.

This paper also contributes to a growing literature on the notion of "political capitalism" (Holcombe, 2018a). In this framework, the state's role in the economy is not limited to establishing and enforcing the "rules of the game." Instead, the state is actively involved in the allocation of wealth across the economic and political elite. This literature focuses on the institutions that facilitate rent seeking and extraction rather than on these activities themselves. Holcombe (2017), for example, argues that both politicians and interest groups have an incentive to limit competition for politically created rents in order to prevent dissipation. In a similar vein, Holcombe (2018b) argues that policies that create transitional-gains traps are in fact not mistakes

[6]See Goldberg (1976) for a discussion of the role of insurance contracts in reducing post-contractual opportunism in private transactions.

[7]Verret (2010) uses a similar "rent-transfer" approach wherein the government extracts rents from one group and transfers them to another. In his framework, the government uses its equity power to extract politically-created rents from rescued firms that are then transferred to politically-important interest groups. See also: Appelbaum & Katz (1987).

because they enable politicians to engage in rent extraction that would otherwise be infeasible. This paper takes a similar approach by focusing on the incentives that politicians have to devise institutional mechanisms that facilitate political exchange.

Finally, this paper contributes to the "political Coase theorem" literature (Acemoglu, 2003; Munger, 2018; Parisi, 2003). The debate in this literature centers around whether it is possible to bargain away from inefficient institutions in the sense described by Coase (1960) when credible commitments are impossible. I argue that mechanisms like the Department of Justice's settlement authority can be used to compensate interest groups on the losing side of a change in the status quo, thereby facilitating reform. Moreover, I argue that politicians have an incentive to create such mechanisms because they raise the value of legislative outputs, and with it the price that politicians can charge for special-interest legislation.[8]

The remainder of the paper is organized as follows. In the next section, I discuss the problem of durability and show that an insurance mechanism that indemnifies interest groups on the losing side of changes to the status quo can increase the value of special-interest legislation ex ante. Section 3 provides an overview of the Department of Justice's settlement authority, illustrating how it is particularly well-suited to providing the sort of indemnification mechanism that I discuss in Section 2. Following this overview, I present evidence from recent settlements that is consistent with the theory in Section 4. The final section concludes.

2 Increasing the Durability of Politically-Created Rents

2.1 The Problem of Durability

In the interest-group theory of government, the majority of the state's activities involve transferring resources among the citizenry (McCormick & Tollison, 1981). Wanting to avoid being on the "losing" side of a transfer, the citizens have an incentive to organize in order to influence government policy in their favor. Some groups will be more effective in this regard,

[8]There is a parallel literature that applies these insights to the evolution of political institutions. See, for example, Barzel (2000), McGuire & Olson (1996), and North & Weingast (1989).

and it is this difference in effectiveness that gives rise to a market for special-interest legislation (Olson, 1971).[9] Those groups that can organize to secure \$1 for less than \$1 will demand politically-created wealth transfers, while those groups that cannot will supply them. The market is brought into equilibrium by politicians who, acting as brokers, pair suppliers with demanders.

The fact that bargains reached between interest groups and politicians are not easily enforceable complicates this relationship. In private sales and contracts, legal sanctions exist to ensure that each party honors their part of the bargain. The influence that these sanctions have on economic activity depends on how quickly the parties execute the transaction and the extent to which each party's concern for their reputation induces them to act in good faith. The present value of a stream of contracted benefits will be larger in the presence of such sanctions because they reduce the possibility of post-contractual opportunism.[10] Likewise, legal sanctions can reduce the likelihood of opportunistic behavior as reputational constraints become less binding.

The lack of a mechanism to enforce special-interest legislation increases the likelihood of post-contractual opportunism in political exchanges. Broadly speaking, such opportunism can take two forms in a political context. The first occurs when a politician reneges on an agreement, e.g., he accepts payment in exchange for a politically-created benefit and fails to honor his end of the bargain. The second occurs when there is an unanticipated change in the makeup of the legislature such that the politically-created benefit is no longer consistent with the political equilibrium and is thus repealed (or never enacted). Interest groups, aware of this possibility, discount the value of politically-created benefits. The more likely post-contractual opportunism becomes the more interest groups will discount the value of a politically-created benefit.[11]

[9] See McCormick & Tollison (1981, 25-27) for a simple proof of the proposition that differential organization costs are a necessary condition for politically-mediated wealth transfers to occur.

