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ABSTRACT

Existing legal and economic theory presumes a clear line between private firms and government regulating agencies. It generally assumes that corporations maximize profit in the factor markets and government regulators alleviate externalities in those markets. The circumstances of the financial crisis of 2008 have altered this existing dynamic. As a result of the bailout, the government now holds a controlling equity interest in many of the nation's largest financial and automotive companies. As a prime example, the government owns a 34% voting, and thereby effectively controlling, equity interest in Citigroup, the nation's largest bank.

This Article examines economic theory and evidence of government ownership in private firms and finds that government ownership and control correlates with overwhelming costs to firm efficiency as governments push the firms they control to subsidize influential interest groups. As the government does not want to lose its ability to subsidize these groups, the usual product markets and the market for corporate control that would otherwise maintain profitable enterprises are largely muted.

Part of the explanation for the government's interest in using its control over private firms to serve interest groups is the government's ability to do so off-budget. As such, this Article argues that laws

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governing the debt ceiling of the United States and the financial statements of the United States should be changed to take into account a realistic perspective of the government's obligations that accompany its ownership in private firms through the Troubled Asset Relief Program ("TARP") bailout. This perspective should consolidate the financial position of firms controlled by the U.S. government, including their debt, net revenue, and other financial operations, into the financial systems and laws which govern the approval process and disclosure of the U.S. government's finances. In doing so, this Article argues that the reforms proposed can partially internalize the costs of interest group pressure to abuse the government's ownership and can also facilitate the legislature's constitutional requirement to oversee appropriations and debt repayment of the United States. As a secondary thesis, this Article argues that consolidation of the controlled firms will also present a more accurate picture to users of government financial statements.

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I. INTRODUCTION

The essence of finance is the art of balancing equity and debt to fund the production of the goods and services that drive economic growth. This system presumes the existence of two distinct institutions. The first institution is a collection of firms owned by diversified residual equity holders that manage productive resources with a streamlined objective of maximizing shareholder wealth. The second institution is a government that subsidizes interest groups and regulates market dynamics. The government acts in part to maintain equitable outcomes and in part to respond to interest group political pressure.

This Article will examine how the 2008 bailout resulted in a dynamic that is dangerous to both the capitalist system of resource allocation, particularly its emphasis on residual equity holder monitoring, and the American system of government, in particular its emphasis on checks and balances in the budgeting, appropriations, and debt oversight process.

In 2008, the nation faced an unprecedented market correction that threatened limited systemic consequences to a number of large Wall Street firms. Washington reacted by instituting a bailout of those firms as well as the government-sponsored enterprises Fannie Mae and Freddie Mac, largely under the Troubled Asset Relief Program ("TARP"). Washington later extended the bailout to the automotive sector. The method chosen for the bailout was largely for the government to take equity investments in firms that received government funding and backing. The recipient of the lion's share of bailout support, American International Group ("AIG"), was also one of the largest insurance companies in the United States. AIG's bailout was directed by the Federal Reserve, a public institution backed by the Treasury Department but one step removed from the U.S. government. The second largest recipient was Citigroup, the largest bank in the United States. The Treasury Department uniquely took a common-voting equity interest of thirty-four percent in exchange for the funds it injected into Citigroup. Six hundred other banks took TARP funding and gave the government equity shares in return.

The dynamic embraced by the American system of firm economic resource allocation, buttressed by government regulation of that system, presumes a hard black line bifurcating the spheres of private economic activity and government oversight activity. The bailout of 2008–2009 eviscerates that hard black line and instead creates a system of perverse incentives to maximize shareholder wealth while at the same time subsidizing politically powerful interest groups, despite the fact that the two goals are frequently mutually exclusive.

When the government controls companies owned by others, it can use its regulatory leverage, along with its position as a lender of last resort, to encourage private firms to reorient their activities toward goals that serve politically influential interest groups. One would think that private sector resource allocation, including the market for capital and the market for corporate control, would police abuses by government shareholders in companies that maintain private sector ownership. Due to particular aspects of the government's role as shareholder, these constraints lose their force. This is because of the nature of the government's implicit backing of government-owned institutions as well as the disparity between the government's ability to maintain an information asymmetry in relation to its implicit obligations. It is also due to the fact the government actors will have an incentive to maintain their control over firms that permit off-balance sheet transfers.

The government lacks a credible mechanism to commit to not bailing out banks.[1] To the extent that the bailout will take the form of equity investment or will otherwise involve the sorts of strings that will indicate control, this Article will show some changes in the national debt ceiling statute and accounting rules for the government's ownership that may provide the necessary incentive to limit government interest in bailouts, and permit, if not a commitment not to bail out banks, at least a limitation on the prospect of government bailouts. These controls could be expected to limit the market distortions of bank policy as well as distortions on bank bond premiums premised on too-big-to-fail cushions.[2]

This Article argues that the paradox of government ownership, and the government's obligations flowing from that ownership, can at least be minimized in two unique ways. The two methods center around the central principle that, much like private sector companies that use minority equity investments to control other companies, and

1. GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARD OF BANK BAILOUTS 60–66 (2004).

2. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010).

much like the United Kingdom and New Zealand's approach to recognizing ownership of government-owned entities, the United States government should consolidate the financial operations of entities over which it has control and include them in its estimate of the national debt ceiling and the government's financial statements. This methodology would cause the government to partially internalize the cost of its holding an interest in inherently private sector entities. As a secondary thesis, this Article argues that the government can fulfill its disclosure obligations to users of federal government financial statements by consolidating its ownership, in particular by giving economists a more accurate picture of the crowding-out effects of government spending on fiscal growth by noting the government's control over what would otherwise be counted as private sector spending and debt.

This Article examines the laws and accounting methods for internalizing the cost of government ownership and presenting more accurate disclosure to users of financial statements. The first method examines whether the government should follow the lead of its common law brethren in the United Kingdom and New Zealand by consolidating its investment in bailout recipients onto the federal government's financial statements. This method is supported by an uncontroverted assessment of the government's own accounting principles as well as the use of private sector accounting principles that hold force in this unique circumstance where the government is acting like a private sector investor.

This Article does not argue that the U.S. government should include the operations of TARP recipients in the federal budget process. In part, this is because the federal budget process has failed to represent a binding constraint on government appropriations, as Congressional exceptions to limits like the pay-go rules seem to overwhelm the rules themselves.[3] It is also motivated by the fact that consolidating the earnings of government-controlled firms into the federal budget process could be used to actually manipulate the federal budget by manipulating the controlled company's earnings. As the author has explored in previous work, government controlled firms tend to obtain preferential regulatory treatment.[4] Thus it will

3. *See* Lori Montgomery, *House Votes to Revive Pay-As-You-Go Budget Rules*, WASH. POST, Feb. 5, 2010, at A02.

4. *See* J.W. Verret, *The Bailout Through a Public Choice Lens: Government-Controlled Companies as a Mechanism for Rent Transfer*, 40 SETON HALL L. REV. 1521 (2010).

be more likely that a government controlled firm could manipulate its earnings and still avoid investigation by the SEC.

Finally, and most importantly, the government should include the debt of bailout recipients in the statutory definition of the debt ceiling. The requirement that Congress periodically vote to extend the debt ceiling, if at all, helps to maintain the legislature's constitutional obligation to oversee the spending and debt management of the federal government. The debt ceiling statute affords members of Congress an opportunity to consider the long-term health of the nation's finances free from the short-term pressure of the annual budget process. The procedural rules of that vote also help to limit the log-rolling phenomenon that takes place in budget votes and is examined in the public choice literature. Furthermore, the periodic vote on the debt ceiling is subject to filibuster, to which the annual budget resolution is immune. In short, if the executive branch faced the prospect of a hard-fought negotiation over a vote to expand the debt ceiling statute (and it can be hard-fought even if the executive and legislative branches are run by the same party), and if, as this Article suggests, the debt ceiling statute included in its definition those debts held by firms in which the United States maintained controlling equity ownership, then the executive branch would have an incentive to privatize its ownership. This would greatly delay its need to negotiate with Congress over an extension of the debt ceiling statute.

There is no guarantee that the policy goals advocated in this Article will be implemented. Even if they are implemented, they may not fully minimize the costs of government ownership in private sector entities described in this Article. The changes advocated in this Article, however, represent the best short-term and politically feasible policy alternatives that stand to force the government to internalize the costs of its ownership in formerly private firms. That cost, incidentally, is tremendous. The government's current investment, at cost, is approximately $200 billion. That $200 billion is used to control trillions in equity by investors who do not have the incentives or resources to govern their investments in a majority of banking firms. Those trillions in wealth are housed in the banking sector, which itself is foundational to the roughly $40 trillion in publicly traded wealth in the United States.

II. GOVERNMENT CONTROL OF COMPANIES UNDER THE TARP BAILOUT

A. History of the TARP Bailout

In response to a dramatic credit freeze that placed the health of the financial industry under severe pressure in late 2008, the U.S. government initiated a $700 billion bailout of the financial industry that mainly consisted of the Treasury purchasing equity in troubled banks under the Troubled Asset Relief Program ("TARP"). In order to execute its mandate to ensure the health of the nation's banking system under the Emergency Economic Stabilization Act ("EESA"), the Treasury Department purchased controlling interests in hundreds of the nation's largest banks, General Motors ("GM"), and Chrysler, as well as the insurance conglomerate American International Group ("AIG") and GMAC, the financing arm of General Motors.[5] Under the Making Home Affordable Program, the Treasury offered to use nearly $50 billion in TARP funding, in conjunction with at least $200 billion from the Federal Reserve, to support Fannie Mae and Freddie Mac, both of which are now majority-owned by the federal government under conservatorship.[6]

The original plan for the TARP program was for the government to use the $700 billion authorized under the EESA to buy and sell troubled assets held on the balance sheet of banks.[7] That plan was quickly shelved, and the Treasury Department immediately began a number of different programs. As part of that bailout, the Treasury took preferred equity in TARP recipients and subsequently initiated a plan to convert those non-voting preferred shares into shares

5. Former Treasury Assistant Secretary Phillip Swagel provides a first-hand account of the implementation of TARP. *See* Phillip Swagel, *The Financial Crisis: An Inside View*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, Spring 2009, *at* 1–79, http://www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf; *see also*, Steven Rattner, *The Auto Bailout: How We Did It*, FORTUNE, Nov. 9, 2009, at 55, *available at* http://money.cnn.com/2009/10/21/autos/auto_bailout_rattner.fortune/index.htm?postversion=2009102104.

6. *See* OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM Q. REP., July 21, 2009, at 36, *available at* http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf [hereinafter SIG TARP REPORT JULY 2009].

7. *Id.* at 3.

convertible into voting common equity. The Treasury's initial experiment in holding common equity took place at Citigroup, in which it took a controlling thirty-four percent voting stake.[8]

The automotive industry also subsequently garnered TARP support when, in December 2008, the Treasury announced that it would use TARP funds to establish the Auto Industry Financing Program ("AIFP") to stabilize the automotive industry, where over $17 billion in loans were offered to GM and Chrysler on condition that they submit restructuring plans.[9] The Obama Administration rejected the initial proposals and instead created the Automotive Task Force to negotiate a new viability plan.[10]

The government's investment through TARP is fairly concentrated; for instance, as of September 2, 2009, the total outstanding federal government assistance committed to AIG stood at $120.7 billion, of which $69.8 billion represented TARP investment by the Treasury.[11] The Treasury's net investment in GM and Chrysler totaled $76.9 billion, and investments in Citigroup stood at $50 billion.[12] The total of nearly $200 billion invested under EESA authority in these four companies represents well more than half of the $381.4 billion net cumulative funds expended by the Treasury under TARP as of September 30, 2009. As such, this Article will focus particular attention on those four companies. This Article will also analyze Fannie Mae and Freddie Mac in conjunction with TARP recipients, even though technically their conservatorship preceded TARP.

8. *See* Robert Schmidt & Bradley Keoun, *Citigroup 34% Stake Sale Discussed at U.S. Treasury*, BLOOMBERG (Sept. 15, 2009, 4:15 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acs7LZGlwiYU.

9. Roger Runningen & John Hughes, *GM and Chrysler Will Get $13.4 Billion in U.S. Loans*, BLOOMBERG (Dec. 19, 2008, 5:21 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGHdHOHwvZWo; WHITE HOUSE, DETERMINATION OF VIABILITY SUMMARY: CHRYSLER, LLC (Mar. 30, 2009), *available at* http://www.whitehouse.gov/assets/documents/Chrysler_Viability_Assessment.pdf; *see also* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 545 (2009).

10. SIG TARP REPORT JULY 2009, *supra* note 6, at 35; *see also* Lubben, *supra* note 9.

11. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-975, TROUBLED ASSET RELIEF PROGRAM: STATUS OF GOVERNMENT ASSISTANCE TO AIG (Sept. 2009), *available at* http://www.gao.gov/new.items/d09975.pdf [hereinafter GAO STATUS REPORT].

12. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM Q. REP., at 43, 67, 90, *available at* http://www.sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf [hereinafter SIG TARP REPORT OCT. 2009].

B. The Government's Control Through TARP

A substantial line of authority supports the proposition that either just having the power to control a company or the actual exercise of control is sufficient to control a company. In *In re Walston & Co.*,[13] the SEC held that the power to control could be evidenced by a creditor's right to 90% of profits, status as the source of most of Walston's business, and the option to acquire stock.[14] This was despite the fact that the creditor did not participate in the actual management of the business and held no actual stock.[15] In effect, the power to control is sufficient to make one a controlling person, despite the fact that the power is never actually exercised. *SEC v. Franklin Atlas Corp.*[16] also supports the notion the percentage of stock ownership is not alone determinative.[17] In that case, a manager with the ability to control an enterprise was determined to be a control person, even though he actually owned no stock and the company had a controlling shareholder who owned a majority of the stock.[18]

This is analogous to the situation facing many TARP banks. The U.S. government is a substantial creditor of the companies in addition to owning positions in them,[19] and also holds the ability to substantially affect the bank's underlying business through its discretion in setting capital requirements and limiting bank operations. Under this view, the fact that Treasury or the Federal Reserve did not engage in active management of TARP banks, and the fact that Treasury's ownership in most TARP participants is non-voting, would therefore be irrelevant to this determination.

