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Governance Challenges and the Financial Crisis: Seven Key Questions

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"As if the problems in the U.S. and world economies were not enough of a challenge in themselves, the … Obama administration is also being called on to figure out simultaneously how to govern in such an emergency."

—David Broder, The Washington Post, March 9, 2009.

We are in the midst of a global economic crisis. The federal government has responded on an unprecedented scale and scope, with injections of trillions into financial markets, infusions of cash to troubled industries, state and local governments, and people in need. Government is employing tools in ways never before considered and inventing new tools, in the hope of stabilizing the economy and spurring economic recovery.

As difficult as it is to predict whether these efforts will be successful with regard to economic goals, there are other potential implications that have yet to be thought through. Government's response could affect our governance structure and relationships in ways that are not fully understood. Because of the magnitude of the economic crisis and the extraordinary efforts to respond, industries, markets and government will function very differently in the near term and perhaps far into the future.

Will institutions being created to manage trillions of dollars in recovery funds linger long—or too long—after the crisis recedes? How will the challenges of changing demographics of an aging population and unfunded long-term government commitments to Social Security and Medicare benefits be addressed? Will the American people have a different relationship with their government and private enterprise when the crisis is over? How will the decisions being made today affect the roles, responsibilities, functions, laws, regulations and management of government? Simply put, how will basic *governance* in our democracy be changed by these events?

Now is the time to ensure that we are asking the right *questions* as we move forward in this uncharted territory. A timely and critical focus on these issues could be an important guide for our mid-term actions, prevent us from sliding into negative long-term economic consequences, and prepare us to make changes in governance structures that will address our new circumstances. Now is the time for a public discussion of governance.

Under the leadership of National Academy Fellow Don Kettl and National Academy President Jennifer Dorn, the National Academy of Public Administration convened a roundtable of government leaders, business leaders, researchers and other experts to discuss governance issues related to the government's response to the financial crisis. Seven strategic questions related to governance emerged from the discussion held earlier this year, which was moderated by Don Kettl. The National Academy and the IBM Center for The Business of Government are pleased to offer this summary of the roundtable in an effort to stimulate a national discussion of these questions.

Participants in NAPA Roundtable on American Governance

Mark A. Abramson, *Leadership Inc.*

Sarah A. Binder, *Brookings Institution*

David Broder, *The Washington Post*

Frank C. Carlucci, *The Carlyle Group*

Jenna L. Dorn, *National Academy of Public Administration*

Robert D. Ebel, *District of Columbia Government*

H. George Frederickson, *University of Kansas*

Michael P. Jackson, *Firebreak Partners, LLC*

Elaine C. Kamarck, *Harvard University*

Daniel Kaufmann, *Brookings Institution*

Donald F. Kettl, *University of Maryland*

John A. Koskinen, *Freddie Mac*

J. Christopher Mihm, *Government Accountability Office*

Paul H. O'Neill, *former Secretary, U.S. Department of the Treasury*

Sallyanne Payton, *University of Michigan*

Egbert L. J. Perry, *Integral Group, LLC*

Alex J. Pollock, *American Enterprise Institute for Public Policy Research*

Thomas H. Stanton, *John Hopkins University*

Robert M. Tobias, *American University*

David M. Walker, *Peter G. Peterson Foundation*

Question One:
How should the terms of the social contract among government, business, civil society and the American people be redefined?

"The financial meltdown has accelerated our expectations that government will keep us safe…. We're writing this new social contract with three guides: more public money in the private economy, more rules to shape how the private sector behaves, and more citizen expectations that government will manage the risks we face. The problem? We're making it up as we go along, and we're not sure where we're going."

—Donald F. Kettl, *Government Executive,* February 2009

With deference to Locke, Rousseau and other political theorists, the American "social contract" has its roots in the Preamble to the Constitution, which declares that "we the people … in order to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare, and secure the blessings of liberty to ourselves and our posterity." Today, the term has evolved to connote the full array of social arrangements that shape the economy and establish the roles of government, business, non-profit organizations, families and individuals in defining and providing necessities in American life—from education to retirement income to health care.

The current American social contract is rooted in the New Deal, when "workers, employers and the government entered into an implied social contract that afforded Americans a basic level of economic security if they worked hard and took responsibility for their families."* The evolution of employer-based health insurance, the creation of Medicare and subsequent addition of prescription drug benefits, and the establishment of home mortgage deductions, 401(K)s and student loans gradually expanded the social "safety net." But, with decades of generally low unemployment, rising home values, high investment returns and easy credit, discussion of wholesale changes to the social contract in America was largely set aside.