[10] Following Klein et al. (1978), I define post-contractual opportunism as unanticipated non-fulfillment of the contract.

[11] Let the present value of a politically-created benefit, x, be

$$x = \sum_{i=0}^{\infty} \rho_i \frac{x_i}{(1+r)^i}$$

where x_i is the dollar value of the benefit in period i, r is the interest rate, and ρ_i is the probability that the benefit will be delivered as promised, i.e., $0 \leq \rho_i \leq 1$. Here, ρ reflects the durability of a politically-created benefit (Note that the probability that the benefit will be delivered as promised can change in each period). Thus, the present

Political office confers a property right to the officeholder, the value of which is, among other things, a function of the value of legislative outputs.[12] In consequence, politicians have an incentive to devise mechanisms that impart durability to politically-created benefits. One way to do so is to build a reputation for honest dealing. This strategy is similar to that of firms that make large investments in non-salvageable assets, such as brand-name capital, whose value is contingent on contractual performance (Klein & Leffler, 1981). That said, while a reputation for honest dealing is a necessary condition for increasing the durability of politically-created benefits, it may not be sufficient. From the the interest group's perspective, it may not be easy to determine whether the politician has reneged on the deal or whether there has been a shift in the political equilibrium such that producing the politically-created benefit is no longer feasible. Consequently, a reputation for honest dealing must be supplemented with institutional mechanisms that impart durability to politically-created benefits (Weingast & Marshall, 1988).

Setting aside the possibility of cheating, there is no guarantee that the stability of the legislature is sufficient to ensure the durability of politically-created benefits. Even if the current-period political equilibrium exhibits some degree of persistence into the future, competition among special interest groups can cause it to evolve randomly over time such that it will be impossible for both politicians and special interest groups to predict with certainty what the political equilibrium will be in subsequent periods.[13] Absent mechanisms that can ensure durability, this uncertainty reduces interest groups' willingness to pay for politically-created benefits, and with it the value of legislative outputs and politician's political property rights.

value of a subsidy or a tariff, for example, is an increasing function of how long an interest group expects to receive the benefit.

[12]See Crain & Tollison (1977) for analysis of the effects of term limits on the value of political property rights.

[13]By persistence I mean the extent to which the equilibrium generated by the political system in the current period persists into the subsequent periods. For instance, let the equilibrium in the current period be given by: $z_t = \gamma z_{t-1} + \epsilon_t$, where $0 < \gamma < 1$ and $\epsilon_t \backsim N(0, \sigma_\epsilon^2)$. Here, γ measures the persistence of the political equilibrium and ϵ_t captures the uncertainty faced politicians and interest groups with respect to the state of the political equilibrium. As γ increases, so too does the persistence of the political equilibrium. On the other hand, as σ_ϵ^2 increases the political environment becomes increasingly unstable. Accordingly, the gains from implementing durability-enhancing mechanisms will be greater when the political equilibrium exhibits less persistence and when the political environment is less stable, all else equal.

2.2 A Model

In Figure 1, the demand curve, d_0d_1 reflects interest groups' willingness to pay for politically-created benefits under the assumption that the benefits will be limited to the term of the enacting legislature. The demand curve is downward sloping because interest groups will demand more of these benefits the lower is the price of acquiring them. The supply curve, S_0S_1, reflects the marginal cost of producing the benefits.[14] The market will clear at e_1, with the legislature producing Q_1 units of special-interest legislation. The area bounded by $d_0e_1S_0$ represents the dollar value of the political created benefits, which politicians and interest groups share.[15]