In the opening chapter of the auto bailout, the government's behavior also evidences Treasury's control of that industry through its investments. In its September 2009 report, the Congressional

13. 7 S.E.C. 937 (1940).

14. A.A. Sommer, Jr., *Who's "In Control"?—S.E.C.*, 21 BUS. LAW. 559, 564 (1966) (citing *Walston*, 7 S.E.C. at 937).

15. *Id.* at 564 (citing *Walston*, 7 S.E.C. at 937).

16. 154 F. Supp. 395, 400 (S.D.N.Y. 1957).

17. Sommer, *supra* note 14, at 565 (citing *Franklin Atlas*, 154 F. Supp. at 395).

18. *See id.* at 559.

19. Press Release, U.S. Treasury, U.S. Treasury Releases Terms of Capital Assistance Program (Feb. 25, 2009), http://www.treasury.gov/press-center/press-releases/Pages/tg40.aspx. *See also* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 294–301 (2010) [hereinafter Verret, *Treasury Inc.*].

Oversight Panel concluded that Treasury "used its own assumptions to conduct stress tests on these plans, looked at a variety of scenarios in order to formulate cash flow capability and the likely earnings capacity of the companies, challenged the companies to look forward, and created models of 'potential enterprise value.'"[20] The Automotive Task Force was an especially active participant in the proceedings, which saw replacement of the CEO and half of the board of directors, bankruptcy filings, debtor-in-possession financing, and wholesale financial and business restructuring.[21]

In AIG and GM, U.S. government voting rights constitute outright majorities (nearly 80 percent in AIG and 61 percent in GM), while in Citigroup and Chrysler, the combination of concentrated government shareholding and the broad scope of additional federal support[22] justifies the description of the U.S. government as a dominant shareholder.

In the case of AIG, a trusteeship model was formally implemented. The trustees nominated by the Federal Reserve to govern the trust have argued that the Federal Reserve's action minimized any control the government may have over AIG.[23] On January 16, 2009, the Federal Reserve Bank of New York ("FRBNY"), acting in consultation with the Treasury Department, entered into an agreement[24] with three private individuals named as

20. CONG. OVERSIGHT PANEL, OVERSIGHT REPORT: USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 104 (Sep. 9, 2009) (citing Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Senior Advisor at the U.S. Department of Treasury Ron Bloom, *The State of the Domestic Automobile Industry: Impact of Federal Assistance*, at 5–6 (June 10, 2009)).

21. *See generally* Verret, *Treasury Inc.*, *supra* note 19.

22. For example, federal support to Citigroup includes a potential federal liability of as much as $260 billion for guarantees of $300 billion of the bank's pool of asset-backed securities. According to the SIG TARP's Quarterly Report to Congress issued on October 21, 2009, SIG TARP REPORT OCT. 2009 *supra* note 12, at 69, the list of assets to be "ring-fenced" was not finalized, but was expected to be finalized by October 31, 2009. Initial plans called for Citigroup to absorb $39.5 billion in losses prior to government support; TARP assets would cover the next $5 billion in losses, *id*. at 42, with FDIC ($10 billion) and the Federal Reserve bank of New York responsible for any remaining requirements.

23. *Statement of the Trustees of the AIG Credit Facility Trust Before the Committee on Oversight and Government Reform*, 110th Cong. 1 (2009) (joint statement of Jill M. Considine, Chester B. Feldberg & Douglass L. Foshee), *available at* http://www.aigcreditfacilitytrust.com/aigweb/internet/en/files/Written%20Statement_tcm1121-242400.pdf.

24. AIG Credit Facility Trust Agreement (Jan. 16, 2009), http://www.newyorkfed.org/newsevents/AIGCFTAgreement.pdf.

Trustees and placed the authority to vote the government's shares in AIG in the hands of the Trustees.[25]

The Trust agreement gave the Trustees the "exclusive right to vote the Trust Stock, or give written consent, in person or by proxy, at all meetings of stockholders of the Company."[26] Section 2.04(f) of the trusteeship agreement further states that "[i]n no event shall the Trustees become directors of the Company or otherwise become responsible for directing or managing the day-to-day operations of the Company or any of its subsidiaries." The AIG Trust insulates the trustees from liability so long as they believe they acted lawfully and "in or not opposed to the best interests of the Treasury."[27]

Two substantial reports released by the GAO discuss the U.S. shareholding in AIG and in the auto companies.[28] Regarding federal government oversight of AIG, the GAO's report found, "While the government has not taken over management of AIG, it has taken a number of steps to create certain controls over AIG's management of the company."[29] The Federal Reserve and FRBNY have between twenty and twenty-five people assigned to monitor AIG, and FRBNY has hired professional advisors to assist in monitoring. Notably, FRBNY officials receive weekly detailed reports on cash forecasts, liquidity updates, and regulatory developments.[30] The GAO found that in June 2009 AIG trustees used their voting power to force changes in a majority of the company's directors, and that the new board subsequently hired a new chief executive officer in August 2009.[31] Instead of reflecting a hands-off approach to governance, however, the GAO found that Treasury and the FRBNY

25. The agreement provided no binding guidance to the Trustees on the objectives for which shareholding was to be exercised, prevented the Trustees from taking a seat on the Board of Directors of AIG, and indemnified the Trustees against any liability for decisions they might make regarding voting of AIG shares. *Id.* §§ 2.04(f), 3.03(d). However, the Agreement includes a fiduciary duty provision which requires the AIG Trustees to act in the best interests of the Treasury. *Id.* § 2.05(a).

26. *Id.* § 2.04(b).

27. *Id.* § 3.03(a).

28. *See* GAO STATUS REPORT, *supra* note 11; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-151, TROUBLED ASSET RELIEF PROGRAM: CONTINUED STEWARDSHIP NEEDED AS TREASURY DEVELOPS STRATEGIES FOR MONITORING AND DIVESTING FINANCIAL INTERESTS IN CHRYSLER AND GM (Nov. 2009), *available at* http://www.gao.gov/new.items/d10151.pdf.

29. GAO STATUS REPORT, *supra* note 11, at 37.

30. *Id.*

31. *Id.* at 38.

"continue to have their own relationship [with AIG management] and conduct their own monitoring of AIG operations."[32]

On June 1, 2009, after Chrysler's reorganization had been approved by a bankruptcy court, President Obama announced that the United States would be supporting a similar approach with General Motors and would be converting existing and new loans to both companies into common equity.[33] In a press briefing given the evening before the President's press conference, an administration official summarized the White House position on "Government as Shareholder."[34] The Treasury Department's statement on the GM restructuring says that it intends to manage its investment in GM in a "hands-off . . . commercial manner."[35] The Treasury also published a white paper regarding its ownership in GM in which it offered four key principles for how it would try to minimize political influence in GM's operations; yet there is no mechanism by which those principles can be enforced by a third party, nor are there any penalties for their violation.[36]

The government holds non-voting preferred stock in most of the TARP recipients, with the exception of Citigroup and the automotive companies. Notwithstanding the non-voting nature of the Treasury's investment in TARP firms, the government's ownership of TARP-preferred shares gives the government leverage over the business decisions of these firms.[37] For example, the TARP provisions allow the Treasury to nominate two "preferred directors" to the board in the event that a TARP firm misses six consecutive

32. *Id.*

33. President Barack Obama, *Remarks by the President on General Motors Restructuring* (Jun. 1, 2009), http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-General-Motors-Restructuring.

34. Senior Administration Officials, *Background Briefing on the General Motors Restructuring* (May 31, 2009), http://www.whitehouse.gov/the_press_office/Background-Briefing-on-GM-Restructuring-May-31-2009.

35. *Id.*

36. SIG TARP REPORT JULY 2009, *supra* note 6, at 111. Core principles in the Treasury's White Paper include to i) "seek to dispose of its ownership interest as soon as practicable;" ii) "reserve the right to set upfront conditions to protect taxpayers, promote financial stability, and encourage growth;" iii) "protect the taxpayers' investment by managing its ownership stake in a hands-off, commercial manner;" and iv) "vote on core governance issues, including the selection of a company's board of directors and major corporate events or transactions." *Id.*

37. J.W. Verret, *The U.S. Government as Control Shareholder of the Financial and Automotive Sector: Implications and Analysis* (George Mason Law & Econ. Research Paper No. 09-13, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1348256.

quarterly dividend payments.[38] "Treasury['s] preferred shares also retain[] the right to vote on any mergers or exchange activity and on new issuance of shares."[39] The government also mandated certain corporate governance changes for TARP firms. "Assuming that Treasury maintains the legal authority to waive those provisions, it could offer to do so in exchange for other changes in corporate policy."[40]

Much of this Article will consider the implications of the government's ownership in TARP recipients, Fannie Mae, Freddie Mac, and AIG together. Therefore, it will generally not be necessary to delineate between them for the broad theoretical and budget law considerations examined. As such, these entities generally will be referred to as "Bailed-Out Entities" or "BOEs." Where issues are driven by characteristics particular to an entity, as in the case of differential accounting by Federal rules between Fannie Mae and other bailed-out companies, the various BOEs will be examined separately.

III. ECONOMIC THEORY AND EVIDENCE OF GOVERNMENT-OWNED COMPANIES

The final objective of this Article is to determine the appropriate method of representing the government's economic ownership of BOEs in its financial reporting and the appropriate method for harnessing the existing structures that check the federal government's borrowing and spending authority to oversee the government's investment. But before we can do that, we will need to develop an appreciation for the economic nature and the attendant costs of government ownership. This Section will examine the existing theoretical and empirical evidence on government ownership to develop one of the foundational justifications for the thesis that limiting the depth and nature of government ownership in private firms is desirable. This Section will use economic theory, as well as evidence from government ownership from around the globe, to offer some predictions for how governments will make decisions as controlling shareholders.

38. *Id.*
39. *Id.*
40. *Id.*

Comparisons to the different forms of government ownership in Europe, Asia, and South America teach that government-owned banks are frequently used to advance political agendas to the detriment of a bank's financial health. Advancing a political agenda may actually be easier through controlling common equity stakes, an effective semi-nationalization, than through outright nationalization. A government agency using shareholder power over private companies has two unique freedoms: 1) the ability to bypass the administrative law process, the separation of powers, and the judicial review that constrain regulatory discretion, and instead simply require the board to initiate corporate policy changes favored by the Treasury;[41] and 2) the ability to bypass the federal budget process and instead require banks that are not included in the federal budget to themselves fund the transfers.[42] The combination of these exceptions to federal law undermines transparency constraints that work to minimize transfers to political interest groups and instead allows the government to require the bank to make those transfers in the form of increased lending and artificial interest rate caps that reside entirely off the federal budget.[43]

41. *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 468 (2009).

42. *See id.* at 489. The consequences of moving the debt of private banks onto the public budget can be severe. For instance, when the United Kingdom moved the liabilities of two bailed-out banks in which it owns a control stake (i.e., Royal Bank of Scotland Group and Lloyds Banking Group) onto the public balance sheet, it added $2.136 trillion to the public debt, more than doubling the U.K.'s public debt. Alistair McDonald & Laurence Norman, *Bank Bailouts, Sinking Revenue Fray U.K.'s Ledger*, WALL ST. J., Feb. 20, 2009, at A10.

43. Part of the relationship between Fannie and Freddie was a sort of interest group feedback loop that demonstrates this problem. Fannie and Freddie were permitted to lobby Congress with political donations. Peter Wallison, *How Paulson Would Save Fannie Mae*, WALL ST. J., Sept. 12, 2008, at A17. When the government was forced to take Fannie Mae and Freddie Mac into conservatorship, the government did not completely eliminate preferred and common stockholders, but limited its stake to 79.9%. Davidoff & Zaring, *supra* note 41, at 489. Davidoff and Zaring offer four reasons which may have informed the decision to leave some equity outstanding: 1) support of Treasury's position that it did not have to consolidate the Government-Sponsored Enterprises ("GSEs") onto the federal budget, 2) keeping the GSEs from having to adopt government accounting rules, 3) permitting the GSEs to deduct interest on their government loans from their taxes (which they would not be able to do if deemed government controlled), and 4) keeping the government from becoming liable for the GSEs retirement liabilities. *Id.* at 489. David Moffett, Freddie's most recent CEO, resigned after just six months, citing social mandates from the government that impeded his ability to turn around the company and make it profitable. James R. Hagerty & Joann S. Lublin, *Freddie Chief Quits after Six Months*, WALL ST. J., Mar. 3, 2009, at A4. Prior to the revelations of accounting irregularities at the two GSEs, its dedicated regulator performed the sort of inspections and audits typical of a financial regulator without uncovering any problems. Peter

In the context of government ownership of private sector entities, the nature of the government's accounting for its potential future liabilities is one concern driving the analysis in this Article. Other distinct concerns in this context are the distorting effects that government ownership has on the operations of the business in which it owns an interest. Still a third concern is that the prospect of government bailout also distorts market outcomes through moral hazard. As such, after examining the economic theory and evidence describing these effects, this Article will analyze how to use laws limiting the national debt and government accounting principles to achieve three goals: 1) present a more accurate picture of the government's obligations to users of government financial reports; 2) increase the cost to the government for bailing out private sector entities to restrict instances of bailout to only those situations actually implicating systemic risk concerns; and 3) encourage the government to divest of equity positions taken in bailed-out companies as soon as possible, rather than use its equity control to effectuate public policy outcomes.

