

The Revolving Door Indicator: Estimating the distortionary power of the revolving door

The Proxy Challenge Series: Exploring innovative ways to measure corruption

U4's Proxy Challenge initiative promotes methodological fine-tuning and empirical application of pioneering ways to measure types of corruption where no standardised measurement tools yet exist.



When people move between positions as regulator or legislators and private companies within the same sector this can lead to conflicts of interest, regulatory capture, and economic distortions. Such practices are called *revolving doors*. The Revolving Door Indicator is proposed as a proxy for the corruption risks and economic distortionary effects that a high degree of revolving doors practices entail in a given sector.



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media sectors.¹ The revolving door is particularly common in countries where explicit bribes cannot be paid safely, and thus regulators look forward to future employment with the regulated firms (Laffont and Tirole 1996). It leads to strong conflicts of interest and can result in severe economic distortions.

In 2009, the Organisation for Economic Co-operation and Development (OECD) pointed out the role played by the revolving door in the 2008 financial crisis and called for appropriate rules and procedures to control conflicts of interest generated by this phenomenon. However, there have been no attempts to collect and use data on these connections to build an actionable and internationally comparable indicator of the distortions created by the revolving door process.

According to Transparency International UK, the term “revolving door” refers to “the movement of individuals between positions of public office and jobs in the private sector, in either direction” (2011, 5). The multiplying connections between public regulators and private groups have been widely documented, especially in the defence, information technology, pharmaceutical, utilities, and

Following a brief overview of literature on revolving door impacts, this brief introduces the Revolving Door Indicator (RDI) as a proxy for the distortionary effects of the revolving door in regulated sectors and industries.

Negative effects of the revolving door: Lower productivity, corruption risks

The literature makes clear that the revolving door process is a source of valuable political connections for private firms. But it generates corruption risks and has strong distortional effects on the economy, especially when this power is concentrated within a few firms.

Studies of the effect of political connections on firms' performances and aggregate outcomes emphasise the value of different types of connections, including campaign contributions (Classens, Feijen, and Laeven 2008), personal relationships (Amore and Bennedsen 2013), political party membership (Khwaja and Mian 2005), and the revolving door (Faccio 2006; Luechinger and Moser 2012).

The revolving door involves two distinct types of movement. The first is from the *public to the private sector*, as regulators (ministers, cabinet secretaries, legislators, high-level officials, advisers) leave the public sector to enter the private sector they have regulated. The second is from the private to the public sector, as high-level executives of regulated companies enter the executive branch, the legislature, or key regulatory agencies.

In emerging and industrialised economies, where relationships linked to kinship, friendship, or ethnicity have been progressively replaced by market-based relationships in economic exchanges (Rajan and Zingales 1998; Andvig 2006), the revolving door is a major source of political connections with significant positive effects on firms' value (Faccio 2006; Cingano and Pinotti 2013; Kramarz and Thesmar 2013; Luechinger and Moser 2012; Goldman, Rocholl, and So 2013).

This effect on firm value can be predicted from theoretical rent-seeking models emphasising the allocation of talents between productive and unproductive rent-seeking activities (Murphy, Shleifer, and Vishny 1991; Cingano and Pinotti 2013). The revolving door may increase a firm's performances through two competing channels:

- *The productive channel:* The revolving door is used to increase the firm's productivity because revolved regulators may be more skilled and familiar with the regulations.
- *The rent-seeking channel:* The revolving door is used to capture public resources, through legal and illegal means, rather than to increase production or efficiency.

Firms politically connected through the revolving door tend to shape laws and regulations in their favour and to divert state resources to their own benefit.

Transparency International UK (2011) and the OECD (2009) point out that the revolving door may lead to various schemes involving conflicts of interest, both during and after a regulator's term in public office. This in turn generates undue bureaucratic and political power for firms using such schemes.² As an indication of the strong link between the revolving door and corrupt practices, cross-country analyses (Faccio 2006, 2010) and case studies (Cingano and Pinotti 2013; Slinko, Yakovlev, and Zhuravskaya 2005) have shown that the differential in economic returns between connected and non-connected firms increases in high-corruption environments.