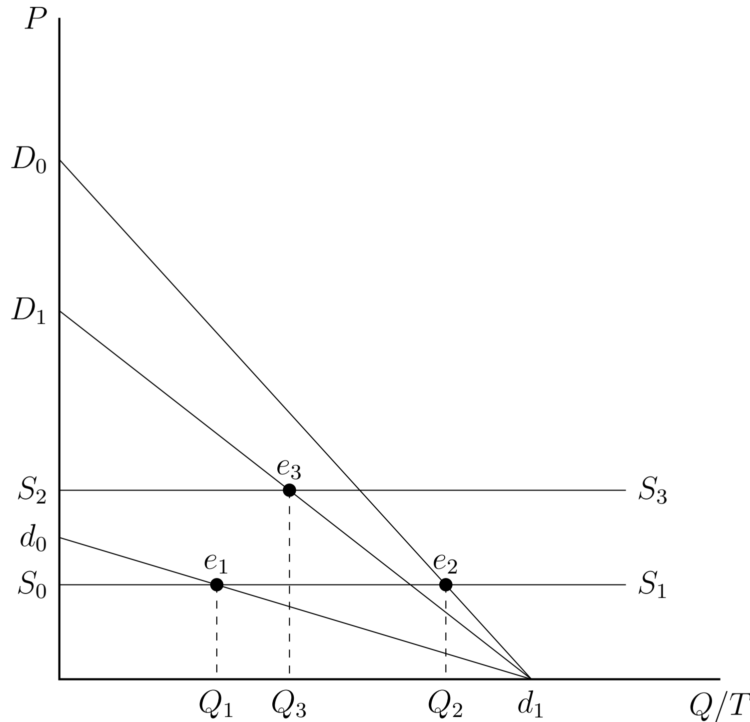

Figure 1: The Demand and Supply of Special-Interest Legislation

On the other hand, if bargains struck between interest groups and politicians were perfectly durable, the increased value of politically created benefits would cause the demand curve to shift up and to the right. The demand curve D_0d_1 reflects such a shift. Assuming that perfect

[14]The assumption of constant marginal cost does not affect the analysis in this paper. Its purpose is to simply the geometric analysis.

[15]The precise distribution of the surplus is not relevant to the analysis in this paper. I assume only that the value of an office holder's political property right is proportional to the size of the surplus.

durability could be achieved without incurring additional costs, the market would clear at e_2, with the legislature producing Q_2 units of special-interest legislation. Note that the increased durability increases the size of the surplus from $d_0 e_1 S_0$ to $D_0 e_2 S_0$. The greater surplus implies an increase in the present value of a politician's political property rights. Thus, politicians have an incentive to devise mechanisms that increase the durability of the deals reached with interest groups; the larger this surplus is the more both groups will benefit from the transaction.

Of course, increasing the durability of special-interest legislation isn't costless nor can durability-enhancing mechanisms be expected to work perfectly. Consequently, the relevant demand and supply curves are $D_1 d_1$ and $S_2 S_3$, respectively. The market will clear at e_3, with the legislature producing Q_3 units of special-interest legislation. Note that despite these shifts in the demand and supply curves the size of the surplus, $D_1 e_3 S_2$, is still larger than what it would otherwise be if there was a total lack of durability. Accordingly, politicians will pursue durability-enhancing mechanisms up to the point where the increase in interest groups' willingness to pay for special-interest legislation is just offset by the costs of producing additional durability. In other words, politicians have an incentive to push the market towards $D_0 d_1$ as long as the dollar value of the surplus is increasing.

To make this point more concrete let's consider a simple model that illustrates how the present value of special-interest legislation would be affected by the existence of an insurance mechanism that paid out when that legislation was repealed. To keep the math simple and intuitive, assume that an interest group - a firm, an industry, whatever - was receiving a dollar's worth of benefits from a legislated benefit. This could take the form of an entry restriction, a tariff, or even a direct subsidy. Now, in the case of perfect durability, the present value of a dollar's worth of benefits in perpetuity is simply equal to $\$1/r$, where r is the interest rate.

Now, as I have already discussed its unlikely that politically-created benefit could be sustained indefinitely, if for no other reason than technological change will cause the political equilibrium to shift in ways that make the original bargains unsustainable. How does this affect the present value of a dollar's worth of politically-created benefits? The simple answer is that

this income stream needs to be discounted to reflect the probability that the benefit will be received in the future (in addition to the standard present value discounting). It also seems reasonable to think that this probability will not be constant across time, with future periods having a reduced probability that the benefit will continue to be sustained. Thus, we need a function that reflects this change. One such function could be:

Without insurance, the present value of a politically-created rent is:

$$x = \sum_{t=0}^{t} (p^t \frac{\$1}{(1+r)^t}), \quad 0 < p < 1 \tag{1}$$

With insurance, the present value of a politically-created rent becomes:

$$x = \sum_{t=0}^{t} (p^t \frac{\$1}{(1+r)^t}) + (1-p^t)\gamma \sum_{t=0}^{t} (p^t \frac{\$1}{(1+r)^t}), \quad 0 < \gamma < 1 \tag{2}$$

Provided that $\gamma > 0$, a mechanism that insures politically-created rents raises the present value of special-interest legislation.