A. Theory of Government Owned Firms

Government shareholders certainly are not the only shareholders that can alter the value of the firm by virtue of their presence as an owner. Evidence suggests that the relationship between ownership by managers and firm value is concave.[44] This is because other shareholders may be concerned that the larger shareholder will use their control over the firm to encourage corporate policy changes that work to the larger shareholder's advantage at the expense of the other shareholders in the firm. The relationship is not static, however, and changes as the relative tradeoff between extracting private value and losing their proportional value invested in the firm

J. Wallison, *Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers*, FIN. SERVICES OUTLOOK (Am. Enterprise Inst. for Pub. Pol'y Research), July 2006, at 3, a*vailable at* http://www.aei.org/outlook/24591 [hereinafter Wallison, *Moral Hazard*]. Everyone was, however, completely taken by surprise when, for instance, the board of Freddie Mac dismissed its top two officers for accounting irregularities. Peter J. Wallison, *The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs' Portfolios Became the Central Issue in Reform of Their Regulation* 14 (NFI, Working Paper No. 2006-PB-03, 2006), *available at* http://www.aei.org/paper/24056 [hereinafter Wallison, *The Evolution of a Policy Idea*].

44. Renè M. Stulz, *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25, 25–54 (1988).

changes for shareholders with larger percentage ownership.[45] A debate has ensued in the corporate governance and finance literature considering at what point the cost of large shareholders exceeds the benefits they offer by lowering agency costs in oversight of firm managers.[46] The unique incentives facing government ownership in the circumstances that are the subject of this Article introduce a new twist to this debate.

Outside of the United States, many Western countries have historically been characterized by significant government ownership of private companies.[47] The United States, however, largely abandoned government investment in private companies after a significant period in the 1840s of explicit use of mixed enterprises as instruments of public policy.[48] One of the reasons for the government's interest in taking a controlling investment in private companies is to utilize its investment to transfer funds to interest groups off of the federal budget. This permits the benefit of appeasing political supporters without the cost of raising taxes or taking on debt. In the dynamic analyzed in this Article, the government is taking an interest in companies in which investors either maintain or formerly held an equity interest, a structure that is fairly new in the United States.[49]

45. Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2741–71 (2002).

46. For the argument that the incentives to extract private value are the more powerful incentive for large shareholder, see Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997). For the other side of the debate, that the benefits of lowering agency costs will tend to exceed the costs of large shareholder private wealth extraction, see Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K Morck ed., 2000).

47. Stephen Brooks, *The Mixed Ownership Corporation as an Instrument of Public Policy*, 19 COMP. POL. 173, 173–74 (1987).

48. *Id.* at 176. Brooks examines some cases in which mixed enterprises were able to maintain autonomy from the government, such as the case of British Petroleum (BP) refusing to divert sales of oil to foreign customers to subsidize British oil consumption during the 1973 oil embargo. *Id.* at 178–79. It may, however, remain difficult to determine whether expressions of managerial autonomy are in fact reflective of a lack of distortionary control exercised by the government shareholder. In particular, such exercise of managerial authority may be merely the result of collusion, either explicit or implicit, between the government and the managers in ways that work to the detriment of other shareholders or to the value of the taxpayer's investment.

49. The same dynamic has been studied in the related area of off-budget public sector

Alcian and Demsetz argue that firm ownership of productive assets offers unique efficiencies as firms obtain superior information about the uses and productivity of internal firm assets, thus reducing the cost of searching out combinations of productive assets.[50] The government-owned firm limits this advantage, however, because the government will have an interest in using resources based not on their efficiency or effectiveness but on rewarding political support from resources or owners of resources either inside or outside the firm.[51] Theory developed to appreciate the implications of pure government ownership of productive assets can inform our understanding of mixed ownership. Peltzman examines the question of pure government ownership of firms when he asks, "If a privately owned firm is socialized, and nothing else changes, how will the ownership change alone affect the firm's behavior?"[52] Peltzman opens by noting that, although government owners will initially have an interest in maximizing firm profits because it will limit the tax burden on constituents, their interest in maintaining their incumbency means they will be willing to trade those profits to obtain support.[53] As such, government owners can be expected to

authorities designed explicitly for the purpose of off-budget public activities. These institutions were intended to evade public debt limitation laws passed to constrict runaway spending by legislatures and town councils. *See* C. Robert Morris, Jr., *Evading Debt Limitations with Public Building Authorities: The Costly Subversion of State Constitutions*, 68 YALE L.J. 234 (1958). As such, since their activities don't alter the debt calculations for their sponsoring municipal organizations, they operate off of the budgets of their sponsoring governments as well. They are pitched as self-financing organizations, but most end up requiring government subsidy and backing to operate, making their off-budget classification a frequently misleading fiction. *See generally* JAMES T. BENNETT & THOMAS J. DILORENZO, UNDERGROUND GOVERNMENT: THE OFF-BUDGET PUBLIC SECTOR 587 (1983). For the unique nature of the TARP companies, see Verret, *Treasury Inc.*, *supra* note 19, at 293.

50. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 793 (1972).

51. One of Alcian and Demsetz's explanations for why firms exist is to solve the problem of metering, or linking rewards to outputs, in team production where marginal products of team members is not easily observable. *Id*. at 778–83. The claimant with the right to residual earnings will have the best incentive to monitor team inputs and meter the marginal productivity of inputs to the team's output. *Id*. at 782. But this requires an ability to discipline individual team members and revise or terminate their contracts. *Id*. at 782–83. With the government as shareholder, this power to discipline is either reduced or potentially used for the wrong reasons. Managers are no longer disciplined for shirking, but for failing to maximize utility for the interest groups to which the government shareholder is beholden.

52. Sam Peltzman, *Pricing in Public and Private Enterprises: Electric Utilities in the United States*, 14 J.L. & ECON. 109, 110 (1971).

53. *Id*. at 112–14.

use the pricing system to confer benefits on voters and interest groups.[54] Peltzman notes that in order to yield a net political gain, government owners will likely be required to charge differential prices to benefit a majority of consumers.[55] This would correspond with the administration's emphasis on pressuring TARP recipients to renegotiate mortgages rather than alter rates across the board, since loan forgiveness is effectively targeted as a price rebate to lower income consumers. Peltzman also argues that the government owned firm will be able to subsidize specific groups with less cost to the government through differential pricing than through changes to tax and subsidy policy.[56]

Since the government will be less willing to sell out its position and lose the off-balance-sheet subsidy mechanism, the market for corporate control as a limiting boundary on manager shirking within the private firm, explored by Henry Manne, will also be muted.[57] One prerequisite to a shareholder's ability to act as an efficient monitor is his ability to sell his bundle of rights, including interest in residual claims and monitoring rights.[58] This helps to create a market that, if liquid, can help to reveal the expected present market value of the firm's future production. But there are a few constraints that limit a government's ability or interest in selling its investment, one of which is its inability to continue to use the entity for off-budget transfers if it has sold its investment.[59] That is not to say that the government will not agree to sell its investment in TARP firms, because it has already done so for Bank of America and others. It is worth noting, however, that the pressures that will limit that option for other firms, particularly those like AIG, in which the government has a large stake and the profitability of the firm, will remain in severe stress for the foreseeable future.

Another cost associated with government ownership of private firms that limits the ability to ever actually privatize the firm is that government ownership can represent a shift in institutional design in

54. *Id.*

55. *Id.* at 113.

56. *Id.* at 119–20.

57. For the origins of the theory of the market for corporate control as a disciplining mechanism, see generally Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

58. Alchian & Demsetz, *supra* note 50, at 783.

59. *See* Peltzman, *supra* note 52, at 119–20.

midstream. The firms are initially organized to maximize returns for residual claimants, but once they are bailed out and the government takes an equity interest in the firm, it can acquire a dual mandate: maximize profits and facilitate the public interest. The government can take steps to limit the ability of private investors to monitor how fulfilling that dual mandate imposes costs on the other residual claimant shareholders. For instance, the government can give government-owned firms preferential regulatory treatment in rules designed to require firms to provide informative disclosures to investors. The Treasury Department's position on Fannie Mae is an example of how the government emphasizes the national interest mission of a private business.[60] And yet some evidence suggests that only highly profitable companies can be effectively privatized. Thus, the more the government uses the firm for off-balance sheet subsidies, the less likely it will be to privatize the firm.[61]

Another criticism of government-owned firms is that the threat of bankruptcy or takeover, which would otherwise discipline management, is not present in government-run firms.[62] This criticism supplements the view that governments will reorient the company's objective from profit maximization to other goals like employment maximization.[63] When the government's interest is only a partial interest, many of these problems remain because governments tend

60. *Fannie and Freddie: The Last SIVs*, WALL ST. J., Feb. 23, 2010, at A18.

61. Pint's study of the British nationalization and subsequent privatization of coal and other industries suggests that governments are more concerned with the redistribution of interest group benefits than with economic efficiency in both of those processes. Ellen M. Pint, *Nationalization and Privatization: A Rational-Choice Perspective on Efficiency*, 10 J. PUB. POL'Y 267, 270 (1990). The National Coal Board that was created as part of Britain's nationalization of the coal industry was charged with "making supplies of coal available in such quantities and at such prices as may seem to them best calculated to further the public interest." *Id.* at 274. The British Treasury also tended to distribute any profits from the industries they oversaw to labor, rather than minimize the costs to government nationalization by returning those profits to the Treasury. *Id.* at 276. It was also found that once nationalization occurred, it became very difficult to re-privatize those firms unless they returned to profitability. *Id.* at 279. This occurs because the only alternative is for the government to shut down the firm and fire the workers, which governments are loathe to do, and because after the interest groups have had their way with the firm, the firm becomes worthless without the government guarantee behind it.

62. Alexander Muravyev, *Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences for Enterprise Performance* 17 (Bank of Fin. Inst. for Economies in Transition, Discussion Paper No. 12, 2002), *available at* http://ssrn.com/abstract=1015707.

63. *Id.* (citing Andrei Shleifer & Robert W. Vishny, *Politicians and Firms*, 109 Q.J. ECON. 995 (1994); Maxim Boycko, Andrei Shleifer & Robert W. Vishny, *A Theory of Privatisation*, 106 ECON. J. 309 (1996)).

to bail out firms in which they have an equity stake with greater frequency.[64] When other shareholders lose confidence in management, they sell their stock, but when governments lose confidence in management, they inject more capital into the firm. This means that the bankruptcy constraint is minimized. If the government maintains the ability to limit takeovers through voting in M&A situations, it will also exacerbate the managerial limitation.

B. Evidence Regarding Government-Owned Firms

A substantial amount of prior literature evidences the risks of the second form of government nationalization of banks. However, there is relatively little literature on government ownership of private and publicly traded firms in the United States; thus, most of this Section will require an international focus.[65] With respect to the banking industry in particular, a leading study finds that government ownership of banks is negatively correlated with financial development and economic growth.[66] One study uses comparisons across 36 countries to reveal that governments tend to lend more

64. *Id*. at 18.

65. One of the few existing systematic studies of government ownership in private firms in the United States is from Stacey Kole and J. Harold Mulherin. Stacey R. Kole & J. Harold Mulherin, *The Government as a Shareholder: A Case from the United States*, 40 J.L. & ECON. 1 (1997). They focus on a sample of 17 firms in which the government held a large stake just following World War II, largely as a result of the federal government seizing corporate assets of Japanese and German companies. *Id*. at 3–4. The comparison is limited, only 7 of the 17 had shares traded publicly at the time of seizure. *Id*. at 6. Further, the type of business will have some effect on the level of subsidization activity the firm will be encouraged to provide. Interest groups and voters will not be equally motivated to obtain subsidies from the same firms with the same level of interest. The five firms that Kole and Muhlerin target to determine effect of government ownership on growth are American Potash, American Bosch, General Aniline and Film, Rohm & Haas, and Schering. *Id*. at 9–10. One was an engine parts manufacturer, another was a commercial solvents manufacturer. The mean number of employees at these firms was 2,810. *See id*. at 10. By contrast, the mean number of employees of the top TARP recipients is much larger, thus creating a more powerful interest group feedback loop in TARP recipients than in the five firms focused on in the Kole and Mulhern inquiry. For example, AIG has 96,000 employees. *See* CNNMONEY.COM, http://money.cnn.com/magazines/fortune/global500/2010/snapshots/2469.html (last visited Feb. 2, 2011). The unique thing about both the banking and automotive industries is that they serve as a potential subsidy vehicle for nearly every household that buys a car or owns a home. By using a bank to encourage lowering interest rates, the government can directly transfer wealth to those households without needing to recognize the transfer on the government's books and without facing a challenge from the bank.

66. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Government Ownership of Banks*, 57 J. FIN. 265 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=309161.

generously, compared to private banks, during election years.[67] One empirical examination of state-owned banks in Italy found that, all else equal, state-owned banks charge an average of 44 basis points less than privately held banks for the same borrower.[68] This study also found that companies in certain political regions lent money at different rates, with regions in which the national political party held more power likely to experience lower interest rates from the state owned banks than other areas.[69]

Other studies directly compare the efficiency of government-owned firms to that of private firms. Boardman and Vining point to

67. I. Serdar Dinç, *Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets*, 77 J. FIN. ECON. 435 (2005).

68. Paola Sapienza, What do State-Owned Firms Maximize? Evidence from Italian Banks 3 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303381.

