



11350 Random Hills Road, Suite 800, Fairfax, Virginia 22030 Phone (703) 934-6101 Fax (703) 352-3678

fff@fff.org www.fff.org

Failure Leads to “Success” in the Public Sector

by Gregory Bresiger

We are playing out the latest chapter in the “crisis and leviathan” model in the financial-services business. It is a model in which public-sector failure leads to bigger government. It leads to success for socialists who want the government to expand into every aspect of our economy but don’t want to overtly call for nationalization and don’t even want to whisper the word “collectivist.”

“Chief among the enduring legacies of emergency governmental programs has been ideological change,” writes Professor Robert Higgs, “in particular a profound transformation of the typical American’s beliefs about the appropriate role of the federal government in economic affairs.”

But what makes this transformation insidious, I believe, is that it is accomplished without a conscious collectivism. This is the principle of socialism without doctrines. It is also the idea of social engineering through financial institutions, as I see almost every day. It is the idea of using “the emergency” to stampede people into economic ideas that they normally would reject. It is an idea that was brilliantly documented several years ago.

In *Crisis and Leviathan* Higgs detailed the historic buildup of the federal government over the last century or so. How did it happen? Real or imagined crises occur. Wars or crashes happen. Instead of examining the causes of these problems — a bellicose foreign policy that blows up or interventionist, inflationary central-bank policies — and critiquing failed government policies, popular media and pols blame the private sector.

Then the federal government takes on tremendous new regulatory and taxing powers. When the emergency is over, the federal government retains every bit of its new power. Few notice a sea change.

We now see still another confirmation of Higgs’s thesis in the financial-services industry, an industry I often cover as a journalist.

Higgs's book came to mind recently as I was writing a story on the coming new rules governing compensation for top financial-services executives. Needed or not, new executive-compensation diktats from the federal government are inevitable.

How did we get here?

The latest chapter began with the inability of the federal government to leave things alone. Instead of allowing Joseph Schumpeter's creative destruction to operate, which would mean letting badly run investment banks and other financial institutions fail, the federal government rushed in with politically favored bailouts. I use the phrase "politically favored" because some firms were bailed out, while others were not. Maybe if Lehman Brothers had been a better player it would still be with us today.

The bailout vehicle was TARP, the Troubled Asset Relief Program. But TARP has opened the door to all kinds of executive-compensation mischief.

If a firm is taking taxpayer dollars, the federal government can impose pay rules for the firm's top people. That would be a problem for many firms, which need to pay big bucks to attract top talent. Thus, some firms have been trying to repay TARP money.

But several experts have told me that TARP is a precedent. New rules are surely on the way telling financial institutions, even though they never took TARP money, how to pay key personnel. Treasury Secretary Timothy Geithner affirms that a "say for pay" law is on the way.

And the new rules will very likely require more regulatory supervision of the risks financial institutions take. That, of course, raises some obvious questions: Why in a highly regulated industry, with rules on top of rules, did all those financial institutions fail? Why were regulators unaware of what was going on?

Under the new rules, the top executives will also be required to have more pay deferred. That's an idea that seems good to those who have never run a financial firm.

"It's not a great idea, but it's out there," says Alan Johnson, a compensation expert. "It has a native appeal, but for a big firm, it would be a nightmare to try to make that work."

"That type of legislation has always had unintended consequences — good politics and bad policy," a securities attorney told me. "Talent flows to the institutions with the least restrictions on meeting competitive pay levels." Indeed, once the federal government starts tinkering with executive pay, and once government officials start blaming much of our economic woes on highly compensated executives, apparently there is no stopping what may be the latest chapter in *Crisis and Leviathan*.

Certainly firms that were badly run should take their lumps. Still, the irony is that the same federal government that dithered gets no blame. Instead, it will get more power to determine what are correct pay levels for some key personnel. Does that make sense?

Doesn't almost everyone agree that myriad regulators were sleepwalking through the Bernard Madoff and the subprime scandals? In the former, the SEC was warned about Madoff's

fraud years ago, but the regulators did nothing. In the latter, a former central banker makes no apologies for his huge errors.

Alan Greenspan, in his book *The Age of Turbulence*, admits that he and others at the Federal Reserve skewed loan criteria. Their blunders allowed almost everyone to get a home with a subprime loan. And Greenspan actually makes no apologies for his gross mistakes. He writes, “I was aware that the loosening of the mortgage credit terms for subprime borrowers increased financial risk, and that subsidized home ownership initiatives distort market outcomes. But I believed then, as now, the benefits of broadened home ownership are worth the risk.”

And speaking of the central bank, almost everyone agrees that it, at the urging of Congress and the president, blundered by keeping interest rates artificially low. Today we are living through the mother of all recessions.

Now all of us, including those who didn't blunder, must pay for yesterday's mistakes and the mistakes to come as the federal government starts telling business what is the right pay. The next crisis is already on the horizon.

Gregory Bresiger is a business writer living in Kew Gardens, New York.

This article was originally published in July 2009.