What we have here is function whose value is decreasing as time passes. Now, durability enhancing mechanisms that reduce the probability reduce p, thus raising the present value of special-interest legislation and the price that politicians can charge for it. Note, however, that for any given degree of durability, the value of the politically-created benefit is decreasing over time. It just so happens to be the case that this value deteriorates at a slower rate the higher p is. The probability that the special interest legislation will be eliminated is $(1 - p)$. Obviously, absent an insurance mechanism the interest group on the losing side of reform will receive nothing such that the present value of the politically-created benefit is determined entirely by equation (1).

Now, let's introduce an insurance mechanism that pays out in the event that the politically-created benefit is terminated. Before proceeding, however, a few qualifications are in order. First, there is no guarantee that such an insurance mechanism will work, so it isn't sufficient to discount the lump sum payout using $(1 - p)$. Second, I just realized that I haven't discussed the

lump sum payout. One way to think about this mechanism working is that when the benefit is terminated, the interest group on the losing side of reform receives a lump sum payout equal to the present value of the remaining income stream. However, as I said, receiving such a payout isn't guaranteed, so the value needs to be discounted by the probability that the insurance mechanism actually works. Let's denote that probability γ.

With that in mind, equation (1) can be ammended to the following:

$$x = \sum_{t=0}^{t}(p^t \frac{\$1}{(1+r)^t}) + (1-p^t)\gamma \sum_{t=0}^{t}(p^t \frac{\$1}{(1+r)^t}) \tag{3}$$

As time progresses, the probability that the legislation will be repealed increases, which causes the remaining payment stream to decline. If the benefit is repealed, there is some probability, γ that the interest group will receive a lump-sum payout equal to the value of that payment stream. What this means is that we have the probability of repeal, times the probability that the insurance mechanism works, times the present value of the remaining payment stream.

It is quite obvious from equation (2) that the present value of special-interest legislation is higher with the insurance mechanism than without it. How much higher? Table 1 shows the present value of a dollar's worth of politically-created benefits under different assumptions about the model's parameters. It is quite clear that the mere existence of such a mechanism, even at low probabilities of being used to indemnify interest groups on the losing side of reform, increases the present value of legislative bargains considerably. In other words, it doesn't take much for such a mechanism to have a positive effect on the value of special-interest legislation.

This logic reflects the intuition expressed in Figure 1. Increase durability raises the value of special-interest legislation, and with it the value of legislative outputs. Since the value of a politician's political property right depends positively on the value of legislative outputs, an insurance mechanism of the sort described in this section will raise the value of legislative outputs, and with it the value of a politicians political property right. Assuming that politicians' objective is to maximize the value of their political property right, my analysis indicates that

they have a strong incentive to identify and implement such mechanisms.

A note on the idea of maximizing the present value of one's political property right. Whether or not that's what politicians consciously try to do or not is irrelevant. To understand why this point is not germane to my analysis, one must keep in mind that political office is a scarce resource and as such is subject to competition. Over time, these competitive pressures weed out those politicians that fail to maximize the value of their political property rights and rewards those who do by ensuring re-election.

I want to be crystal clear on how this insurance mechanism works. In some future period the political system eliminates the special interest legislation, terminating the payment stream the interest group expected to receive. The present value of this loss is equal to the probability-weighted amount the group expected to receive in each subsequent period, discounted back to the present.

2.3 Insuring Politically-Created Benefits

One of the primary implications of the previous section is that politicians have an incentive to implement durability-enhancing mechanisms up to the point where the increased costs of doing so are just offset by interest groups' willingness to pay for legislation. In this section, I derive a simple theory of how an insurance-like mechanism that indemnifies interest groups on the losing side of changes to the status quo could aid in addressing the durability problem. Assuming that such a mechanism was credible, and if it could be implemented at a sufficiently low cost, a mechanism that compensates interest groups whose legislatively-created benefits have been terminated would raise these groups' willingness to pay for politically-created rents and with it the value of politicians' political property rights.