69. *Id*. Sapienza has also found that government run banks in Italy lend at rates approximately 20 to 50 basis points lower than private banks. *Id*. at 11–14. The case of India's bank nationalization is also instructive. *See* Shawn A. Cole, *Financial Development, Bank Ownership, and Growth. Or, Does Quantity Imply Quality?* 23 (Harvard Business Sch., Working Paper No. 09-002, 2007), *available at* http://ssrn.com/abstract=1158078. "In 1980, the government of India nationalized all private banks with a deposit base above Rs. 2 billion." *Id*. at 2. Those banks were subject to direct control of the federal government, with the entire board of directors nominated by the ruling party. *Id*. at 7. Between the nationalization of 1969 and 2000 "there were twenty-one private bank failures in India. Banarjee, Cole and Duflo [found] that the cost to the government of making whole depositors in [those] failed banks was less than the cost of recapitalizing public sector banks," after adjusting for scale. *Id*. at 8 (citing Abhijit V. Banerjee, Shawn Cole & Esther Duflo, *Banking Reform in India*, 1 INDIA POL'Y F. 273 (2005), *available at* http://www.brookings.edu/global/ipf/banerjee_cole_duflo.pdf). The identified goal of the Indian nationalization was to increase the scope of banking and lending in rural areas. *Id*. at 19. This rural focus was intended to benefit lower income groups, and by association the agriculture industry. *Id*. at 22. The effect of the Indian nationalization was that nationalized banks grew more slowly than private banks in the 1990s, and that they lent more to agricultural, rural areas, and to the government at the expense of lending to trade, transport, and the financial industry. *Id*. at 13. Cole found that towns with nationalized branches experienced an annual growth rate of 2–3% higher than rural towns without nationalized branches during 1980–1990, and the amount of credit in those towns increased by a factor of 1.5 to 2.5. *Id*. at 20. He also found, however, that the effect of increased credit on rural towns was not a sustained impact, as the annual growth rate in towns with nationalized banks was 2–4% lower from 1990–2000, essentially wiping out the prior decade's additional growth. *Id*. This suggests that the additional liquidity was merely invested in bad loans. Nationalization also resulted in a significant reallocation of lending to agriculture as well as lower interest rates. *Id*. at 21–24. Government ownership also reduced the quality of financial intermediation as evidenced by the fact that loans made by public sector banks were substantially more likely to default than loans issued by private sector banks, eventually resulting in a substantial drain on the public treasury when the national government eventually recapitalized them. *Id*. at 23. Further, Indian bank nationalization failed to even attain its modest goal of increased employment or increased investment in the agricultural sector over the long term, despite the high cost of nationalization. *Id*. at 24–27.

a large body of literature which studies the efficiency of government-owned firms as compared to private firms.[70] They construct a model that examines 500 state-owned, mixed-ownership, and private companies operating internationally in competitive environments, and find that on average state-owned enterprises have a return on equity that is 12 percent less than private companies.[71] They also note that the firms in their study were not nationalized as a result of poor performance, thus removing bailout as a reason for the lower value of government-owned firms.[72] They also note that performance of mixed-ownership companies tended to be worse than state-owned companies, leading to a suggestion that partial nationalization can actually be worse than full nationalization.[73]

Various studies on privatization of state-owned enterprises offer a useful comparison for the costs of government ownership, particularly as many of those studies indicate that privatization makes state owned firms run more efficiently.[74] Thus we can indirectly get a view for how government shareholders operate by considering how the value of the firm changes after the government closes its ownership position. A study of Russian privatization indicates that firms in which the government kept residual equity ownership received preferential treatment in the application of government regulations over firms that were not government owned, magnifying the distorting effects of government ownership.[75] This is similar to the exemption from the federal securities laws that Fannie Mae and Freddie Mac were able to obtain for so long, as well as Wallison's suspicion that they received preferential treatment in application of the antitrust laws.

70. Anthony E. Boardman & Aidan R. Vining, *Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State-Owned Enterprises*, 32 J.L. & ECON. 1, 4–5 (1989) (noting that much of the investigation is skewed by the fact that most of the industries are Western, in which most government owned firms are intensely regulated industries, particularly utilities, which limit their application to a study of government versus privately owned firms in more competitive environments).

71. Boardman & Vining, *supra* note 70, at 17.

72. *Id*. at 23.

73. *Id*. at 26.

74. William L. Megginson & Jeffrey M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321, 380 (2001).

75. Daniel Berkowitz & Yadviga Semikolenova, *Privatization with Government Control: Evidence from the Russian Oil Sector* 22 (William Davidson Inst., Working Paper No. 826, 2006), *available at* http://ssrn.com/abstract=920509.

Direct nationalization offers more concrete control for the government. Unions are the stakeholder most likely to seek influence in a government owned firm.[76] One of the reasons why nationalized, or even partially nationalized, firms are difficult to then re-privatize is that stakeholders obtain patronage networks from the firm through political influence; thus privatization requires a substantial political battle.[77] Study of nationalization and privatization is thus useful in considering the Treasury's equity holdings, but the best analogy for the semi-nationalization created by the Treasury's TARP holdings is the case of nationalized firms in which governments maintain significant and powerful residual holdings. Those residual holdings were particularly characterized by the power to block acquisitions, known as golden shares.[78] Those governments' residual holdings also

76. *See* Aaron Tornell, *Privatizing the Privatized* 5 (Nat'l Bureau of Econ. Research, Working Paper No. W7206, 1999), *available at* http://ssrn.com/abstract=202743.

77. *See id.* One of the political explanations for privatization in late twentieth century Britain was that the conservative government was interested in allocating underpriced equity to the middle class through privatization, which would then create a constituency that would support market oriented policies and thereby increase the Conservatives' chance of reelection. *See* Bernardo Bortolotti & Mara Faccio, *Government Control of Privatized Firms*, 22 REV. FIN. STUD. 2907, 2926 (2009). In effect, the privatization itself would give voters more of a stake in the profitability of the enterprise, thereby ensuring that they would support government policies supportive of the business management already allied with the conservative government. In the United States, this motive for privatization would not likely hold because equity holdings are already widely distributed among the middle class. And so, at the very least, pointing to Europe as justification for the fact that governments can be forced to induce privatization of firms they have run may be troublesome. The only other inducement to privatization we have seen is that governments can be induced to divest themselves of profitable firms if the public budget is in severe stress. *See id.* at 2928. This implies that only banks in which interest group rents do not capture all of the firm's profits could be later privatized by the Treasury. But even when they do privatize, that privatization may be only partial. Governments face pressure to maintain powerful residual ownership in the privatized firms. The Russian privatization experience also supports the idea that privatization is more likely when the government is suffering from severe budget deficits. *See* Muravyev, *supra* note 62, at 12. Russian firms with residual government ownership were also characterized by the presence of government officials in administrative and board positions. *Id.* at 14. Those representatives had little experience in the underlying business. *Id.*

78. *See generally* Larry Catá Backer, *The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law*, 82 TUL. L. REV. 1801, 1807 (2008); *see also* Bortolotti & Faccio, *supra* note 77, at 2908, 2918–19; Jullian Ellison & Duncan Reed, *Getting Tough on Golden Shares*, FIN. TIMES, June 6, 2003. During the privatization wave of the 1980s and 90s in Western Europe, governments sold off majority stakes in airlines, automotive and other manufacturers, banks, utilities, and a variety of other industries. Many of them kept shares that included provisions that permitted the holder to block any merger or acquisition of the newly privatized company. *See* Bortolotti & Faccio, *supra* note 77, at 2907–09. Though these shares represented minority positions in those firms, the ability to veto mergers gave state investors a powerful voice in the

gave them the ability to also influence major corporate policy decisions.[79]

It is also interesting to note that nearly two-thirds of privatized firms in Europe during the great privatization wave of the 1980s and 1990s, from a sample including firms privatized prior to 1996, were characterized by this form of powerful residual government control.[80] This indicates that once American banks have come under government control for the purposes of running them as enterprises, even if they can later be re-privatized, the Treasury may also be expected to maintain for the federal government residual interests whose control exceeds their proportionate interest. The consequences of residual golden shares can threaten the profitability of the partially privatized firm.[81] One study found that more fully privatized firms tended to be more profitable than those in which governments had powerful residual equity holdings, with market-to-book and return-on-equity ratios negatively correlated with a decreased level of privatization.[82]

One may argue that the market for equity and debt in mixed-ownership firms would limit the firm's freedom of action to accede to government mandates that reduce profit. However, two unique

company's decision-making. *Id.* Many argue that those governments used their rights in golden shares to block legitimate offers to acquire those companies out of an interest in maintaining inefficiently high levels of employment or reducing cross-border flows of capital and services. For instance, France and Germany have been the subject of extensive litigation before the European Commission over their golden shares in, for instance, Airbus and Volkswagen. These golden shares typically possessed powers, among which were "(1) the right to appoint members to corporate boards; (2) the right to consent to or veto the acquisition of relevant interests in the privatized companies; and (3) other rights . . . to consent to . . . ordinary management" changes. *Id.* at 2918. Those European governments with the right to appoint directors frequently appointed government officials to the board. *See id.* at 2919.

79. *See* Bortolotti and Faccio, *supra* note 77, at 2907–08.

80. *See id.* at 2909.

81. One might ask why constituents of the corporation would lobby for policies which may threaten the long term profitability, and by extension the long term viability, of the corporation from which they seek to extract rents. But even with its interest in general public welfare, rather than profit maximization, the opportunity costs of employees who were never employed in industry, that otherwise may have been under competitive pricing, or the opportunity costs of shareholder returns to private pensions that do not otherwise accrue as a result of the price controls, are not factored into the analysis. These hidden costs cannot make their way through the political process to exert pressure because actors who would otherwise lobby for these opportunities, like future stockholders or future consumers, do not know of their potential interest ahead of time. And so, as an interest group, they are unable to organize to protect their interest.

82. *See* Bortolotti & Faccio, *supra* note 77, at 23.

aspects of mixed-ownership firms distort that mechanism, and they are readily observable in the case of the government-sponsored enterprises Fannie Mae and Freddie Mac. As a particularly egregious example of how Fannie and Freddie's operational risks were ignored by private markets due to the government's backing, Fannie and Freddie were not permitted to file financial statements with the SEC starting in 2003 due to revelations of earnings manipulations and accounting fraud.[83] And yet, during the years that investors had no access to filed financial statements, the demand for Fannie and Freddie debt continued unabated.[84] Although, Fannie and Freddie were originally chartered by Congress as federal agencies, they were later privatized by a sale of equity in their operations to private shareholders in order to ensure that their purchases and sales of mortgages could be removed from the federal budget.[85] Nonetheless, members of Congress expected Fannie and Freddie to subsidize low-income borrowers.[86]

Merely increasing regulation of government owned businesses will not sufficiently limit the moral hazard problems attending the government's guarantee.[87] As Federal Reserve chairman Alan Greenspan observed at the time, increased regulation of an implicitly governmentally guaranteed enterprise only enhances the market's perception that the government is all the more willing to guarantee its debt.[88] Indeed, prior to the revelations of accounting irregularities at the two GSEs, its dedicated regulator performed the sort of inspections and audits typical of a financial regulator without uncovering any problems, particularly at Freddie Mac.[89]

In order to deal with these challenges, this Article will now examine a new solution suggesting the use of government financial statements and a method of determining the statutory debt ceiling to counter the government's incentives to use its investment in private

83. Wallison, *Moral Hazards*, *supra* note 43, at 2.

84. *See id.*

85. *Id.* at 2. *See also* Amity Shlaes, *Fannie Mae's Demise Rooted in the Swinging '60s*, BLOOMBERG.COM (Sept. 10, 2008, 12:01 AM) http://www.bloomberg.com/apps/news?pid=newsarchive&refer=columnist_shlaes&sid=ab3S57i4MOtw.

86. Wallison, *Moral Hazards*, *supra* note 43, at 3. *See also* Charles W. Calomiris & Peter J. Wallison, *Blame Fannie Mae and Congress for the Credit Mess*, WALL ST. J., Sept. 23, 2008, at A29.

87. Wallison, *Moral Hazards*, *supra* note 43, at 5.

88. *Id.* at 3.

89. *See* Wallison, *The Evolution of a Policy Idea*, *supra* note 43, at 14.

companies to facilitate off-balance sheet subsidies. This solution will seek to achieve three goals: 1) limit the government's incentive to bail out troubled firms, particularly by methods that involve taking a controlling equity position; 2) give the government an incentive to close out its position in bailed-out entities in which it ends up taking equity; and 3) present an accurate picture of the value of government's holdings and its obligations associated with those holdings, and how that value affects the government's overall financial picture.

IV. INTERNATIONAL BUDGETARY LAW AND ACCOUNTING APPROACHES TO GOVERNMENT CONTROLLED CORPORATIONS

There are two international cases that provide useful precedent in figuring out how to account for the U.S. government's investment in TARP recipients regarding the various financial legal and accounting mechanisms that govern and disclose government expenditures and financial borrowing. The United Kingdom bailed out its two largest banks, Royal Bank of Scotland ("RBS") and Lloyds, by way of equity injections in much the same manner used by the United States. Yet, the U.K. accounted for that bailout in a distinctly different manner from the United States. This Section will look into the reasons for the U.K.'s approach in comparison to the current U.S. method of bailout accounting. Additionally, New Zealand recently undertook a wholly new method to account for its government owned corporations, and this policy shift will also be examined. That such closely analogous common law and advanced economy analogues would account for their bailouts so differently from the United States calls the current U.S. approach into question.

The U.K. took a 100% interest in Northern Rock, an approximately 84% interest in RBS, and an approximately 43% equity interest in Lloyds Banking Group.[90] To purchase the RBS shares, Her Majesty's (HM) Treasury reports having paid 46 billion pounds.[91] It paid 23 billion pounds for its shares in Lloyds and 20 billion pounds for its ownership of Northern Rock by way of a

90. See NATIONAL AUDIT OFFICE, REPORT BY THE COMPTROLLER AND AUDITOR GENERAL: MAINTAINING FINANCIAL STABILITY ACROSS THE UNITED KINGDOM'S BANKING SYSTEM, 2009–10, H.C. 91, at 37 (U.K.), *available at* http://www.nao.org.uk/idoc.ashx?docId=99ee9a41-99a2-4cbb-b7b1-df61f035e427&version=-1.