The revolving door is also related to lawful behaviours (Brezis 2013), termed "legal corruption" by Kaufmann and Vicente (2011). This phrase refers to "efforts by companies and individuals to shape law or policies to their advantage, often done quasi-legally, via campaign finance, lobbying or exchange of favors to politicians, regulators and other government officials. [...] In its more extreme form, legal corruption can lead to control of entire states, through the phenomenon dubbed 'state capture,' and result in enormous losses for societies" (Kaufman 2012). Brezis (2013) proposes a theoretical model to show how revolved regulators create excessive red tape while in public office in order to cash in on their bureaucratic expertise in the private sector after leaving office. In this way, the revolving door gives substantial political and bureaucratic power to revolving firms while imposing extra costs on other firms and reducing overall productivity in the public and private sectors.

Firms connected through the revolving door may therefore derive undue advantages by legally and illegally influencing the formulation, adoption, and implementation of laws, regulations, and public policies. For example, when firms are connected to (former) members of Parliament, they may influence the enactment of laws and regulations in their favour. When firms are connected to (former) ministers and their advisers, they may influence the upstream formulation and implementation of policies and regulations in their favour. When firms are connected to (former) high-level officials, they may influence the downstream implementation of regulations in their favour.

Regarding the effect on firms' productivity, Cingano and Pinotti (2013) find no relationship in their sample of Italian firms between corporate appointments of local politicians and higher productivity. Kramarz and Thesmar (2013) and Bertrand et al. (2006) show that when French firms are

politically connected through their chief executive officers (CEOs) and directors, they tend to overpay these individuals and are less likely to fire them when they underperform. Firms with such connections also display poorer accounting performances and excessive employment rates and make bigger and worse acquisitions. Moreover, Slinko, Yakovlev, and Zhuravskaya (2005) find that politically powerful Russian firms adversely affect the performance of small or politically powerless firms by influencing policy in the direction of excessive regulation over the latter and by diverting government spending in their own favour. By contrast, they find that politically powerless firms invest more and are more productive in regions where the concentration of political power among firms is lower.

Empirical studies suggest that the revolving door gives firms political and bureaucratic power that enables them to divert state resources by biasing public procurement processes (Goldman, Rocholl, and So 2013; Cingano and Pinotti 2013), obtaining preferential access to public finance (Faccio, Masulis, and McConnell 2006; Boubakri et al. 2012), and unduly benefiting from tax exemption, arrears, and subsidies (Faccio 2010; Slinko, Yakovlev, and Zhuravskaya 2005; Johnson and Mitton 2003).

Therefore, firms politically connected through the revolving door tend to shape laws and regulations in their favour and to divert state resources to their own benefit. They are unlikely to gain a productivity advantage, and indeed may reduce productivity in the private and the public sectors. The literature on state capture and political influence (Hellman and Kaufmann 2004; Hellman, Jones, and Kaufmann 2003; Slinko, Yakovlev, and Zhuravskaya 2005) supports the thesis that such distortions result from the high concentration of political and bureaucratic power among a few powerful firms.

The Revolving Door Indicator

An indicator based only on the number of revolved regulators would not be very informative about the distortions generated by the revolving door, because it might also reflect the positive effect of skilled workers on economic outcomes. Instead, in line with Slinko, Yakovlev, and Zhuravskaya (2005) and Hellman and Kaufmann (2004), we propose to use as a proxy for the distortions created by the revolving door a measure of concentration of revolved regulators among firms at the sector level. We term this the Revolving Door Indicator (RDI).³

The RDI is a normalised Herfindahl-Hirschman index formula.⁴ It measures the concentration in sector s of revolved regulators r among private firms i :

$$RDI_s = \frac{\sqrt{\sum_{i=1}^K \left(\frac{r_i}{R_s}\right)^2} - \sqrt{1/K_s}}{1 - \sqrt{1/K_s}}$$

This RDI is between 0 and 1. Note that the higher the index in sector s , the stronger the concentration of revolved regulators and the greater the likelihood of distortions in sector s . R_s is the total number of revolved regulators, and K_s is the number of firms in sector s .