Durability-enhancing mechanisms are of essentially two types. The first are automatic; they impart durability via the structure of the government and its subsidiary institutions, e.g. the separation of powers, bicameralism, etc. These mechanisms increase the durability of special-interest legislation by increasing the procedural costs that must be incurred if the legislature

wants to repeal legislation. The second type require active use by other parties, e.g., judges, the executive, etc. The trouble with implementing an insurance-like mechanism that indemnifies interest groups whose legislatively-created benefits have been terminated is that, at least in the Untied States, the legislature has authority over the raising and allocation of the government's revenue.

Consider a case where the the automatic mechanisms have failed; it seems reasonable to conclude that the political equilibrium is such that the current legislature would be unwilling to compensate interest groups on the losing side of the realignment. In order for such a mechanism to be credible, it must be capable of circumventing the legislature's appropriations power; otherwise, the mechanism would have no effect on the demand for special-interest legislation. In other words, the organization responsible for indemnifying those groups harmed by the reform must be sufficiently independent from the legislature or it will be ineffective.[16]

One way to achieve this degree of independence would be for the legislature to empower the executive branch with the ability to raise and allocate revenue without the legislature's approval such that the organization responsible for implementing it is largely free of interference from the legislature - at least at the time when the decision is made to indemnify the interest group or groups on the losing side of reform.[17] In other words, the legislature would need to delegate a part of its appropriation power to another branch of government to ensure that when its preferences change such that the original bargain between it and the interest group or groups is no longer sustainable there is an external organization that can compensate those whose legislatively-created benefits have been terminated.

To see how such a process could work, consider the following scenario. First, there is a change in the makeup of the legislature whereby the party that was in the majority is now in the minority - either in one or both chambers of the legislature. This shift, in turn, may mean

[16]This point is similar to that emphasized by Landes & Posner (1975); if the independent judiciary is going to act as an effective enforcement mechanism it must be sufficiently independent of Congress otherwise it would have no effect on interest groups' willingness to pay for legislation.

[17]I abstract away from issues related to how it is that the legislature controls this organization. In the final section of the paper, I discuss possible mechanisms that the legislature could use to ensure that the responsible organization acts in a manner that is consistent with maximizing the value of politicians' political property rights.

that bargains struck in the past may no longer be consistent with the political equilibrium, e.g., it may no longer be possible to produce benefits - tariffs, subsidies, or entry regulations - for particular interest groups. The groups on the losing end of the realignment are likely to be constituents of the now-minority party. If the President was a member of the same party as the new majority, it is unlikely that the minority party in Congress could count on him to compensate the losing parties. On the other hand, if the President was a member of the minority party he may be willing to provide compensation to those whose legislatively-created benefits have been terminated, provided that they are an important constituency to him as well.

The foregoing discussion suggests the following refutable implications. First, this mechanism will be more likely to be used following a change in the makeup of the legislature such that the party that was in the majority is now in the minority in at least one of the two chambers of the legislature. Second, this mechanism will be more likely be used when the President is a member of the same party as that which is in the minority in the legislature. Third, the recipients of funds via this indemnification mechanism will be groups whose legislatively-created benefits have been terminated following the realignment in the legislature. Finally, these recipients will be constituents of the now-minority party, but their importance will not be limited to a particular Congressional district or state.

3 The Department of Justice's The Settlement Authority

3.1 A Brief History

The Department of Justice's settlement authority derives from its role as litigator on behalf of the United States government. Congress formally established this authority when it created the Department of Justice in 1870 to centralize decision making regarding litigated cases within the Executive Branch (Peterson, 2009, pp. 343). Under this authority, the Department of Justice can settle cases with those it suspects of violating federal law with little-to-no oversight from the other branches of government (Peterson, 2009, pp. 370-373). Indeed, the broad discretion

and limited oversight that the Department of Justice has over the terms of the settlements into which it enters allow it to extract substantial amounts of financial resources from firms and other organizations that it can then allocate to politically-important groups.

The broad discretion that the Department of Justice has over the terms of the settlements it negotiates allows it to sidestep Congress' appropriations power by requiring the violator of federal law to undertake certain actions that can have fiscal implications (Peterson, 2009, pp. 347-348). For example, the Department of Justice might require the violator to undertake an activity that would otherwise be performed by an executive agency, freeing up resources for other projects. Alternatively, the terms of the settlement might direct the violator to donate money to third-parties in lieu of a transfer payment that the recipient would have otherwise received from an executive agency.