91. *Id.* at 38.

combination capital injection and loan.[92] In November 2009, the Treasury announced that future capital injections of up to 39 billion pounds were anticipated for Lloyds and RBS.[93]

Much like the U.S. approach, the U.K. bank recapitalization took the form of capital injections in exchange for preferred stock.[94] Akin to the approach the Federal Reserve took in managing its investment in AIG, the U.K. set up the U.K. Financial Investments Ltd. ("UK FIL"), a quasi-independent company set up to manage the government's equity in bailed-out banks.[95] Unlike the United States, however, the U.K. Office of National Statistics ("ONS") determined that the UK FIL should be classified as part of the U.K. government.[96] The ONS noted that the public financial sector corporations on the U.K. balance sheet would now include RBS, Lloyds, Northern Rock, and Bradford and Bingley.[97] It estimated that the effect on public sector net debt would be an increase of 1.5 trillion pounds.[98] This was roughly equivalent to 100% of the U.K.'s GDP.[99]

In its decision to classify these four companies as public sector concerns, the ONS relied on the European System of Accounts 1995 ("ESA95"), part of the body of rules that governs European public sector accounting.[100] That standard requires the U.K. to consolidate onto the national debt the debt of companies over which it exercises

92. *Id.*

93. *Id.* at 5.

94. *See* MARTIN KELLAWAY, OFFICE FOR NAT'L STATISTICS, PUBLIC SECTOR INTERVENTIONS IN THE FINANCIAL CRISIS 61 (U.K.) (2009), *available at* http://www.statistics.gov.uk/articles/nojournal/Financial-crisis.pdf [hereinafter PUBLIC SECTOR INTERVENTIONS].

95. *Id.* at 62–63.

96. *Id.* at 63. The ONS is charged with producing the U.K.'s National Accounts Estimate, an internationally accepted accounting framework, and the U.K. government as well as the European Union base their fiscal policy frameworks on the National Accounts. *See id.* at 4. These estimates are used in the Maastricht Treaty measures to determine Stability and Growth Pact compliance for eurozone members, and also used to measure Gross National Income to determine an EU members required contribution to the EU budget. *Id.* The U.K. government also bases its fiscal policy objectives on the National Accounts Estimates promulgated by the ONS. *Id.*

97. *Id.* at 1.

98. *Id.*

99. The U.K.'s GDP in 2010 was 1.47 trillion. *See UK Gross Domestic Product GDP History*, UK PUB. SPENDING, http://www.ukpublicspending.co.uk/uk_gdp_history (last visited Mar. 26, 2011).

100. *See* PUBLIC SECTOR INTERVENTIONS, *supra* note 94, at 5.

effective control.[101] Listed as factors that supported the ONS determination that Northern Rock should be classified as a public sector institution as of October 2007 (prior to its full nationalization in February 2008) were that, according to its agreement with the Bank of England ("BOE"), it had to obtain permission from the BOE "before entering into any corporate restructuring, making substantial changes to the general nature of the business, making dividend payments, and acquiring or disposing of certain types of assets."[102] The ONS noted that, as of 2008, the government's ownership and right to appoint directors made the classification question even clearer.[103]

The ONS determined that RBS and Lloyds, and their subsidiary companies, should be classified as public sector entities starting October 2008 based on its judgment that "government has the ability to control the respective banks' general corporate policy through the conditions associated with the agreements signed relating to recapitalization."[104] Those agreements included provisions

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101. ESA95 notes that control is the basis for consolidating private companies into the public sector, defining control as:

> [T]he ability to determine general corporate policy by choosing appropriate directors, if necessary.
>
> A single institutional unit . . . secures control over a corporation by owning more than half the voting shares or otherwise controlling more than half the shareholders' voting power. In addition, government secures control over a corporation as a result of special legislation decree or regulation which empowers the government to determine corporate policy or to appoint the directors.

Id. at 6 (quoting Council Regulation, 1996, O.J. 2223/96 (L 310) ¶ 2.26). The ONS also mentioned that:

> ONS National Accounts classification case law uses an assessment of a number of control indicators to form a judgment on whether there is control. This is a similar approach to business accounting, which recognizes that companies can be controlled other than through the majority ownership of voting share capital.

Id. at 7. Accordingly, the ONS states its method for determining whether to consolidate partially government-owned companies into the public sector balance sheet as follows:

> The ONS approach to classification cases involving the public sector is to first consider whether government, or any other part of the public sector, can exercise control or influence over an entity's directors through the appointments process. It then examines the situation to see whether there are any special factors or contractual arrangements that enabled any part of the public sector to determine general corporate policy, either individually or collectively.

Id.

102. *Id.* at 15.

103. *Id.* at 16.

104. News Release, Office for National Statistics, Classification of Royal Bank of Scotland Group plc and Lloyds Banking Group plc (February 19, 2009), *available at*

with restrictions on the declaration and payment of dividends or distributions, director pay, and obligations relating to lending.[105] Even when Lloyds redeemed its preference shares from the government in June 2009 and its dividend restrictions were lifted, the ONS still maintained its classification as a public sector entity for these purposes because the other restrictions remained in effect.[106]

The factors on which the ONS relied in requiring consolidation of private bank debt into the U.K.'s debt largely mirror the restrictions included in the preferred shares and capital injection agreements of TARP recipients in the United States. The ONS did note, however, that it would not consolidate the operations of RBS and Lloyds into the public sector current budget.[107] This Article will argue that the United States should follow the U.K.'s lead in consolidating debt of bailed-out companies into the national debt.

In July of 1989, the New Zealand Parliament passed the Public Finance Act requiring Royal Departments to consolidate state-owned enterprises into the government's financial reporting and budget process.[108] The policy debate in implementing that mandate provides informative precedent for dealing with the post-bailout holdings of the Treasury and Federal Reserve, as well as the Government Sponsored Enterprises (GSEs) under federal conservatorship.

In deciding how to account for its investments in government-owned enterprises, one of the concerns raised in New Zealand was that consolidation would raise skepticism from the private sector because of the government's assertion that it would not guarantee private firm debt, which would itself perhaps increase interest rates of sovereign debt.[109] If this is true, then attendant private sector skepticism is a policy goal favored by the analysis in this Article. Governments tend to give added backing to bailed-out entities, and consolidation would offer yet another incentive to the government to avoid bailing out an entity in the first place.

http://www.statistics.gov.uk/pdfdir/crbslbg0209.pdf.

105. *Id*.

106. *See* PUBLIC SECTOR INTERVENTIONS, *supra* note 94, at 78–79.

107. *See id*. at 72.

108. *See* Sonja Pont Newby, Consolidation Accounting: A History of the Development of Financial Reporting Standard FRS-37 and Sector-Neutral Consolidation Accounting for Crown Financial Reporting by the New Zealand Government 108 (2006) (unpublished Ph.D. thesis, University of Canterbury), *available at* http://ir.canterbury.ac.nz/bitstream/10092/868/1/thesis.fulltext.pdf.

109. *Id*. at 167.

Another argument raised against consolidation in the New Zealand case was that it may give the government further control over the accounting policies of government companies because the Treasury could use the argument of the necessity of consistency in reporting to mandate that the company adopt certain accounting policies, thus furthering government control over the company.[110] In order to address this concern in the U.S. case, any implementing legislation would need to affirm that GAAP rulemaking would remain independent of the Treasury Department.

Still another argument raised against full consolidation was that the policies put into place by the government to limit its ability to direct management of state-owned enterprises advocated separating the two in financial reporting.[111] Otherwise, consolidating the two may provide an inappropriate means of monitoring the relationship between the government as an investor and the business running under some measure of independence. These advocates instead argued for using the equity method to account for the government's ownership.[112] This was in effect an accuracy of disclosure argument, and no doubt a similar argument will be raised in the United States concerning the policies articulated in the Treasury Department's white paper on voting equity in TARP recipients.

In determining whether the existence of a trust eliminated a finding of control, the applicable Australian Accounting Standard used as precedent by New Zealand found that where a trust is guided by a fiduciary duty to the trust beneficiary, the beneficiary is likely in control of the assets held by the trust.[113] If the United States followed a similar approach, it would consolidate its investment in AIG despite the existence of the AIG Trust because the trust explicitly defines the Treasury Department as the beneficiary.

Once New Zealand passed its law requiring consolidation, the final question its Treasury had to consider in deciding how to account for its substantial Crown (government) investments in standalone companies was whether to utilize the equity method or full consolidation.[114] New Zealand decided to abandon use of the

110. *See id.* at 139.

111. *Id.* at 116.

112. *See id.* at 117–18.

113. *See id.* at 177.

114. *See id.* at 85. *See infra* Part VI for a summary of the differences between the equity and full consolidation methods of accounting for ownership in subsidiaries.

equity method in favor of full consolidation for its government owned enterprises.[115]

These two countries demonstrate the unique nature of the U.S. government's approach to accounting for its holdings in government-owned companies. The debt calculation and accounting systems governing the United States are unique, due in part to its three-branch governmental system. Yet the U.S. government's decision not to consolidate its holdings in any way is without precedent. And the separation of powers and three-branch system written into the U.S. Constitution actually provide an even more forceful argument for consolidation than the U.K. and New Zealand systems, as the next Section will demonstrate.

V. STATUTORY AUTHORIZATION FOR THE NATIONAL DEBT CEILING

The Constitution encourages separation of powers in the borrowing and repayment of money. Article I specifically grants to Congress the power "to pay the debts . . . of the United States"[116] and "to borrow money on the credit of the United States."[117] In order to facilitate its legislative function of overseeing the debt, Congress passed the Debt Limit Statute, also known as the debt ceiling.[118] The Debt Limit Statute is Congress's way of fulfilling these two required Constitutional functions of overseeing the borrowing and repayment of the public debt.[119] If government deficit spending requires borrowing above a specified debt limit, called the debt ceiling, "Congress must enact a law to raise the ceiling."[120] At present, the government's debt ceiling statute states that "[t]he face amount of obligations issued under this chapter and the face amount of obligations whose principal and interest are guaranteed by the United States Government . . . may not be more

115. Newby, *supra* note 108, at 204.

116. U.S. CONST. art. I, § 8, cl. 1.

117. U.S. CONST. art. I, § 8, cl. 2.

118. Second Liberty Bond Act of 1917, Pub. L. No. 65-43, 40 Stat. 288 (codified as amended at 31 U.S.C. § 3101 (2000)).

119. Anita S. Krishnakumar, *In Defense of the Debt Limit Statute*, 42 HARV. J. ON LEGIS. 135, 136–37 (2005) (citing U.S. CONST. art. I, § 8).

120. COMM. ON THE BUDGET, 105TH CONG., THE CONGRESSIONAL BUDGET PROCESS: AN EXPLANATION 4 (Comm. Print 1998), *available at* http://budget.senate.gov/republican/major_documents/budgetprocess.pdf [hereinafter COMMITTEE REPORT].

than $14,294,000,000,000, outstanding at one time, subject to changes periodically made in that amount as provided by law through the congressional budget process."[121] The intent behind the Debt Limit Statute was to grant the Secretary of the Treasury the authority to issue debt periodically, up to a specified limit, and require that the Administration return to Congress periodically to obtain authorization for additional borrowing.[122] Although the list of items included in the referenced chapter does not currently enumerate debt issued by companies controlled by the U.S. government, this Article will argue that it should include the debt held by such companies.

If the executive branch is allowed to use its controlling stake in private companies to borrow money for the purposes of subsidies and policy outcomes which the executive may otherwise need to seek Congressional approval to achieve, then Congress's ability to oversee borrowing and debt repayment is diminished. If, as is the case with many of the TARP recipients and Fannie and Freddie, those private companies continue to borrow with the implicit backing of the United States, then separation of powers with respect to borrowing and paying debts is entirely sidestepped. One phenomenon which indicates the implicit backing of banks is the low discounts of private bank debt in relation to the decreases in their stock price.[123]

One approach to consolidation would be to net the assets of TARP firms against their debt, and report the balance. This was not the approach taken by the U.K.[124] One policy reason not to net the debt against the assets of TARP recipients when consolidating them into the debt ceiling estimate is that it could leave the government with an incentive to keep some firms under government control, in the event that assets exceeded debt at those firms. The Debt Limit Statute itself does not include a method for consolidating the debt of the United States against its assets, but instead directly limits the gross outstanding debt of the United States without any mention of assets in the statute.[125] The fact that very little attention is paid to assets held by the United States in the Debt Limit Statute is, from a constitutional perspective, consistent with evidence from the

121. 31 U.S.C.A. § 3101 (West 2010).

122. Krishnakumar, *supra* note 119, at 136.

123. *See* Bebchuk & Spamann, *supra* note 2, at 258.

124. *See* PUBLIC SECTOR INTERVENTIONS, *supra* note 94, at 1.

125. 31 U.S.C.A. § 3101 (West 2010).

Federalist papers demonstrating the Founders' fixation with paying off, and minimizing, debt held by the government. Federalist No. 7, written by Alexander Hamilton, the first Treasury Secretary of the United States, reveals an important concern underlying the debt clauses of the Constitution.[126]

One of the very real consequences of the Debt Limit Statute, and its requirement that the Treasury obtain periodic approval for increases in the debt limit, has been that negotiations over legislation to increase the debt limit have led to compromises that have spawned significant balanced-budget and budgetary reform legislation aimed at reducing the size and growth of the national debt.[127] During the 1960s, Congress used votes on increases in the debt ceiling to push for budgetary reform from the executive branch.[128] Members of Congress felt the sting of the debt ceiling votes quite acutely, and were subject to harsh criticism during re-election.[129] Debt ceiling increases were frequently voted down as a result of this pressure.[130] Pressure was felt so acutely that, for a short period, the House passed the Gephart Rule, which automatically

126. It states:

> The public debt of the Union would be a further cause of collision between the separate States or confederacies. The apportionment, in the first instance, and the progressive extinguishment afterward, would be alike productive of ill-humor and animosity. How would it be possible to agree upon a rule of apportionment satisfactory to all? There is scarcely any that can be proposed which is entirely free from real objections. These, as usual, would be exaggerated by the adverse interest of the parties. There are even dissimilar views among the States as to the general principle of discharging the public debt.