Now, with personal retirement savings reduced by the financial downturn, a clear and growing gap between the dedicated revenue and promised benefits from Social Security and Medicare, and health care costs that are increasing twice as fast as the economy, there is an increasing call for forthright discussion of the rights, roles and responsibilities of citizens, businesses and government. As one Roundtable participant observed, "Rescuing banks, mortgage brokers, automakers and home buyers implies moral hazards in federal ownership or part ownership … but the equity question arises when we privatize economic gain and federalize risk and loss." Add to this a general acknowledgement that we are, as a nation, living beyond our means and leaving unreasonable bills for coming generations to pay.

There are now two fundamental questions for Americans to grapple with as we "renegotiate" our social contract: (1) Who should bear risk in our society, and (2) how should we balance the books between generations of Americans?

* Judith Rodin, "The New Social Contract," *Time,* July 17, 2008.

Question Two:
What is the new global role for the United States in the wake of the economic crisis?

"World trade is declining, the effects of which will become clear in the next 10 years. Will federal institutions have to give way to global institutions?"

—Roundtable Participant

The economic crisis has tarnished the political oversight and economic institutions of the United States, and dealt a significant blow to the U.S. economy. It has also caused international observers to question whether a U.S.-dominated global financial system is appropriate. The international economic leadership role long-played by the United States may yield to a more collaborative approach.

Much of the debate about a new role for the United States globally is predicated on the assumption that the financial crisis will so reduce the economic power of the United States and so discredit its institutions that a redefined role will be necessary. Some are calling for the internationalization of the global public financial regulatory system. Others are pressing for a greater role for international organizations in mitigating not only financial crises, but political and social problems, as well.

It can be argued, however, that because the economic crisis has reached international proportions, the power of the United States is not likely to erode significantly. Further, some say, the reforms undertaken in the U.S. as a result of the crisis may mean that the country will emerge from it economically stronger.

Nevertheless, the prospect of any lessening or redirection of U.S. economic influence raises numerous issues for the U.S. and for the rest of the world. Which country or countries will emerge as world economic leaders? How will these emerging economic powers exercise their influence in world financial institutions? How should the U.S. respond? What roles and responsibilities should the U.S. be prepared to assume in the world community?

Should America reconsider or redefine its global economic leadership role? What role does America want to play in global financial institutions?

Question Three:
What structural changes in the financial system should be made to foresee, prevent, and respond to future economic crises?

"Did we not know enough about what was going on because of lack of capability? Or did we know all along, but political forces prevented us from acting?"

—Roundtable Participant

The federal institutions charged with regulating the financial system and managing the economy failed to anticipate and prevent the financial crisis. Some argue that the government's regulatory system may have contributed to the crisis.

Yet controversy about financial system regulation remains high, and agreement on systems to foresee and prevent future problems will likely be difficult to achieve. Indeed, there is little consensus about whether more regulation is the answer. There remain two basic schools of thought:

- Financial markets are essentially self-regulating, and will right themselves eventually, if not hindered by government regulation.
- Financial markets are subject to a number of failures that threaten their effective and equitable operation, and that can only be addressed through government regulation.

Those in the first camp argue that government regulation and policies contributed to the financial crisis by creating perverse incentives. They reject calls for additional regulation on the grounds that it will dampen investment, innovation and economic growth.

Even proponents of regulation, however, disagree about exactly why the system failed and what changes ought to be made. Most agree that the regulatory institutions, created largely during the New Deal, are far too fragmented, with authority shared among the federal and state governments and among multiple federal entities. Whether they are also underfunded, understaffed or too limited in their scope is the subject of intense debate. Proposed changes include a greater regulatory role for international bodies and more cooperation among regulatory bodies in countries with a strong financial presence in the global economy. Regardless of what steps are taken, many question the prudence of undertaking major regulatory system reforms in the midst of the financial crisis.

In addition to regulatory policy, the roles of the Federal Reserve Bank, the Federal Deposit Insurance Corporation, and the Department of the Treasury in managing the economy have been questioned. It is widely believed that these institutions collectively failed to anticipate the crisis, likely contributed to it, and lacked a coherent response strategy.

How can we strengthen the nation's financial management and regulatory institutions and improve our ability to diagnosis and provide early warning about potential problems?