These examples are not just hypothetical. Violators of environmental statues such as the Clean Air and Clean Water Acts have been required to perform Supplemental Environmental Projects as part of their settlement agreements with the Department of Justice - projects that would otherwise have to be funded via appropriations from Congress (Peterson, 2009, pp. 351-358). Similarly, the Department of Justice recently required Gibson Guitar to make monetary donations to the National Fish and Wildlife Foundation for violating the Lacey Act by importing wood from Madagascar (*Settlement Agreement between DOJ and Guibson Guitar Corp.*, 2012).

The settlement authority enables the executive branch to raise revenue independent of the legislature and allocate it without their direction. This authority is a "creature of Congress," however. Legislators could curtail this authority and yet they have not, which suggests that they may benefit from the arrangement. The analysis in the previous sections suggests that one of the ways that politicians could benefit from this arrangement is by using the settlement authority as an insurance-like mechanism that compensates interest groups if their politically-created benefits have been terminated. To illustrate how this mechanism works, I examine evidence from two recent settlements between the Department of Justice and Bank of America and Citigroup.

3.2 Transferring Rents by Extracting Rents

In order to analyze how these settlements, it will be useful to develop a simple framework to analyze the relationship between the Department of Justice and the alleged violators of federal statues. The basis of this framework is McChesney's (1987; 1991) model of rent extraction wherein politicians extract rents from organizations by threatening to impose even greater costs on them if they fail to comply. This framework differs from the standard interest-group approach to wealth transfers in that the suppliers of the wealth transfers are small, potentially well organized groups rather than large ones. In other words, being a small, well-organized interest group can cut both ways - it improves the group's ability to secure politically-created benefits, but it also lowers the costs that politicians must incur to confiscate the group's surplus making it more susceptible to rent extraction.

To be effective, rent extraction requires that the threat to impose costs be credible (Shavell, 1993). In other words, the threatened party must believe that the threat will be carried out if, and only if, the demands are not met. If, for example, following through with the threat is prohibitively costly, then there is little reason for the threatened party to acquiesce to the demands. Alternatively, the person, or organization making the threat may simply enjoy carrying out the threat regardless of what the threatened party does. Again, there is little reason for the threatened party to acquiesce to the demands.

The key, therefore, to successful rent extraction is ensuring that complying with the demands is the rational choice from the threatened party's perspective. In the case of the settlement authority, for example, the Department of Justice could offer the alleged violator a choice: pay the settlement or go to court. As long as the terms of the settlements are less than the expected costs of going to court it will be rational for the alleged violator to pay the settlement even if they did not violate the statute.

The Department of Justice's ability to extract rents and then allocate them enables the executive branch to circumvent the legislature's appropriations power. This mechanism does not require Congress' approval, nor are the settlements subject to much oversight by the Judicial

system. In short, the settlement authority allows the executive branch to make fiscal policy with little-to-no influence from the two other branches of government. As I argue in the subsequent subsection, this authority can be used to indemnify interest groups whose legislatively-created benefits have been terminated.

3.3 Evidence From Two Recent Settlements

Following the 2010 midterm elections, the Democrats went from being in the majority to the minority in the United States' House of Representatives.[18] In 2011, the new Congress eliminated the $88 million appropriation that the Department of Housing and Urban Development had been receiving to fund its housing counseling assistance program, which provided funding for Department of Housing and Urban Development-approved non-profit organizations. In 2012, Congress restored $45 million for the program, leaving the funding for the program at 50% of what it was prior to 2011. This level of funding remained consistent in 2014 and 2015 at $45 million and $47 million, respectively (*Stop Settlement Slush Funds Act of 2016*, 2016). Despite Congress restoring approximately half of the original $88 million, many of the recipient organizations were displeased with the reduction in funding, including the National Urban League, the National Community Reinvestment Coalition, and the National Neighborworks association (Prior, 2011).