THE FEDERALIST NO. 7 (Alexander Hamilton) "The citizens of the States interested would clamour; foreign powers would urge for the satisfaction of their just demands, and the peace of the States would be hazarded to the double contingency of external invasion and internal contention." *Id*. And later, it urges that the new Constitution, "must embrace a provision . . . for the payment of the national debts contracted, or that may be contracted; and, in general, for all those matters which will call for disbursements out of the national treasury." THE FEDERALIST NO. 30 (Alexander Hamilton). At the Convention, delegate Sherman urged that "[t]he national debt & the want of power somewhere to draw forth the National resources, are the great matters that press." JAMES MADISON, NOTES OF DEBATES IN THE FEDERAL CONVENTION OF 1787, at 160 (1966).

127. *See* Krishnakumar, *supra* note 119, at 138. ("[A]lthough [the Debt Limit Statute's] existence has not stopped the trend towards increased borrowing, it has slowed that trend by acting as a catalyst for budget-reform and budget-balance measures aimed at reducing national borrowing.").

128. *Id*. at 152.

129. *Id*. at 153.

130. *Id*. (citing H.R. 12641, 95th Cong. (1978) (vote to raise debt ceiling to $849 billion which was voted down 167-228)).

enrolled a bill for submission, without a separate vote by the House, to the Senate extending the debt ceiling whenever a series of budget resolutions resulted in a projected increase in the debt sufficient to violate the existing debt ceiling.[131] In 1985, a coalition of Democrats and Republicans strategically used the required vote on whether to raise the debt ceiling to pass the Gramm-Rudman-Hollings Deficit Reduction Act, which was a legislative mechanism to cap budget deficit ceilings for the following five years and thereby reduce deficit spending.[132] In particular, during the period from 1995 to 2002 the Gephart Rule was waived every year as Congress has embraced votes on the debt ceiling as an opportunity to push for deficit reduction and balanced budget legislation.[133] The proposed Balanced Budget Constitutional Amendment from the 1990s would have also used the national debt ceiling to maintain a new constitutional limit on spending.[134] One such iteration would have required a three-fifths vote of each house of Congress to approve an increase in the debt ceiling.[135] One of the results of consolidation, depending on the accounting method chosen, could be to have a balance sheet eliminating inter-entity balances for the duration of the consolidation.[136] For instance, amounts owed by Citi to the federal government and Treasury bonds held by Citi would be eliminated from the government's budget, financial statements, and debt ceiling estimate.

Krishnakumar presents both an interest group theory and decision theory in support of the debt ceiling statute that are even more applicable in the case of controlled bank debt than in the more general case she analyzed.[137] Krishnakumar builds her analysis on work by Posner, Arrow, and others which argue that decisions which we might consider to be built on majoritarian ideas are in fact a product of interest group coalitions that lead to outcomes which a majority of the electorate would otherwise vote against if given the

131. *Id*. at 153.

132. *Id*. at 154–55.

133. *Id*. at 156 & n.135.

134. *Id*. at 156.

135. H.R.J. Res. 1, 104th Cong. (1995).

136. *Cf.* Newby, *supra* note 108, at 120 (quoting a joint paper prepared by the OAG, the British State Services Commission, and the British Treasury suggesting that this was one possible accounting method for Crown and sub-entity balance sheets).

137. *See* Krishnakumar, *supra* note 119, at 160–62.

opportunity to vote on each individual item.[138] Average citizens thus have their interests diffused, such that they suffer from collective action constraints in their ability to form coalitions to lobby for or against legislation. This is contrasted to tightly formed minority interest groups for whom an investment in lobbying is a wise investment.[139] Krishnakumar in part relies on Arrow's theorem that "decisions made by majority vote in Congress are not truly majoritarian" because they are more a function of the rules governing presentation, debate, and the voting structure of policy choices.[140] Krishnakumar also notes that party control of the budget process can lead to logrolling in budget decisions,[141] which in turn can influence decisions about subsidies to individual interest groups which may override a focus on the overall size of the budget deficit and the national debt. Krishnakumar also argues that a shift in the House from committee chairmanships based on seniority to those based on majority election every session by the majority caucus has limited the selection of safe-district, senior members who had room to focus on the national interest rather than maintaining their chairmanships and their seats.[142]

The debt ceiling's requirement that Congress hold a recorded vote to periodically increase it helps restore the accountability mechanism that is diminished by the interest group dominance of the ordinary budget and appropriations process. One of the most important reasons why the interest groups who should be most concerned about the size of the national debt are not able to influence the budget process is because they do not yet exist. Most of the generations of taxpayers who will eventually pay off the national debt through taxes are not yet born or old enough to vote. Even the generation of younger voters who could potentially have an interest in the future deficit would be overpowered by the more cogently formed interest groups with a stronger interest in government subsidies.

138. *See id.* at 160–62 & nn.158–162.

139. *See* Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265–66 (1982).

140. Krishnakumar, *supra* note 119, at 161 (citing Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 903 (1987)).

141. *Id.* at 161 & n.162 (citing Neal E. Devins, *Budget Reform and the Balance of Powers*, 31 WM. & MARY L. REV. 993, 994, 997 (1990)).

142. *Id.* at 162.

Evidence suggests that "yes" votes on increasing the debt ceiling were used against incumbents in election campaigns in the 1970s and that, predictably, members of Congress were reluctant to vote in favor of the debt ceiling; indeed, that concern was the purpose behind the Gephart Rule, which was passed to provide political cover on debt limit votes.[143] The Gephart Rule was frequently waived after this period as a result of influence by members of Congress who themselves were interested in using the disciplinary power of the debt ceiling vote to keep spending down.[144]

Krishnakumar observes that the debt ceiling vote actually functions as an anti-logrolling vote.[145] Individual interest groups are less galvanized to lobby for an increase in the debt ceiling because the link between their interest and the increased spending is difficult to distinguish among the thousands of spending compromises that eventually constitute the budget process and in any event, the link is usually temporally distant.[146] Thus, even if failure to pass an increase in the debt ceiling will result in a required reduction in expenditures, interest groups will be unable to determine at the time of that vote whether that will equate to a reduction in their particular project.[147] That uncertainty limits their incentive to lobby the vote. Indeed, Krishnakumar notes that interest groups may have reason to fear supporting an overall increase in the debt limit, as it may brand them negatively.[148] Where they could link their spending increase to supporting their cause, interest group support of runaway debt could limit their own ability to recruit new members or maintain links with congressional members that may support special interest funding projects as an exception to their overall interest voting against increases in the debt ceiling.[149]

One of the reasons why a vote on the debt ceiling may be a more useful accountability mechanism than the accumulated voting record of a member could relate to work on voter ignorance. Voters have been shown to have little understanding of complex policy decisions, and in particular have rational incentives to remain ignorant because

143. *See id.* at 153–56, 179–80.
144. *See id.* at 156 & n.135.
145. *See id.* at 178–179.
146. *See id.* at 166–67.
147. *See id.*
148. *Id.* at 166.
149. *See id.* at 161–68.

of the cost of learning.[150] But a decision to raise the debt ceiling is a simple one, and one that overarches the accumulation of spending policy decisions that make up the budget process.

Krishnakumar also argues that the debt ceiling vote permits legislators more time to deliberate over the long-term consequences of government debt than the rushed budget process affords.[151] This notion would be even more important in the context of bailed-out companies. When legislators initially considered the TARP bailout, they were faced with an impending market panic, and indeed many have asserted that their second vote in favor of the bailout was influenced by a substantial decline in the Dow Jones Industrial Average just after their initial vote against it.[152] One could expect future bailouts to be structured similarly to this one, since there will always be pressure to take equity in bailed-out companies, with the argument that the taxpayer should be allowed to participate in any future upside to the bailed-out firm. But after the bailout is executed—and if future bailouts are structured similarly to the last one, where the decision of when to divest of equity was left to the executive branch—the legislative branch will similarly be unable to reconsider the bailout or force the government to sell off companies that make for useful subsidy devices. But if, as a consequence of the bailout, Congress is required to hold a vote on the debt ceiling earlier than it would otherwise, then Congress gains both the incentive and the opportunity to push the executive branch to divest its interest in the bailed-out firm. Further, at that time, Congress would have an opportunity to deliberate over the wisdom of continued government ownership without needing to do so in the midst of a market crisis.

One important aspect of the debt ceiling vote is that it is not typically used as a vehicle for other legislation, but rather is passed in clean form.[153] For example, from 1978–2002, there were relatively few debt ceiling votes that included one or more substantial amendments, and almost all of these rider amendments were directly related to the national debt, such as balanced budget provisions and

150. *See* Ilya Somin, *Voter Ignorance and the Democratic Ideal*, 12 CRITICAL REV. 413 (1998).

151. Krishnakumar, *supra* note 119, at 167.

152. Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J. , Oct. 4, 2008, at A1.

153. Krishnakumar, *supra* note 119, at 172.

the Gramm-Rudman-Hollings Act; only four of the forty-two debt-limit increase bills had non-debt-related riders attached.[154]

Critics of the debt ceiling argue that it risks perilous consequences if the President and Congress are not able to come to a consensus on the debt ceiling and thus force the United States into default on its debt obligations.[155] Abramowicz argues that the Debt Limit Statute is dangerous because it creates the threat that Congress will default on its debts, it thereby gives Congress excess leverage in negotiations with the President.[156] It is precisely this threat of serious consequences that is required to limit the executive branch's temptation to use its interest in TARP recipients for political ends. It can ultimately give Congress both the incentive and the leverage to push the Administration to cut spending. Krishnakumar points out, however, that, in the eighty-six year history of the debt ceiling preceding the writing of her article, the United States has never defaulted on its debt.[157] But even if that criticism of the debt ceiling were to hold in the general case, it would be muted in the context of this paper's argument, as the President would have an easy alternative to obtaining congressional approval. He could instead sell off the private companies controlled by the government, and thereby reduce the national debt and put off the need to increase the debt ceiling until the other public debt rose up to that level.

As the national debt nears the debt ceiling, Treasury Secretaries find themselves in the unenviable position of scurrying to move funds around in order to temporarily maintain the government's finances. One method readily available to the Treasury Secretary is to manipulate its pension funds for government retirees.[158] This, however, buys the administration only a small window of time. If, however, the Treasury Secretary had the option of divesting federal holdings in government controlled private businesses, it would open a much larger window for Treasury to delay the required vote on the debt ceiling.[159]

154. *Id.* at 172–73.

155. *Id.* at 175.

156. *See* Michael Abramowicz, *Beyond Balanced Budgets, Fourteenth Amendment Style*, 33 TULSA L.J. 561, 579 (1997).

157. Krishnakumar, *supra* note 119, at 175.

158. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-526, DEBT CEILING: ANALYSIS OF ACTIONS TAKEN DURING THE 2003 DEBT ISSUANCE SUSPENSION PERIOD *passim* (2004), *available at* http://www.gao.gov/new.items/d04526.pdf.

159. *Id.*

In addition, the debt ceiling statute serves as a backstop to the budget process.. Krishnakumar argues that the 1974 Budget Act, which allocated budgetary authority from a group of appropriations subcommittee chairmen to a new central Congressional Budget Committee, actually resulted in "increased party control and manipulation of the budget process at the expense of diverse floor deliberation" as she argues that the fact that a single chairman would be more susceptible to party control than several subcommittees.[160] Another restraint imposed on typical Senate procedure is that rulings of the presiding officer on points of order relating to budget issues require a sixty-vote majority to overturn, rather than the simple majority usually required.[161] That filibuster right is also constrained for specific votes. For example, some of the exceptions to the filibuster state that budget resolutions and budget reconciliation amendments, motions to proceed to consideration of those amendments, and questions of germaneness on appropriations amendments are all non-debatable.[162] The result is that the filibuster does not operate for consideration of the budget and appropriations process. This limits the ability of individual senators to challenge Senate leadership and enforce the unique deliberative process of the Senate. There is also an important procedural difference between votes on the budget resolution and votes on increases in the debt ceiling: the budget resolution cannot be filibustered, but a vote to authorize an increase in the debt ceiling can be filibustered.[163] The national debt limit vote helps to buttress the procedural protection of the Senate, which is limited in the annual budget context, and brings that procedural protection to bear in making the less-frequent statutory debt ceiling vote an opportunity for long-term contemplation of the nation's financial situation. The ability of senators to extend debate indefinitely, or filibuster, and the corollary cloture process requiring sixty votes to proceed, are two of the defining features of the Senate.[164] In effect, highly contentious issues

160. Krishnakumar, *supra* note 119, at 152.

161. *See* Pub. L. No. 99-177 § 271(b), 99 Stat. 1037, 1094, *amended by* Pub. L. No. 100-119, tit. II, § 211, 101 Stat. 787 (1987).

162. *See* MARTIN B. GOLD, SENATE PROCEDURE AND PRACTICE 68–69 (2008).

163. *See id*. (listing procedures immune from filibuster).

164. *See* Douglas Dion, William MacMillan & Charles R. Shipan, A War of Words: Explaining the Duration of the Filibuster in the U.S. Senate, 1919–1993, at 1 (April 15, 2006) (unpublished manuscript, University of Iowa), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019807.

can require a sixty-vote threshold for approval rather than a mere majority.

Even more importantly, the prospect of having to add the debt of bailed-out institutions into the national debt would discourage the government from bailing out institutions in the first place. This is because the government would be faced with two difficult votes: an initial appropriation for the bailout (which would likely be rushed due to financial panic) and a debt ceiling vote (the timeline for which would be brought substantially forward). There is a surplus of literature detailing the economic effects of government bailout on moral hazard, and the consistent conclusion of this literature is that governments are hard-pressed to commit to not bailing out institutions; this leads institutions to take risks that ultimately pressure governments to later bail them out.[165] Including the debt of bailed-out institutions in the debt ceiling might, however, offer an element of credible commitment that could limit not only actual instances of government bailout but also increase the distorting effects on market behavior that the potential for government bailout encourages, particularly in the financial services sector.