Question Four:
What should be done to improve Congressional oversight and expertise?

"There has been a decrease in [Congressional] oversight hearings and an increase in 'fire site" hearings.… Congress has to go back to work and make its oversight capacity more constructive. Congress must modernize itself."

—Roundtable Participant

Much has been written about the apparent lack of Congressional foresight and oversight with regard to the regulation of financial institutions. As one participant in the Roundtable put it, "Congress does not know how to do oversight that is not aimed at undermining the President," and, so, it did little in the way of regular "vanilla oversight" that might have prevented the worst of the abuses that contributed to the financial industry meltdown.

Even with its dismal public approval ratings, Congress has shown little interest in reforming itself. Many believe the institutional lack of interest in reform is rooted in political reality. "Our government," one Roundtable participant observed "is run by politicians whose survival depends on reelection, not the good of the whole"—a delicate way, perhaps, to state the obvious link between political contributions and the desire of current Congressional committee incumbents to retain their scope of jurisdiction in order to maintain their positions of power.

A recent National Academy report on the 2009 Presidential Transition at the Department of Homeland Security made it clear that the impact of dysfunctional Congressional oversight is not limited to the financial sector. Citing the potential policy disarray that results from conflicting Congressional direction, the National Academy Panel called upon Congress to "Implement the 9/11 Commission recommendation to reduce the number of [Department of Homeland Security] Congressional oversight committees and subcommittees from its current unwieldy eighty-seven."

Effective oversight was not the only concern raised by the Roundtable participants, however. A number expressed concern about the apparent lack of policy expertise in Congress, particularly with respect to financial issues. "No policy incubation is going on in Congress," was the view expressed by at least one participant. Some pointed to the lack of conditions or objectives attached to the first round of "bailout" funding given to banks, while others lamented major legislation that is "so detailed that the ability of the Executive Branch to manage it has been leached out." Both of these conditions, it seems, have contributed to what was described by one former government official as a "shift of power away from the cabinet and government, toward 'heroic' leadership from a White House that does not have to respond to Congress."

Can Congress reform itself and reassert the balance of power envisioned by the nation's founders in the Constitution?

Question Five:
Is it time to re-examine the distribution of roles, power and authority among federal, state, and local governments in light of the financial crisis?

"Much that is now federal was established in the past when needs were different … when state and local governments were weak."

—Roundtable Participant

Over the last 30 years, the federal government has incrementally redefined the roles and responsibilities of states and localities. One Roundtable participant observed, "Almost everything the federal government initiates is actually done by somebody else at some level—state, local, non-profit, private contractors." In addition, some now argue that states, often with the encouragement of federal demonstration projects, have become the engines for innovation engines in major policy and program areas like the environment, education and health care. Supporters of these developments have called for further redefinition.

The current economic crisis has re-opened issues of federal-state-local roles, particularly as the American Recovery and Reinvestment Act funds flow through the federal system to state and local governments. The $787 billion Act, passed in February 2009, provides about $280 billion for states and municipalities to spend on infrastructure projects, Medicaid, unemployment insurance benefits, green energy project and other programs. The law, however, includes stringent oversight and reporting requirements, and the Obama administration has given every indication that it will require grant recipients to provide a full and transparent accounting of both spending and results.

While the economic crisis has prompted an outpouring of federal funds to states and municipalities, some believe this has only heightens the need for more federal control and uniformity. As unemployment rises and more people lose their employer-based health insurance, questions are being raised about the wisdom of having states offer a patchwork of health care programs with different eligibility requirements, benefits and options, and potentially disparate health outcomes and social equity issues.

Further, the disparate impacts of the recession on state tax bases, combined with state requirements for a balanced budget, have also created added pressure to compensate for different unemployment, health care and other need-based assistance among unemployed and low income citizens living in different states. Finally, some argue that inconsistent state regulation of financial institutions and the insurance industry has contributed to the current economic crisis.

Should Americans reconsider how best to allocate the roles and responsibilities among federal, state, and local authorities?

Question Six:
How do we strengthen transparency and accountability?

"There is nothing wrong with sub-primes, but they are fundamentally different. Had these packages been transparent, they would have been packaged differently, with higher risk at higher rates. Lack of perspicacity in looking into these loans is a greater problem; consumers have to be able to look into the loan packages."