The first thing to note about this situation is that the election represented a shift in the political equilibrium, and with it a change in the pattern of government spending. While the Democrats remained in the majority in the Senate they lost their majority in the House of Representatives. This shift was such that the durability-enhancing mechanisms failed to prevent the termination of the politically-created benefit, which means that if the recipients of the appropriation were going to receive compensation for the loss it would need to come from outside the legislature. In this case, the President was a member of the now-minority party in the House of Representatives, which means that it would be potentially feasible for the executive

[18] Prior to that point the Democrats had a majority in both chambers of Congress since 2006. Moreover, they also had the Presidency following the election of Barack Obama in 2008.

branch to indemnify these groups. In terms of the theory derived in the previous section, the conditions sufficient for the use of the type of indemnification mechanism had been met.

In 2014, the Department of Justice reached settlements with a number of financial institutions - including Bank of America and Citigroup - for their alleged misconduct in the period leading up to the crisis. As Wilt (2017, pp. 258-259) notes, these financial institutions have strong incentives to settle with the Department of Justice. For example, negative publicity can cause a firm's stock price to fall and a negative legal judgement may jeopardize its financial health. Moreover, going to trial presents a serious risk that, all else the same, corporations would probably prefer to avoid. Consequently, the possibility of settling with the Department of Justice offers an attractive alternative. In other words, the conditions for effective rent extraction were likely present.

Statutory authority to bring these claims against Citigroup and Bank of America, and to seek financial restitution against these institutions, came from the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which Congress passed after the savings and loan crisis. Under this law, the Attorney General can pursue civil action against federally-insured institutions that engage in fraudulent behavior. An additional feature of this law is that the burden of proof that must be established to impose financial penalties is lower than in a criminal trial. The Attorney General need only show that a preponderance of the evidence indicates that the charged institution is guilty. In the context of rent extraction, this reduced burden of proof has important implications for the credibility of the threat. By weakening the evidentiary burden that must be established to find the firm guilty, the law makes compliance more likely. The Department of Justice used this law to pursue civil action against the aforementioned banks, and to seek financial restitution for their actions, which the Department of Justice argued included defrauding their customers, investors, and the government (*Settlement Agreement between DOJ and Bank of America*, 2014; *Settlement Agreement between DOJ and Citi*, 2014).

While the terms of each settlement are highly detailed and complex, the agreements with Bank of American and Citigroup are notable for several reasons. First, the settlements required

each firm to make donations to the same non-profit organizations whose funding had been reduced by Congress two years earlier. The settlement with Bank of America required at least $20 million in donations to Department of Housing and Urban Development-approved organizations, and the settlement with Citigroup required at least $10 million in donations. Second, not only were these firms required to make donations to the organizations whose funding had been terminated by Congress, the Department of Justice incentivized them to do so by offering a $2 credit for every $1 donated.

As of 2016, Bank of America and Citigroup have received a credit of $46 million and $23 million, respectively, for their donations to approved organizations. The available data does not clearly delineate between money actually donated by each firm and the credits they have received from the Department of Justice from doing so. Assuming that both firms are receiving the two-to-one credit then as of 2016, the approved organizations have received combined donations of $34.5 million (Wilt, 2017, p. 270). Between the $47 million approved by Congress in 2015 and these settlements, funding for the housing assistance counseling program totaled $81.5 million - $6.5 million shy of its pre-2011 amount.

These settlements essentially counteracted Congress' decision to reduce the amount of money allocated for the housing counseling assistance program. Moreover, the recipients of the settlement funds were also constituents of the the Democrat's and Obama administration's coalition such as the National Community Reinvestment Coalition and the National Council of La Raza, both of whom have received a total of $6.05 million and $3.5 million from the settlements, respectively Wilt (2017).

While certainly not conclusive, the evidence provided in this section is consistent with the theory presented in the previous section. The Department of Justice's settlement authority enabled it to collect revenue independent of Congress, which, in consultation with the Department of Housing and Urban Development, it then allocated to groups whose funding had been reduced following a shift in the makeup of the legislature. Although the Department of Justice retained no control over the use of money donated to third-party organizations, it did control

which organizations are eligible for donations by relying on the Department of Housing and Urban Development to determine the eligibility requirements.

