CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES | Simon Chair in Political Economy

ISSUES IN INTERNATIONAL POLITICAL ECONOMY

December 2008, Number 108

What Can We Believe In Now?

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Trust in decisionmaking in the United States has almost completely evaporated. This is true with respect to government, Congress, private companies, and the regulatory arena, where public and private intersect. A well-known Mexican politician once said: "Show me a politician who is poor, and I will show you a poor politician." Illinois governor Rod Blagojevich seems to have made this the core of his credo. CEOs in the financial sector competed over which one raked in the largest pot; the losers obviously lacked entrepreneurial drive. Bargaining with prospective CEOs included the particulars of their golden parachutes, or what do I get when I'm fired.

I began to understand this mentality after I repeatedly received corporate proxy statements on proposals inserted by shareholders asking to have an advisory vote on executive compensation. The boards of directors invariably recommended a "No" vote, arguing that the companies had to hire the most hungry executives. The board position almost always prevailed.

I confess to being slow to fully grasp that much too often the majority of Americans were sold a bill of goods from two groups, those who were doing well and wanted to sustain the status quo, and others who looked forward to feeding at public and private troughs—and that neither group wanted to entertain opposing positions. Examples of this can be cited almost endlessly. Indeed, a new example seems to arise just about every day. I will give just a few examples of the kinds of things I have in mind. The Bush administration provided inaccurate information to get congressional consent to go to war with Iraq; and despite voluminous indications that the information given was false, the Congress voted to go to war. It is not just Governor Blagojevich who wants to sell appointments. The president's office (this president and his predecessors from either party) have long sold ambassadorships, the more money donated, the more important the country of assignment. President Bush gave the directorship of the Federal Emergency Management Agency (FEMA) to a person unequipped for the job, as we learned after Hurricane Katrina. The political parties in most states control the process of redrawing districts for congressional elections, usually done after a new census or sometimes between censuses, and it is obvious that both parties do this in a way to limit losses of their incumbents. To hell with democracy; long live the incumbents.

We now know that we got into the current financial mess because managers of banks wanted high profits from risky mortgages. It was no secret that subprime mortgages were risky, but they were packaged so as to obfuscate this reality. Banks are now being bailed out, but they are still not lending. The price of this greed at investment banks is being paid by the general public as they watch their assets decline in value and their carefully built up retirement savings being destroyed. The fight over the rescue package for the big three auto companies has devolved into a fight to destroy the union; union busting is apparently still important to conservative politicians. Bernard Madoff was able to run a massive Ponzi scheme, and he now estimates that he has lost $50 billion of assets of individuals, institutions, and charities—and the Securities and Exchange Commission did nothing for many years despite repeated warnings that something was amiss. We have long known about federal regulatory agencies becoming the captive of the sector being regulated, such as the Federal Communications Commission over many years allowing the same companies to dominate both print and television media in specific locations.

The specific examples are the result of an attitude that the less the supervision from government and regulatory authorities, the more innovative and productive the market mechanism will be. Innovative, yes—the way the schemes led to the global credit crisis, first in the housing market and then in the leverage to enlarge profit increases, demonstrate this. Productive, no—the horrible consequence of unfettered private activity is now clear for all to see. Ronald Reagan, when he was president, repeatedly argued that the regulatory power of the government and its agencies should be reduced; in his calculations, the government was the problem. The Congress bought this view and deregulated. The Glass-Steagall Act requiring the separation of investment and commercial banks, dating from the early years of the Great Depression, was still in existence when the large merger of Citibank, Travelers Insurance, and Salomon Smith Barney took place. To a layman, this seemed to violate Glass-Steagall, but the merger was allowed to proceed. After considerable lobbying by the banking industry, the Glass-Steagall Act was formally repealed in 1999 while Bill Clinton was still president. Citicorp got its deregulation, but it is hemorrhaging value today.

The central theme of libertarians is that the right things will be done if the government just gets out of the way. Alan Greenspan confessed recently that he misjudged what the behavior of bank managers would be after he failed to take action against what he had called “irrational exuberance.” We have now had experience with bank deregulation and have discovered that greed dominates—greed, not the perfectibility of financial managers. We still do not know how much damage this misjudgment will cause around the world. What we do know is that the economic situation in the United States and the rest of the world will get worse before it gets better.

The political shortcomings with which we live are partially corrected from time to time because politicians overstep reasonable limits and are exposed by independent media. We have always known that many (most?) politicians sell their votes for cash or other benefits, but in the main there is no direct connection between the benefits politicians receive and the votes they cast. Every now and then the connection is made crystal clear. That happened at least twice this year, first in the conviction of Senator Ted Stevens of Alaska for repairs and remodeling of his house in return for favors he gave; and then in spectacular fashion with the direct language of Governor Blagojevich. There is likely to be some reform to limit crass quid pro quos between politicians and their benefactors, but these reforms are not likely to touch the sophisticated trading of favors that is more common. Those who opposed legislation to control political financing used the argument that contributions to politicians are a form of free speech—cash may be a form of speech, but surely it is not free. The ability of state legislatures to rig the shape of congressional districts is a clear diminution of democracy—one designed to diminish the power of one person/one vote—yet it persists.

For many years, we have witnessed the growing disparity between the financial rewards of senior managers of private corporations and the rank and file of company employees. This has been especially true in the financial sector. New college graduates sought jobs in investment banks because compensation was extraordinarily generous—and the greater the risks taken, the higher the income was likely to be. The senior people who should have been rewarded for reducing investment risks were instead financially rewarded when they also took greater risks. Speak about perverse incentives. The heads of U.S. auto companies received outsized rewards as they ignored signs that their strategic views of the industry were mistaken. The boards of directors of corporation after corporation regularly argued against shareholder involvement in management compensation. Governance practices in large corporations have made it evident that they do not welcome shareholder views that differ from their own. The public in the United States today is angry over the manner in which the economy has been managed in recent years because they are paying the price of the economic downturn. We now learn that despite the promise to curb outsized salaries and benefits to senior managers, much of the lending to banks may not accomplish this. If exorbitant executive rewards are not corrected, the public anger will only grow.

The main issue I wish to raise in this commentary is whether the current anger will result in durable changes. I wonder if political leaders will change their habit of selling favors, and whether redistricting will be turned over to bodies other than the interested politicians themselves. The answer in both areas is that durable changes will probably not take place.

There is now an apparent consensus that governmental financial oversight of private companies needs to be strengthened. The argument that this might stifle innovation no longer has much credibility; there has been little innovation in the auto industry despite the high compensation of company CEOs, and the innovation in the financial sector was aimed at figuring out how to enrich the leaders rather than at minimizing risk. Increased regulation to correct the problems that *now* exist will not have a lasting effect because managers will surely be able to figure out new ways to enrich themselves. The market and the private sector was the problem this time. But the argument against government interference is likely to return as succeeding generations take the reins of power.

To paraphrase something else that President Reagan once said: trust the market, but verify.

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