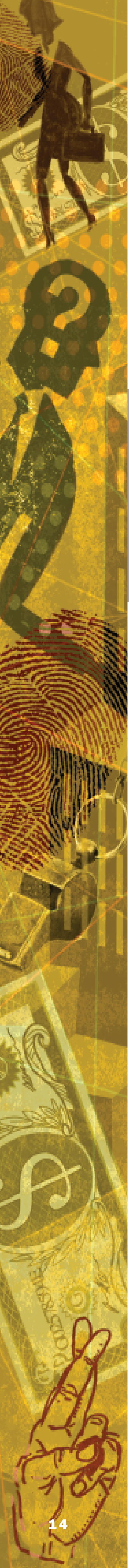

Curtis C. Verschoor, CMA, Editor

Can Government Manage More Ethically Than Capitalism?

The continuing fallout from the recent economic crisis has resulted in some thought leaders questioning whether the basic precepts of capitalism are consistent with today's socio-economic system.

As the economy slowly moves toward recovery, one ongoing debate about the economic crisis has focused on evaluating whether additional regulation of capitalistic market tendencies will be effective in avoiding unethical practices that could lead to a repetition of the disaster.

One of the events exploring the underpinnings of the legitimacy of capitalism in light of the financial crisis was sponsored by Harvard University as part of the Harvard Business School Centennial Business Summit. Some of the conclusions from this event reinforce thoughts already expressed by many writers, while others are more penetrating and are expected to influence policymakers on a number of subjects. (Summit conclusions are expressed below in italics.)

The financial crisis may shift societal views on the legitimacy of business. This is perhaps the most profound conclusion coming from the Summit. Because of the many examples of illegal and unethical behavior exposed by the crisis, the general feeling among investors and even the public at large appears to be a demand for structural change. The gravity of the shock caused by the crisis suggests systemic weakness that may stimulate increased government influence in society, particularly in business. Government influences over bank management were illustrated by the bailout payments to banks in 2008, which were accompanied by federal controls over executive compensation and demands for strict accounting as to the purpose for which the payments were used. Critics believe such controls stifle innovation and growth.

The crisis also demonstrates that markets aren't effective in controlling unethical practices driven by greed, which is only an extension of the concept of enlightened market self-interest. The American ideal that heightened effort and innovation will lead to financial success is diminishing, largely because of the increasing financial disparity between the "haves" and the "have-nots." The U.S. has had centuries of experience with CEOs who basically looked out for themselves, and possibly their shareowners, but not their neighbors. The government has been looked to for the responsibility of assuring a level playing field, but that hasn't always been achieved.

In the current crisis, public support appears to be continuing for government bailout efforts for financial service firms and 2009 efforts to save companies in the automotive industry. The observation that taxpayers, through their 80% ownership of AIG, would pay out nearly $1 billion to banks and lawyers in advisory services regarding the sale of portions of the company seems to have attracted little adverse comment. Federal spending to improve bank balance sheets and minimize foreclosures by reducing mortgage payments of some homeowners to reflect reductions in the market value of their homes, as well as settling some credit card debt for less than the amount owed, generally hasn't been viewed adversely.

Ethical lapses, failures of understanding, herd behavior, self-deception—all contributed to the financial crisis. In explaining some of the ethical lapses, an unnamed attendee of the Summit expressed the thought that in the past 20 years or so, moral ambivalence has increased. Things that used to be called corrupt are now cloaked in language that makes them seem acceptable. The attendee said, "We've lost the ability to discern what's really not right." Many problems would be avoided if people were less greedy for financial rewards and less gullible to accept a deal that really was too good to be true.

A working paper by Harvard Business School researchers Lisa Shu, Francesca Gino, and Max Bazerman concludes that a decision to break ethical rules reflects a degree of moral disengagement. The paper, titled "Was That Wrong?" shows that people are less willing to engage in dishonest or illicit behavior when they are made aware of ethical standards—for example, when they sign a code of conduct. The paper reports results from four experimental studies. Participants in the group that were asked to read an honor code before being presented with an ethical dilemma were significantly less likely to behave unethically. The authors suggest this means making employees adhere to an established code of conduct increases their awareness of moral stringency. Reinforcing ethical rules also ensures a greater adherence to ethical behavior. The authors found that participants were more willing to bend the rules and claim they didn't realize what they had done when the rules weren't presented clearly.

A roundtable report in *Time* magazine, "The Future of Capitalism," brought expressions from thought leaders. Arianna Huffington of the *Huffington Post* asserts that the founders of capitalism understood the need for a moral foundation, not selfishness. She said, "We need to recapture the principle that you do well, but in the process of doing well, you give back." She added, "What is fascinating is the agreement among serious economists that we're doing the wrong thing by trying to protect the Wall Street oligarchy. What's amazing is that we're not having enough of a populist outrage about that."

Time reported musician John Legend putting it this way: "I believe there is a role for the government to play in evening the playing field and investing in development. We need to invest in the future and invest in the global good. Capitalism is not just a free-for-all, every man for himself."

The Wall Street Journal in June 2009 summarized how important the federal government has become in the details of how American capitalism is working in the economy. The *Journal* points out that since the beginning of the financial crisis in the summer of 2008, the government has become the nation's biggest mortgage lender, with the resuscitated Federal Housing Administration (FHA) now financing mortgages with only a 3.5% down payment. The Federal Reserve is accumulating a huge portfolio of mortgage-backed securities. Buying them helped to push mortgage rates down and keep them low. If the Fed decides it needs to sell some to meet its monetary responsibilities, that action could meet political resistance because it would push interest rates up, with negative implications for economic growth.

While trying to be ethically neutral by avoiding picking winners and losers in its bailout efforts, the government has already guaranteed nearly $3 trillion in money-market mutual-fund assets; taken an equity stake in nearly 600 banks while others have been allowed to fail; supported the life insurance industry; lent more than $300 billion to some blue-chip companies but not others; and become a credit source for buyers of cars, tractors, and even weapons for hunting.

As an example of the latter, Cabela's, Inc., the large Nebraska-based retailer of hunting and camping gear, received nearly $400 million of federal financing to bolster its store-issued credit card operation. Another example is Deere & Co., the giant farm equipment company. Because it purchased a thrift institution years ago, it qualified last December for a government guarantee on $2 billion of its corporate debt. This would have given Deere a

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competitive advantage over its competitors, including Caterpillar. After prodding and lobbying, the Fed extended its lending facility to others in the industry with top credit ratings. Smaller and needier, less creditworthy companies continue to pay high interest rates. Taxpayers also find themselves holding the risks of significant ownership of General Motors Corporation and American International Group.

Unfortunately, no exit strategy seems to exist for the Federal Reserve's eventual need to soak up the staggeringly high quantity of banking reserves and other financial stimuli it has created through its various bailout programs. Further, the Fed needs to continue to buy portions of the increasing stream of Treasury borrowings caused by the government's fiscal deficit in order to keep interest rates at a politically desirable low level. For the same reason, foreign governments also need to continue to purchase large quantities of new Treasury debt offerings.

Josef Ackermann, chief executive of Deutsche Bank AG and an economist, says business has itself to blame for the government's heavier hand because it spawned problems it couldn't handle. "A trusted third party was needed—and I hate to say this as a market economist—and that was the state," he said on a recent visit to the U.S. "The pendulum will probably swing back to a larger role for the state than is sensible for long-term growth."

The real question is: Can the government act in a more ethical manner to manage the economy than the capitalistic marketplace? The answer may be "NO" in light of the increasing scope of "too big to fail" banks, with the result that moral hazard and potentially unethical behavior is probably increasing. **SF**

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