VI. THE FINANCIAL STATEMENTS OF THE UNITED STATES

Another reporting mechanism independent of the budgetary process is the preparation of the financial statements of the United States. The Government Management Reform Act of 1994 requires the preparation and audit of consolidated financial statements for the federal government.[166] The Federal Financial Management Improvement Act of 1996 "directs [agency] auditors to report on whether agency financial statements comply . . . with federal accounting standards."[167] In 1990, the OMB, Treasury Department, and GAO, three agencies claiming lead responsibility for promulgating federal financial accounting standards, created the Federal Financial Accounting Standards Advisory Board ("FASAB").[168] The FASAB issues a number of pronouncements

165. *Cf.* Dani Rodrik & Richard Zeckhauser, *The Dilemma of Government Responsiveness*, 7 J. POL'Y ANALYSIS & MGMT. 601 (1988) (detailing general dilemma of government's inability to bind itself not to act, and citing multiple sources).

166. ALLEN SCHICK, THE FEDERAL BUDGET: POLITICS, POLICY, PROCESS 297 (3d. ed. 2007).

167. *Id.*

168. *Id.* at 293.

which those agencies, and all agencies of the federal government, are then expected to follow in implementing particular accounting policies for their agencies.[169] The financial statements of the United States opted to recognize the securities taken in the GSEs, Fannie Mae and Freddie Mac, at their investment value.[170] They have not yet been released with respect to the BOEs, but their governing pronouncements offer a window into their expected position.

With respect to accounting for the nation's debt and asset position in the financial statements of the United States, put together annually by the Department of the Treasury, the governing pronouncement is FASAB Statement of Federal Financial Accounting Concepts 2: Entity and Display.[171] This Statement helps define entities that should be included on the federal government's financial statements.[172] The purpose of that inquiry is to ensure that the following is true of the reported entities: (1) the federal government has some control over deployment of resources and some accountability for the entity's performance; (2) "the entity's scope is such that inclusion would provide a meaningful representation of operations and financial condition;" and (3) that there are likely to be users of those statements who would find the information useful in their own resource allocation decisions and would use it to hold the government entity accountable.[173]

FASAB statements are intended to guide the OMB in setting the government's rules for financial statement preparation.[174] This guidance is intended to ultimately help hold the government accountable for its taxing and spending decisions by presenting accurately the effects of new policies on the budget.[175] FASAB outlines a number of informative criteria for determining whether to consolidate an entity into the federal government's books, including some which hold particular relevance in this context: (1) "whether it is owned by the federal government"; (2) whether the government

169. *See, e.g.*, *Statements of Federal Financial Accounting Concepts and Standards*, FED. ACCOUNTING STANDARDS ADVISORY BD. (2008), *available at* http://www.fasab.gov/pdffiles/codification_report2008.pdf (representing an example of such pronouncements) [hereinafter FASAB].

170. *See* 2008 U.S. DEP'T TREASURY FIN. REP. U.S. GOV'T 62.

171. *See* FASAB, *supra* note 169, at 76.

172. *See id.*

173. *Id.*

174. *See id.* at 79.

175. *See id.* at 80.

has "the ability to select or remove the governing authority . . . particularly if there is to be a significant continued relationship with the governing authority or management with respect to carrying out important public functions"; (3) whether the government has "the ability to veto, overrule, or modify governing body decisions or otherwise significantly influence normal operations"; and (4) whether and the extent to which the government retains implicit or "moral responsibility" for the entity's debt.[176]

FASAB makes clear that the Federal Reserve System is not considered part of the "government-wide reporting entity" because of the Federal Reserve's operational independence from the executive branch.[177] Even if this is the case, it does not speak for excluding AIG from consolidation. Though the Federal Reserve created the trust that serves as custodian of the Federal Reserve's investment in AIG, the operating documents of that trust make clear that the trustees look to the Treasury Department for leadership.[178] The fiduciary duty of the trustees is in fact specifically defined as being to the best interest of the Treasury.[179] FASAB makes a curious decision about accounting for government sponsored enterprises. It says, with little analysis, that they do not function in a manner consistent with the indicative criteria.[180] Even if this is true in the general case, that rule was not promulgated at a time in which the GSE were, as they are now, under federal conservatorship and subject to an explicit and unlimited guarantee from the Treasury Department, and given a special accommodation from the Federal Reserve to agree to buy vast quantities of GSE debt.

It also makes a curious observation about bailout entities. It notes that

> [t]he Federal Government occasionally bails out, i.e. guarantees or pays debt, for a privately owned entity whose failure could have an adverse effect on the nation's economy . . . . As a condition of the bailout, the Federal Government frequently obtains rights similar

176. *See id.* at 90–91.

177. *Id.* at 93.

178. *See* J.W. Verret, *Testimony Before the House Committee Concerning the AIG Trust Agreement and Implications for Pending Citigroup and Other TARP Trust* 2 (George Mason Univ. Law & Econ., Research Paper Series 09-27, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1408188.

179. *Id.*

180. FASAB, *supra* note 169, at 91–92.

> to the indicative criteria . . . . The existence of these rights does not make the bailed out entity part of the Federal Government reporting entity or any of the other reporting entities that are part of the Federal Government.[181]

This blanket statement is offered with little analysis of why ignoring nearly all of the indicative criteria listed in the entity reporting guidance is logical or consistent with the objectives of federal financial reporting.[182] But even assuming it were consistent, the federal government's actual behavior in directing corporate policy at many bailed-out entities can still provide the extra support to remain consistent with FASAB and still support consolidation of the TARP recipients.

With respect to the financial statements of the United States, consolidation would reshape important items in the financial statements, including the balance sheet estimates of assets and debt, the statement of net costs, the statement of operations, the reconciliation of net operating revenue or cost with the unified budget surplus or deficit, the comparison of actual budget uses with projected budget uses, and the statement of changes in cash balance.[183]

The existing pronouncements from public sector accounting principles are a useful beginning, but it is also worthwhile to examine the private sector's approach to consolidation as well. Private sector accounting and public sector accounting are distinctive. Private sector accounting preceded and informed the development of public sector methods. Though they have many close analogues, they are promulgated by different bodies. One of the significant distinctions of governments is that they have the power to print money and to

181. *Id*. at 92.

182. *Id*. By contrast, The United Kingdom 1989 Companies Act offers a clear rule on consolidation of financial reporting for its private sector analogue to GAAP. Newby, *supra* note 108, at 155. The indicative criteria it lists for consolidation of a subsidiary investment, based on Article I of the EC Seventh Directive, include any of the following: "a majority of voting rights, control of the membership of the administrative, management, or supervisory body, [or] the right to exercise dominant influence" defined as "influence exercised to achieve the operating and financial policies desired by the holder of that influence." *Id*. The U.K. definition does not exclude powers that an owner might hold by, for instance, its concomitant status as a major creditor or regulator of the entity. *Id*.

183. *See* FASAB, *supra* note 169, at 110; *see also Overview of Federal Accounting Concepts and Standards*, FED. ACCOUNTING STANDARDS ADVISORY BD., 12–13 (September 30, 1996), http://www.fasab.gov/pdffiles/con_stan.pdf.

tax citizens to pay off their debts.[184] Yet, with the bailout the principles behind private and public sector accounting methodologies are merging in a unique way. The government holds control over private sector entities, many of which still have publicly traded equity. Their private sector objectives remain, but have been meshed with public sector goals as well. As such, this unique dynamic consideration of using private sector accounting methods for the federal government's foray into the private sector may be consistent with the objectives of federal financial statements and budget laws.

The private sector takes, in certain circumstances, a whole entity approach to accounting for a parent entity that has partial but controlling ownership in another entity. The reasoning behind the entity approach is to treat entities that are jointly controlled as one.[185] Though some may argue that consolidation of subsidiary activities onto the books of a controlling investor is a useless exercise, since investors can perform the consolidations themselves if they think it presents a more accurate picture of the parent firm. However, evidence indicates that the issuance of SFAS 94, the current rule requiring consolidation of majority owned subsidiaries, resulted in a substantial decrease in market share value for those firms affected by the accounting rule change.[186] This indicates that consolidation of partly owned but controlled entities altered the market's perception of the value of the controlling firm.

Under an initial accounting rule, companies were required to consolidate firms over which they held a greater than 50% voting interest.[187] In 1971, APB No. 18 was issued, which required

184. *See* Michael J. Boskin, *Concepts and Measures of Federal Deficits and Debt and Their Impact on Economic Activity* 25 (NBER Working Paper Series, Working Paper No. 2332, 1987), *available at* http://ssrn.com/abstract=303492.

185. Maurice Moonitz, *The Entity Approach to Consolidated Statements*, 17 ACCT. REV. 236, 237 (1942) (stating that "[t]he central premise is that consolidated statements are exhibits in conventional accounting form of the status and operations of a group of related companies—exhibits prepared as though the companies were legally as well as economically mere administrative subdivisions of one concern. The legal separateness of each unit is disregarded, the fiction of separate corporate entities ignored. Legal lines of cleavage are replaced by the more useful but less definite boundaries of economic unity. That consolidated statements are of primary interest to investors and creditors of the dominant company is a corollary of our major premise.").

186. Inder Khurana, *Security Market Effects Associated with SFAS No. 94 Concerning Consolidation Policy*, 66 ACCT. REV. 611, 613 (1991).

187. The Financial Accounting Standards Board (FASB) has been trying to reconcile the

companies to use the equity method in accounting for companies over which they held significant influence, defined as ownership of between 20% and 50% of voting stock.[188] "Under the equity method, an investor company would recognize its proportionate share of the investee's GAAP income along with an offsetting increase in the investment asset, and recognize dividends as a decrease in the investment asset."[189]

The general difference between the equity method and full consolidation is that a company fully consolidating will appear larger, with more assets, liabilities, revenues, and expenses, whereas a company using the equity method to recognize its investment in a subsidiary will have better debt-to-equity ratios and ratios for return on assets and sales.[190] This results in many companies taking a 49% interest in subsidiaries to avoid full consolidation, dubbed the "49% solution."[191] In 1987 FASB issued SFAS 94, which modified APB 51 and made clear that a previous exception permitting non-consolidation if the subsidiary was in a different line of business from the parent was no longer valid.[192] SFAS 94 also stated FASB's goal of developing a reporting entity concept which should be based on a concept of actual control rather than the rough estimate of majority

evolving standards for consolidation into a single codification through its consolidation project. Private Sector accounting principles (Generally Accepted Accounting Principles or GAAP) on consolidation begins with Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51), promulgated in 1959. Al L. Hartgraves & George J. Bentson, *The Evolving Accounting Standards for Special Purpose Entitites and Consolidations*, 16 ACCT. HORIZONS 245, 248 (2002). That initial guidance was subsequently reshaped by Statement on Financial Accounting Standard 94 (SFAS 94), Consolidation of All Majority-Owned Subsidiaries in 1987. Also related subsequent rules include SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets in 2001 and FASB Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities: An Interpretation of ARB No. 51 (FIN 46(R)). Under ARB 51, consolidated financial statements were necessary if one of the companies in the group had a direct or indirect controlling financial interest in the other companies (control being defined as having ownership of a majority voting interest, with particular emphasis placed on the ownership of more than 50% of the outstanding voting equity of the company). *Id.* at 255.

188. *Id.* at 249.

189. *Id.*

190. *Id.* at 250.

191. *Id.*

192. Dennis R. Beresford, *Should the FASB Abandon the Consolidation Project?*, J. OF CORP. ACCT. & FIN., 51, *available at* http://www3.interscience.wiley.com/cgi-bin/fulltext/113441390/PDFSTART.

ownership, indicating that sub-majority control would be sufficient to require consolidation.[193]

The equity method displayed the investor's share of the investee's net assets and net income as single and separate items on the parent's income statement and balance sheet.[194] A firm reports its investment in an entity as a single line item, like "investment in subsidiary," at the cost to initially purchase the investment.[195] In each accounting period the investor's proportionate share of the investee's net income or loss is included as a single line item. Any

193. Hartgraves & Bentson, *supra* note 187, at 250. In 1999 FASB issued a proposed Statement of Financial Accounting Standards (SFAS), Consolidated Financial Statements: Purpose and Policy: Revision of Exposure Draft issued October 16, 1995. This statement was part of the FASB's ongoing consolidation project to reshape its consolidation rules to cover a broader effective control definition to include sub-majority control effectuated through a lack of other large shareholders or through contractual provisions giving control to the sub-majority shareholder. *Id.* at 255. This Statement requires a reporting entity to consolidate the financial statements of all entities that it controls, where control is now defined in a much broader way to encompass methods other than holding a majority of voting shares. The FASB determined in 1999 that it lacked the board votes to approve a final draft, and so the project is still ongoing. Paragraph 6 of the exposure draft defines control as relating to two key characteristics:

> a) a parent's decision-making ability (that is not shared with others) that enables it to guide the ongoing activities of its subsidiary; and b) a parent's ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary. These characteristics, which are similar to those included in the control concept adopted by international accounting standards and already adopted by the European Union and many other foreign countries,

can be based on holding a controlling block of voting equity shares, but they may also result from other sources of control. Patrick A. Casabona & Alex Ashwal, *The Concept of Control in Consolidated Financial Statements: Convergence of U.S. and International Accounting Rules*, 26 REV. OF BUS. 36 (2005). The proposed Statement also provides guidance for applying its definition of control, which includes the following situations identified in paragraphs 18 and 21 that lead to rebuttable presumptions of control:

> i) The entity has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of its members. ii) The entity has a large minority voting interest in the election of a corporation's governing body and no other party has a significant voting interest. iii) The entity has a unilateral ability to 1) obtain a majority voting interest in the election of a corporation's governing body or 2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.

See Federal Accounting Standards Board, *Consolidated Financial Statements: Purpose and Policy*, 19–22 (1995).