Typology of revolved regulators and revolving door flows

The revolved regulators considered for RDI calculation include former top-level officers in private firms who are current members of a ministry or cabinet department, parliament or other legislature, or regulatory agency, as well as current top-level officers in private firms who are former members of these public bodies.

For the purposes of calculation, these regulators are sorted according to (a) their position in the private sector and (b) their influence and power in the public sector. In terms of their position in the private sector, they are classified into *category I*, for CEOs; *category II*, for board of directors; and *category III*, for all other positions. In terms of their influence and power in the public sector, they are classified into two categories. Powerful revolved regulators (*category P*) are top-level government officials and legislators. Non-powerful revolved regulators (*category NP*) are individuals with lower-level positions in the government or in a relevant administration.

Then, three types of revolving door flows are identified:

Type 1, public-to-private: Former members of a relevant ministry, administration, or legislature currently hold an executive position in a regulated company.

Type 2, private-to-public: Former executives of a regulated company are currently members of a relevant ministry, administration, or legislature.

Type 3, private-to-public-to-private (two-sided): Executives have engaged in both type 1 and type 2 movements and are therefore prone to favour firms both during and after their term in public office.

Following this typology, it is possible to compute specific RDIs focusing on different categories of revolved regulators or different types of revolving door flows, as well as an RDI for a sector or other cluster as a whole.

Data collection

The RDI requires collecting information on the names of company officers and matching them with the names of regulators. Name of corporate officers can be obtained from national registries of private companies,⁵ international databases,⁶ companies' official websites, and business websites.⁷ Names of public officials can be obtained from official government and public sector commission websites,⁸ as well as from websites focused on public actors and conflicts of interest.⁹ Table 1 presents data for three major US financial firms: Goldman Sachs, Citigroup, and Fannie Mae.

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TABLE 1. THE REVOLVING DOOR IN THREE MAJOR US FINANCIAL FIRMS

Number of revolved regulators by category						
Revolving door flow	Total	I	II	III	P	NP
Goldman Sachs (GS)						
1. Public to GS	19	0	0	19	5	14
2. GS to Public	12	1	0	11	10	2
3. GS to Public to GS	6	1	1	4	4	2
Total	37	2	1	35	19	18
Citigroup (CG)						
1. Public to CG	20	0	0	20	3	17
2. CG to Public	1	0	0	1	0	1
3. CG to Public to CG	5	0	0	5	4	1
Total	26	0	0	26	7	19
Fannie Mae (FM)						
1. Public to FM	11	1	1	9	2	9
2. FM to Public	3	1	0	3	0	3
3. FM to Public to FM	12	2	0	9	6	6
Total	25	4	1	20	8	17

Source: Data collected by the authors from official company websites, LexisNexis Academic, and OneSource (Avention), and cross-checked with data from OpenSecrets.org website and biographies provided by government agency websites (Securities and Exchange Commission and Treasury), social network websites (LinkedIn), and business websites (Businessweek, Business Insider, Bloomberg).