—Roundtable Participant

There is a strong sense that transparency and accountability mechanisms—both public and private—were grossly inadequate in mitigating the financial crisis, in spite of the fact that accountability is high on the agenda of many organizations. Not surprisingly, calls for government transparency and accountability have gained increased support in the context of the public and private failures contributing to the financial crisis, as well as the scale of government intervention and spending that the crisis has induced.

While there are a variety of ways to improve accountability and transparency, many observers agree that these mechanisms should:

- **Provide incentives for people to do the right things.** Current accountability systems typically, in the best case, monitor behavior against some standard or target, or, at a minimum, require that actions and decisions be transparent. For the most part, accountability is equated with compliance. Lacking are incentives for people to behave well or better.
- **Discourage people from doing the wrong things.** Conversely, there are few disincentives to deter people from behaving badly, unless a law has been broken or a performance target has not been met. What is needed is discouragement of bad behavior.
- **Create transparency that focuses on values and risks, as well as data and information.** Since the advent of web 2.0 and related technology platforms, providing data and information to stakeholders and the public at large is becoming an important tool for harnessing "the wisdom of the crowd." Ensuring that this data—and the knowledge it informs—highlights the values and risks associated with outputs and outcomes is critical to accountability.
- **Distinguish between accountability and transparency.** Accountability is defined as the assignment of responsibility and consequences for actions taken. It should not be treated as the equivalent of making data, actions and decisions transparent. Transparency is but one mechanism by which people might judge the performance of those to be held accountable. Holding them accountable is something else.

Can and will the American people insist that the growing emphasis on "transparent government" be translated into increased accountability, as well?

Question Seven:
What is the government's exit strategy from various sectors of the economy in which it has intervened in response to the financial crisis?

"We have gone into this without an exit strategy. The tunnel is longer, the problems bigger than anyone expected, and it is not clear what will happen except that the world will look much different when we exit than when we entered."

—Roundtable Participant

Since the onset of the financial crisis, the federal government has intervened in unprecedented ways in the economy. In addition to massive spending under the American Recovery and Reinvestment Act, the government has taken extraordinary actions through the Federal Reserve Bank, the Federal Deposit Insurance Corporation, and the Department of the Treasury to stabilize the financial sector and the economy. Along the way, it has assumed ownership and control of several large banks, an insurance company, two government-sponsored enterprises, and two automobile manufacturers. Through these interventions, the federal government is exerting extraordinary control and influence on major sectors of the economy.

The federal government will face conflicting pressures to exit and to retain control. If it retains control for too long, the commercial viability of those and competing companies could be undermined. If it exits too soon or too abruptly, it may cause undue economic disruption and forego a return on taxpayer dollars.

Government investments also have the potential to transform the role the federal government plays in the private economy more generally. While largely intended to be temporary, many fear that they will create long-term, almost "permanent" expectations—particularly with regard to education, unemployment insurance, infrastructure and tax breaks.

One challenge confronting the government is to devise exit strategies that balance policy objectives, such as minimizing economic disruption and securing a return on taxpayer dollars, while not undermining the viability of companies receiving aid or their competitors in the market. Another challenge is to determine the appropriate scope of ongoing federal regulatory authority in light of both practical demands and the appropriate role of the federal government in managing the economy.

How can the Administration and Congress reach agreement on—and share with the American public—an effective "exit" strategy, while minimizing adverse effects on the companies and sectors in which it has intervened?

About the Authors

Terry F. Buss is Distinguished Professor of Public Policy, Carnegie Mellon University and consultant, National Academy of Public Administration. He earned a doctorate in political science from the Ohio State University. He has managed public administration programs and research centers at Ohio State University, Youngstown State University, University of Akron, Suffolk University, and Florida International University. He has also served as a senior policy advisor at the Council of Governors Policy Advisors, Congressional Research Service, U.S. Department of Housing and Urban Development, and World Bank. He has published ten books and several hundred papers.

Lois Fu is a Program Area Director at the National Academy of Public Administration and a member of the senior management team. She has over 30 years of public sector and non-profit experience in program management and policy development, and has served in senior positions in a number of Federal agencies and in the U.S. representative's office at the World Bank. She also served for 14 years in a variety of leadership positions at the American National Red Cross and was the staff director for the U.S. Senate Subcommittee on Aging. She holds a master's degree in public policy from the University of Michigan.

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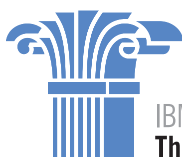

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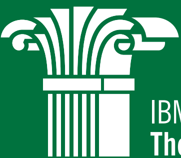

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