4 Conclusion

Like private markets, interest group politics requires certain institutional mechanisms to function - a fact that economists working within the public choice and law and economics traditions have long recognized. To date, however, their focus has been on mechanisms that raise the cost of repealing politically-created benefits rather than on mechanisms that compensate interest groups who are on the losing side of changes to the status quo. In this paper, I have shown how politicians can benefit from mechanisms that compensate interest groups whose legislatively-created benefits have been terminated. To illustrate how this process works, I examined two recent settlements wherein the Department of Justice used its settlement authority to extract substantial financial resources from Citigroup and Bank of American and then reallocated those resources to housing counseling assistance organizations whose funding had been reduced by Congress following the 2010 midterm election. Still though, more work remains to be done on this important topic.

While the evidence I presented in this paper is consistent with the theoretical justification I provided for an insurance-like mechanism, additional case studies and quantitative work will be necessary to determine the extent to which mechanisms like the settlement authority are used to compensate interest groups on the losing side of changes to the status quo. Moreover, future research should attempt to identify other, similar mechanisms. The Consumer Financial Protection Bureau, for example, has a settlement authority similar to that of the Department of Justice and is likewise insulated from interference from Congress. Whether it has been used in a manner similar to that described in this paper remains an open question.

One of the important issues that I have not addressed is how Congress ensures that Department of Justice officials use the settlement authority the manner I have described in this

paper. Here, I can offer three conjectures that should be explored in future research. The first is that Congress controls the Department of Justice via its budget, e.g., Congress rewards the Department of Justice for acting in a manner consistent with its wishes. The second is similar to the first; Congress controls the scope of the Department of Justice's power via changes to its statutory authority. The final conjecture is that insofar as the interests of the current administration and the minority party in Congress are aligned, as they are in the theory developed in this paper, then such control may be unnecessary.

In addition, my analysis of the settlement authority has been confined to what Peterson (2009, p. 347) has called the "augmentation problem," by which he means the ability of federal agencies to augment their budgets independent of Congress by requiring alleged violators of federal statutes to either undertake projects or transfer financial resources to third parties that would otherwise need to be funded by the agencies themselves. This channel is not the only way that the settlement authority can be used, however. Congress has not only given the Department of Justice the authority to settle cases brought against the United States, it has also created a permanent, indefinite appropriation known as the Judgement Fund that the Department of Justice can use to pay settlements against the United States. As Peterson notes (2009, p. 348), this "unauthorized grant problem" allows the Department of Justice to settle with politically-important plaintiffs independent of the legal merit of the plaintiffs' claims. Future research should examine the recipients of such settlements to determine whether the pattern of disbursements is consistent with the theory presented in this paper.

This paper has two important implications for the interest-group theory of government. First, I have identified an additional role for the executive branch beyond the veto, which while effective in terms of imparting durability to special-interest legislation, is a blunt instrument. By contrast, the settlement authority enables the executive branch to direct targeted benefits to politically-important interest groups thus making it a more precise mechanism for assuring interest groups that they will be compensated if their politically-created benefits are terminated.

A second, and perhaps counter-intuitive implication of this paper is that mechanisms like

the settlement authority may improve economic efficiency. Absent a mechanism to compensate those who are currently benefiting from the status quo, interest groups on the losing side of a policy reform may invest significant resources towards preventing the reform from occurring. This outcome can be avoided by paying the "losers" the present value of their politically-created benefits out of the surplus generated by the policy reform, which avoids wasteful efforts to preserve the status quo.[19] In this sense, the settlement authority can be seen as an efficient response to the transaction costs that would otherwise need to be incurred if the "winning" coalition was to pay off the "losing" one. If the settlement authority acts in the manner described in this paper, then efforts to limit these types of transfers may be welfare reducing as interest groups and politicians are forced to adjust along other, less efficient margins to increase the durability of the bargains they reach.

Following the 2016 election wherein the Republicans retained control of both the House of Representatives and the Senate in addition to winning the Presidency, the use of the settlement authority in this manner was ended by then-Attorney General Sessions (*Attorney General Jeff Sessions Ends Third Party Settlement Practice*, 2017). This development comports with the theory offered here; the interests of the executive branch and the minority party in Congress were no longer aligned. Whether this mechanism will be used in a similar manner following the 2018 election remains to be seen.

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[19]Thompson (1966) proposed a similar idea wherein the government uses an insurance mechanism to identify Pareto-efficient reforms and compensate those on the losing side. See also: Bailey (1996, 1997).

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