Sample application

Let us consider the US financial sector and the three firms shown in table 1: Goldman Sachs, Citigroup, and Fannie Mae. If we compute a “standard RDI” for these three firms, without differentiating between categories of revolved regulators and types of revolving door flows, we get:

$$RDI_{\text{standard}} = 0.024$$

According to this standard RDI, the revolving door concentration is low.¹⁰ The three financial firms have almost equal political and bureaucratic power, and none is likely to shape regulations and divert state resources to its individual advantage. However, when we compute the RDI for specific categories of revolved regulators, the diagnostic may change slightly. For instance, it is possible to compute a RDI focused on “powerful revolved regulators” only:

$$RDI_{\text{Powerful}} = 0.150$$

When we consider revolved regulators who hold or have held influential public sector positions, the concentration increases. Moreover, if one considers that private-to-public sector flows of revolved regulators are more damaging to the economy than public-to-private sector flows—because they give direct preferential access to public decision making, as suggested by Luechinger and Moser (2012) – then it is possible to compute a “type-2 RDI”:

$$RDI_{\text{Type 2}} = 0.560$$

According to this type-2 RDI, the concentration of type-2 revolving door flows is much higher. That is, Goldman Sachs should be able to derive stronger political or bureaucratic power from revolved regulators in public office than its competitors. This shows that the RDI is a flexible indicator which can be focused on specific revolving door flows and/or categories of revolved regulators, allowing a refined analysis adapted to research or policy needs.

Conclusion

In view of the evidence of economic damage associated with the revolving door, there is an urgent need to identify institutional configurations under which the revolving door is likely to cause economic distortions and to set effective rules to control it. By measuring the revolving door concentration within a given sector, the RDI is a first step toward sizing up the distortional power of the revolving door. This in turn can allow us to compare countries in terms of the progress they have made in implementing safeguards against the conflicts of interest associated with promiscuous public and private elites.

The effect of such policies and regulations should be reflected in RDI values in various ways. For instance, post-employment restrictions that require a minimum “cooling off” period after an individual leaves public office should slow down public-to-private and two-sided flows, and this in turn should reduce the influence of revolved regulators over public decision-making. Their value for captor firms should therefore decrease, along with the incentives to hire them for rent-seeking purposes. As a consequence, the concentration of public-to-private revolving door flows should be reduced.

Regarding private-to-public flows, pre-employment restrictions that prevent former private sector employees from undertaking certain tasks in the public sector should help dissuade captor firms’ staff from entering government to influence regulations and divert state resources. An empowered regulatory commission of public servants, rules of transparency (such as rules on asset disclosure by parliamentarians and ministers), and regulations with clear emphasis on conflicts of interest related to specific positions in the public sector should also reduce the concentration of revolved regulators by decreasing the value of these regulators for rent-seeking firms.

Endnotes

¹ Some leading examples of revolving door firms in the United States are the Pharmaceutical Research and Manufacturers of America, financial firms such as Goldman Sachs and Fannie Mae, the National Association of Manufacturers, General Electric, and Lockheed Martin. See the Center for Responsive Politics’ OpenSecrets.org website www.opensecrets.org/revolving/. For the European Union, see the Corporate Europe Observatory’s Revolving Door Watch (corporateeurope.org/revolvingdoorwatch).

² These include abuse of office, regulatory capture, undue influence, profiteering, and switching sides (Transparency International UK 2011, 9–10).

³ Clustering firms by sector makes most sense for the RDI calculation, since firms from the same sector are expected to compete with each other. However, because an entire industry may also capture the state, this indicator can be calculated at a higher level. For instance, it is possible to compute the RDI for the entire economy or to cluster firms from various sectors of the economy.

⁴ Used by the United Nations Conference on Trade and Development for its export concentration index (UNCTAD 2013, 212).

⁵ Examples include the DAFSA yearbook of French firms, the Securities and Exchange Commission’s EDGAR system for US firms, the Financial

Services Register of the Financial Conduct Authority for UK financial firms, and RERLD and ALBA datasets for Russian firms.

⁶ The Reuters Worldscope and Extel databases, and LexisNexis.

⁷ The Bloomberg Businessweek website provides biographies of many companies’ officers.

⁸ For example, the ACOBA in the UK provides detailed information on movements from the public sector to the private sector.

⁹ Such as the OpenSecrets.org and Revolving Door Watch websites (see note 1).

¹⁰ Because we collected data for three major financial groups known to intensively engage in the revolving door process, it is not surprising that the concentration is low.





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