194. Mark P. Bauman, *The Impact and Valuation of Off-Balance-Sheet Activities Concealed by Equity Method Accounting*, 17 ACCT. HORIZONS 303 (2003).

195. *Id.* at 305.

difference between the initial cost of the investment and the investor's subsequent percentage interest of net assets is allocated to identifiable assets of the investee. The investment account is adjusted downward if the investee gives the investor dividend payments. Critics of the equity method assert that it distorts the financial statements of the investor by, for example, overstating the investor's return on assets and other leverage ratios.[196]

An alternative method is proportionate consolidation, which consolidates the parent entity's proportionate share of each component of net assets and net income into the parent's books. For instance, a 40% investor would add 40% of the controlled subsidiary's short term debt, accounts receivable, cash, property, accounts payable, electricity expense, and all other financial statement components (except for stockholder's equity and retained earnings) into each individual line item on the books of the parent entity.[197] Critics of proportionate consolidation assert that it is inappropriate in the absence of an explicit guarantee from the parent for the investee's debts.[198]

These different methods produce widely different results. Studies comparing the two methods find that proportionate consolidation is a better predictor of investor profits than equity method accounting.[199] It is unclear which method would be more appropriate for government consolidation of BOEs, and it may differ depending on the entity, but either of them would provide more information than the current at-cost method. Bauman also demonstrates empirically that market participants tend to place more weight on off-balance sheet liabilities than off-balance sheet assets, thus supporting the idea that consolidation of debt rather than of assets is the central reason users of financial statements may favor the proportionate consolidation method.[200] Other accounting research demonstrates that bond risk premiums tend to lack the information to incorporate implicit guarantees of subsidiary debt.[201] Statements

196. *Id*.

197. *Id*. at 303.

198. *Id*. at 305.

199. *See* Roger C. Graham, Jr., & Craig E. Lefanowicz, *Evidence of the Relation Between Accounting for Equity Investments and Equity Valuation*, 11 J. ACCT., AUDITING, & FIN. 587 (1996).

200. *See generally* Bauman, *supra* note 194.

201. *See* Ronald L. Stolzfus & Ruth W. Epps, *An Empirical Study of the Value-Relevance of Using Proportionate Consolidation Accounting for Investments in Joint Ventures*, 29 ACCT.

from the Treasury Department during the bank stress tests of 2009 indicate the Treasury's willingness to guarantee the debt of TARP recipients if they are unable to meet capital demanded by the Treasury from market offerings, and as such, this finding would support the utility of consolidation for both taxpayers and bondholders as users of government financial statements and accounting projections.[202] But even if bondholders can put together the necessary information on their own, at the very least it could be useful to consider retooling government provided information to accurately reflect the government's liabilities to reduce bondholder information costs. Further, literature on voter ignorance shows that voters rationally do not take the time to educate themselves about policy decisions. But the growth in the national debt or deficit is a fairly simple concept by comparison.

Newby asserts one argument against consolidation of government owned enterprises: accounting consolidation, and the accompanying statutory authorizations to require government owned companies to give information to the government in order to facilitate the government's obtaining information to fulfill its accounting statement requirements actually gives the government more control over the government owned company. Newby argues that accounting policy actually creates the reality rather than the other way around.[203] It seems clear however that whatever minor influence the government might gain would be dwarfed by the influence it possesses, as discussed in the analysis in Section II of this Article. Further, the independence of GAAP promulgated by the private sector could easily be maintained.[204]

FORUM 169 (2005).

202. There is some evidence to indicate that private markets already assume that the government stands fully behind the debt of TARP companies, as the price of bonds for companies like Citigroup have maintained most of the value through the financial crisis. *See, e.g.*, Bebchuk & Spamann, *supra* note 2.

203. Newby, *supra* note 108, at 213.

204. One issue that might be raised with respect to government consolidation of private sector financial statements would be the timing disparity between the financial years for private entities versus the budget cycle and financial statement year for the federal government, which would involve reporting years that ended on different dates. As such, if for example the private sector entity had to give information to the government prior to its issuance of an annual report, including that information in a report issued by the government might leak information to the public and to competitors in advance of the timing required under the existing SEC reporting requirements. Or, if a convention were adopted that government financial estimates consolidated items from the most recently issued financial statements of the private entities, it

A. Economists as Users of Financial Statements

There are a number of users of government financial statements, including purchasers of government bonds, who seek to price the riskiness and returns of their investments. Examples of such members include: members of Congress who are exercising their constitutional oversight duties, taxpayers seeking to hold elected officials accountable, and economists who make predictions about the future of the economy.[205]

Economists as early as Adam Smith argued that government labor was less productive than private labor.[206] One articulation is that if the government were to borrow money from banks to finance its investment spending, the government's increased purchasing power would drive up the price of the goods it purchased, deterring private investment.[207] In the present context, the government would not need to borrow from banks, but could actually direct fiscal policy actions through its control over the corporate policies of the banks themselves.

Keynes himself even notes that "[w]ith the confused psychology which often prevails, the Government programme may, through its effect on 'confidence,' increase liquidity-preference or diminish the marginal efficiency of capital, which, again, may retard other investment unless measures are taken to offset it."[208] What Keynes did not consider, and what may even enhance this effect, is that the business psychology of the financial services industry could change substantially when the government becomes a controlling owner of a bank or of a bank's competitor.

One policy argument which favors making sure that the government's deficit and debt are both properly estimated, and demonstrate the government's influence over the productive assets

could be the case that the government reports would be inaccurate by a large margin. Consolidation would also require that the government adopt policies with respect to the consolidation of transactions that are estimated using different conventions in the private sector than in the public sector.

205. Newby, *supra* note 108, at 190.

206. *See* Roger W. Spencer & William P. Yohe, *The "Crowding Out" of Private Expenditures by Fiscal Policy Actions*, FEDERAL RESERVE BANK OF ST. LOUIS 12, 15 (Oct. 1970).

207. *Id.*

208. Spencer & Yohe, *supra* note 206, at 17 (citing JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 120 (Harcourt Brace and Company, 1936)).

of the national economy, is that it will present a more accurate input to determine the crowding out effect of government spending. The crowding out effect holds that public debt crowds out private saving and ultimately diminishes capital formation.[209] The budget deficit or surplus is an estimate of the difference between federal expenditures and federal receipts for a certain year, and it reflects the amount the government will need to borrow to finance that deficit.[210] Amounts the government must borrow are not available for private investment, resulting in consequences for future interest rates, inflation, and the long run performance of the economy.[211] Barro offers an alternative view, the notion of Ricardian equivalence, whereby increases in public debt result in an increased demand for public debt, effectively arguing that the private sector can undo the government's redistribution of resources across generations.[212]

The Ricardian equivalence conjecture rests on a number of unlikely assumptions, including that taxation is non-distortionary and that the private and public sectors use the same discount rate.[213] Thus crowding out would seem to be an important effect of government spending, with its precise magnitude remaining an open question. The inflationary effects of government spending have also been argued.[214] Many studies of government deficits focus on nominally reported amounts, although a few economists have argued for adjustments. Feldstein argues in favor of adjusting for the unfunded liabilities of Social Security.[215] Boskin argues for including the effect of government lending and guarantees.[216]

The effect of government spending on private investment is hotly debated.[217] One group of economists demonstrate that if all

209. Boskin, *supra* note 184, at 13.

210. COMMITTEE REPORT, *supra* note 120, at 4.

211. *Id.*

212. *See* Boskin, *supra* note 184, at 14; *see also* James R. Barth, George Iden, & Frank S. Russek, *Do Federal Deficits Really Matter?*, 3 CONTEMP POL'Y ISSUES 79 (Fall 1984).

213. Boskin, *supra* note 184.

214. *See id.* at 6.

215. Martin S. Feldstein, *Social Security, Induced Retirement and Aggregate Capital Accumulation*, 82 J. POL. & ECON. 905 (1974).

216. Michael D. Hurd & Michael J. Boskin, *The Effect of Social Security on Retirement in the Early 1970s*, 99 Q. J. ECON. 767 (1984).

217. Costas Azariadis & Pietro Reichlin, *Increasing Returns and Crowding Out*, 20 J. ECON. DYNAMICS & CONTROL 847 (1995); Peter A. Diamond, *National Debt in a Neoclassical Growth Model*, 55 AM. ECON. REV. 1126 (1965); Franco Modigliani, *Long-Run Implications of Alternative Fiscal Policies and the Burden of National Debt*, 71 ECON. J. 730

government debt were eliminated in OECD countries, real interest rates would fall by 163 basis points, and potentially more depending on assumptions about the number of consumers that are liquidity constrained.[218] They include an assumption of a positive birth rate which tends to reduce any element of Ricardian equivalence in crowding-out models.[219] They also conclude that the roughly 20% increase in debt/GDP ratio of large OECD countries over the period from 1975–1996 resulted in a loss of roughly 2.9% in annual GDP growth. The growth in the government's debt/GDP ratio over the last five years would seem to indicate much greater fallout. A proper accounting for the Treasury Department's investment in TARP recipients, however, would dramatically increase a proper estimate of that cost to GDP growth. The debt and deficit are not merely the focus of academic studies, professional economic forecasters at banks, and trade groups. The Federal Open Market Committee of the Federal Reserve Board also uses these inputs to guide investment and policy decisions for thousands of member banks, clients, and investment professionals.

Some economists argue that fiscal policy actions or increased government spending financed by government borrowing and designed to stimulate economic growth fail to accomplish their objective. This failure can be explained by the fact that additional government borrowing crowds out of the market an equal, or even greater, volume of borrowing that would have financed private investment.[220] Crowding out is offered as an argument against the so called Keynesian multiplier, which is an assumption that government spending leads to positive changes in aggregate demand through shifts of the IS curve.[221] Other economists have urged that if

(1961); Gilles Saint-Paul, *Fiscal Policy in an Endogenous Growth Model*, 107 Q. J. ECON. 1243 (1992); J.E. Meade, *Is the National Debt a Burden?*, 10 OXFORD ECON. PAPERS 163 (1958).

218. Hamid Faruqee, Douglas Laxton, & Steve Symansky, *Government Debt, Life-Cycle Income and Liquidity Constraints: Beyond Approximate Ricardian Equivalence* (Int'l Monetary Fund Working Paper, 1996) (assuming that 20% of consumers are young and thus more likely to be liquidity constrained. The pending crisis in entitlements indicates that older baby boomers may also face similar liquidity constraints, thus indicating that their estimate may reflect the low end of the spectrum.).

219. *Id*. at 22.

220. *See* Spencer & Yohe, *supra* note 206, at 13.

221. *Id*. at 13.

crowding out does in fact occur, it is less likely when the economy is operating at substantially less than full employment.[222]

Regardless of the outcome of the crowding-out debate, the public/private distinction has become a clear point of delineation for that debate and for the inputs around which the models in that debate are crafted. As such, a convention to account for the government's investment in private enterprise requires careful consideration and more depth than the government's self-serving interest in keeping liabilities and subsidies off-budget and unconstrained from Congressional review.

VII. CONCLUSION

Much of the existing literature on bailouts focuses on the moral hazard problems created by the prospect of bailout. The debates in that arena concern whether governments should bail out companies and how the financial regulators should determine whether bailout is appropriate. A few other writers in this area have recently worked on the issue of bailout design, trying to determine a method to backstop the private markets in a way that harnesses private market solutions through auctions and other procedures. But surprisingly little attention has been paid to the laws governing the national debt and financial statements. There has also been surprisingly little focus on how to get governments to internalize the effects of their actions in exercising control over companies. This Article offers an initial look into both unexplored areas.

Financial accounting is intended to guide users of financial statements in their interactions with the entity under review by giving them an accurate picture of historical operations. The existing legal and accounting approach to recognizing bailed-out entities evade these important functions. By its control over private sector companies, the executive branch has the ability to facilitate transfers and subsidies off-budget through its control over bailout recipients. As such, a failure to consolidate the operations of bailout recipients hides a significant level of economic activity over which the government has control and financial responsibility. The private sector has developed accounting procedures to deal with this problem in its consolidation rules. The public sector accounting rules also have a consolidation provision, but the regulators have opted to

222. *Id.* at 24.

carve out an exception with little justification for bailed-out entities. However, a consolidation mechanism for government control over bailed-out entities is essential to maintain the transparency objective of government financial statements.

The national debt ceiling functions as a powerful limit on congressional spending. It fulfills a vital Constitutional function of providing the legislature with a means to fulfill its ability to check the executive branch's discretion in spending. But the legislature has unwittingly ceded much of its spending and debt oversight powers and responsibilities through the bailout. Not only does the bailout operate as a revolving appropriation, but it gives the government authority to sidestep formal appropriations in favor of off balance sheet transfers. In order to realign the executive branch's incentives to minimize their likelihood of abusing this discretion, the debt of bailed-out entities should also be included in the debt ceiling calculation. That way, the legislature's participation in the process is restored and both branches have a realigned set of incentives with respect to bailed-out entities. They will face budgetary pressure to privatize bailed-out entities held, and also reconsider the need to bailout firms in the first place.

To the extent that there has been some limited debate about consolidation of off-balance sheet entities, this debate has typically focused on the Social Security Trust or the government sponsored entities Fannie Mae and Freddie Mac. The former is a distinct issue, and the latter is only the beginning of the problem. Before the financial crisis began, government regulators frequently commented that they would not bail out risky financial institutions, in the hopes that market distortions based on that assumption could be limited. Fannie Mae and Freddie Mac's regulator also made clear that the GSEs were private sector companies that weren't the beneficiaries of unlimited government backing. Fannie and Freddie's executives asserted that their private sector goals of profit maximization were consistent with their goals of subsidizing the mortgage market. All three of those pronouncements lack as much credibility now as they did when they were made. The best way to limit the distorting effects of government control over private firms is to recognize the costs of government control within the mechanisms that control and report on the government's finances by consolidation of bailed-out entities.