

# Governance Responses to the Economic Crisis in the United States\*

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**Abstract:** The economic crisis that began in 2008 struck the United States harder than many other countries. The responses to that crisis have to some extent reinforced patterns of policy making in the United States, but in other cases have been marked departures from the liberal traditions of American governance. This paper details the patterns of response in the United States and discusses the implications for future governance.

**Keywords:** economic crisis, governance, institutions

The economic crisis that began in 2008 affected the United States more extensively than it did many other industrialized democracies, and the effects of that crisis also appear to be lingering longer there than in many other countries. The extremely risky banking and insurance practices that helped fuel a major economic boom for some years before the crisis proved to have created a massive bubble. That bubble burst, as they all do, and created numerous problems for citizens and businesses. Bankruptcies, foreclosures, and unemployment quickly followed in the wake of the collapse of Lehman Brothers and the recognition of just how much bad debt had accumulated in the financial system.

As well as presenting significant problems for the private sector, the economic crisis raised a number of problems for the public sector. Many of these problems were simply about money, and the need to support the private sector with public money in order to prevent greater decline of the economy. The huge amounts of money that went into the banking and insurance industry, and then into the automobile industry, were funded by borrowing and created a significant increase in the already substantial public deficit. These extensive public policy reactions began under the administration of George W.

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Bush and continued and were increased by the incoming Obama administration.

The government responses were massive in financial terms, although when deflated were not much larger than some previous interventions in the economy. But the structural transformations of the governance system may well have been of greater significance than the number of dollars borrowed or spent. As will be described below, the federal government has considered a number of significant transformations of the relationships among actors involved in economic management. Likewise, the federal programs that have been adopted have exerted a substantial influence over the relationship between the federal government and the states. Public spending has been a major instrument in altering the federal bargain in the United States (and other federal systems), and spending in this current crisis has been a part of that change.

Although the economic crisis has been more significant in the United States than in most other countries, to some extent the reactions have not been proportionate. