SPECIAL REPORT

THE CHANGING BALANCE BETWEEN BUSINESS AND GOVERNMENT*

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THE DILENSCHNEIDER GROUP, INC.

* A deck of the slide presentation Dr. Weidenbaum uses to underscore what follows is available upon request.

200 Park Avenue
New York, NY 10166
212-922-0900

Three First National Plaza
Chicago, IL 60602
312-553-0700

The recent announcement by the Treasury Department's "pay czar" that the government will place caps on the annual compensation of the 25 highest-paid senior executives of companies that received the biggest bailouts from U.S. taxpayers is only one of many indicators of the rapidly changing balance between business and government currently underway – a balance now heavily tilting towards the government.

It appears that the Federal Reserve is also planning to crack down on remuneration policies at scores of other financial institutions in a move to curb excessive risk-taking.

This may be just the beginning.

In the following paragraphs, we detail what is underway and planned in terms of major systemic changes in American life.

BACKGROUND

The level of intervention in the pay practices of Wall Street and the banking sector is, to be sure, unprecedented. The balance between business and government has, in fact, been moving radically in the direction of the government since the new administration took power. But shifts in both directions have been an American political reality from the founding of this nation when Alexander Hamilton, champion of business and a strong federal government, did battle with Thomas Jefferson, who favored agriculture and a smaller role for government.

In the modern era, during the depths of the Great Depression, FDR's New Deal readily triumphed over the traditional limited government philosophy of the Republican Party (under Harding, Coolidge, and Hoover) as did Lyndon Johnson's Great Society three decades later. Today, perhaps more so than any other time in recent U.S. history, after many decades of laissez-faire and deregulation under both Republican and Democratic administrations, the federal government is again aggressively challenging business as President Barack Obama moves ahead with his domestic agenda.

Starting with the $700 billion Emergency Economic Stabilization Act (TARP) passed in 2008 and the Consumer Product Safety and Improvement Act – both initiated under the outgoing Bush administration and further implemented by the new administration – came the Family Smoking Prevention and Tobacco Control Act, the Credit Card Accountability, Responsibility, and Disclosure Act, and the American Recovery and Reinvestment Act, also known as the $787 billion stimulus bill.

TARP also established the so-called Automotive Industry Financing Program that rescued Chrysler and GM. Although a number of TARP recipients have paid back their bailout funds (with interest) to avoid tough government oversight, Treasury Inspector General Neal Barofsky, in charge of overseeing TARP, has just issued a report indicating that most of the bailout money that went to hundreds of businesses may not be repaid.

All of this is a forerunner of the sweeping agenda of the Obama administration to expand federal control over business – not to mention the direct actions already taken, or proposed, by various key executive agencies and departments.

Already, the U.S. currently owns an estimated 80% of AIG, Freddie Mac, and Freddie Mae; 60% of GM; 34% of Citigroup; and 25% of Chrysler.

WHAT'S AHEAD

Pending bills focusing on such critical issues as the fiscal 2010 budget, financial regulatory reform, health care reform, and insurance industry reform plus key legislation now moving through Congress including the American Clean Energy and Security Act (passed by the House in June) and the Corporate and Financial Institution Compensation Fairness Act (passed by the House In July) add, or will add, dramatically to the power and influence of Washington over business.

At the same time, the Justice Department has announced a policy of vigorous enforcement of antitrust laws in sharp contrast to the Bush administration's basically hands-off approach. One inevitable by-product of this stepped-up federal activity, going back many decades, has been an astronomic rise in the staffing and cost of the government's many social and economic regulatory agencies.

Recent typical statements by two key Obama officials underscore the underlying philosophy (which some have labeled "bureaucratic imperialism") behind the administration's policy-making:

> Secretary of the Interior Ken Salazar: "I want to transform this department from what was perceived as a Department of the West to a Department of all America. Together, we will change the world as we oversee the Department of the Interior's responsibilities across all 50 states, the territories, and the oceans."
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> Assistant Attorney-General for Antitrust Christine Varney: "Antitrust must be among the frontline issues in the government's broadest response to the distressed economy. Antitrust authorities are now key members of the government's recovery team."

EXPECTATIONS ON TAXES AND REGULATIONS

In the area of tax policy, major new tax burdens loom for American business. For international trade and investment alone, it's estimated that Federal taxes will increase by some $210 billion over the next decade. Meanwhile, jettisoning LIFO (last in, first out) accounting methods, as planned, will probably boost business taxes by yet another $61 billion over the decade. And to this, add the $31 billion that will be lost by removing oil and gas company tax preferences plus the considerable burden of re-imposing four previously eliminated, costly environmental taxes.

Expect a new era of strong regulation and enforcement reflecting a series of major financial reforms – all tipping the balance heavily in the direction of government dominion.

These include: 1) new Fed powers to combat "systemic risk"; 2) a new Financial Services Oversight Council; 3) a new Office of National Insurance; 4} a new requirement for hedge funds and private equity pools, their advisers, and credit rating agencies to register with the Securities and Exchange Commission (SEC); 5) new powers to regulate derivatives for the Commodity Futures Trading Commission (CFTC); 6) a new Consumer Financial Protection Agency; 7) new authority for the Federal Deposit Insurance Corporation (FDIC) over failing financial institutions; and 8) a new National Bank Supervisor for all federally-chartered commercial banks.

SOME DISQUIETING EXAMPLES

Consider, for example, the many strings the government (both the executive and legislative branches) has attached to its auto industry bailouts. Creation of this new type of government-dependent enterprise will, inevitably, shift major management attention to Washington and make management much more responsive to political influences.

Specific restrictions have already been placed on importing fuel-efficient automobiles that GM and Chrysler produce overseas. Congressional pressures have also been exerted to influence plant closings and dealer terminations. In selling Opel in Europe, GM reportedly was instructed to require the new owner to avoid doing business in both the U.S. and China. One can anticipate that the bailed-out auto companies will be strongly pressured to acquiesce to expensive new environmental and energy policies.

Taking a longer view of significant government intervention in the private sector, it's instructive to look at the history of the U.S. Post Office, which, while running huge deficits, has also been undermined by Congressional interference in its labor relations and operating decisions.

Another historical case in point is the once-powerful Reconstruction Finance Corporation, created in 1932 and finally shut down in 1953 in the wake of numerous scandals and charges of favoritism.

Two of the more egregious on-going examples of seriously under-performing, government-involved industries are the merchant marine and military contracting sectors -- both characterized by excessive levels of federal financial intervention and tough regulations.

Shipping is a heavily subsidized, credit-assisted, taxed industry with resulting very high operating outlays and numerous competitive barriers imposed by legislation such as the 89-year-old Jones Act protecting the rights of injured seamen. We have a maritime industry that cannot compete against other nations' shipping fleets. Foreign ships, free of costly regulation, now dominate international trade. It is an unhappy fact that no commercial vessel designed for global trade has been built in the U.S. for over a decade.

Stealth Regulations

About private manufacturers of military equipment, one journalist covering the sector defined it as an industry "where Franz Kafka meets Alice in Wonderland." To this day, stealth bureaucratic regulations accompany all contract awards, requiring, literally, thousands of pages of procurement regulations and hundreds of pages of standard, mandatory contract clauses.

Government reviewers even occupy permanent offices at many military contracting companies deciding what activities can be sub-contracted; what firms can be used as sub-contractors; which components can be imported; and what internal financial reporting can be used. Only so-called "allowable" costs can be charged to a contract. Those costs can cover everything from overtime and black-and-white advertisements to interest on capital, which is disallowed.

What we see in military contracting is intrusive, super-detailed regulation without an independent regulatory agency or an authorizing statute. The inevitable result is a sector with very substantial and consistent cost overruns. Seventy percent of the largest weapons programs were over-budget in 2008 with total overruns accounting for no less than $296 billions in taxpayer money.

Additionally, most programs were behind schedule an average of 22 months in 2008. Not a pretty picture!

Quite obviously, the balance between business and government today heavily favors the government, which controls a steadily rising share of the capital generated by society while simultaneously discouraging the generation of mew capital thanks to its tax, regulatory and credit policies including the subsidization of housing, traditionally the least productive sector of the broad economy.

IMPLICATIONS FOR BUSINESS

The political results of dramatically increased government intervention in the business sector may be a reduction in income inequality across the board, but at the cost of greatly enlarged overall government power in society. Unfortunately, when government becomes deeply embedded in business decision-making, management, counter-productively, moves major attention to its representation in Washington. The likely economic results will be a deterioration in business productivity and competitiveness; an adverse impact on national living standards; and a significant loss of investment funds and managerial talent to Asia.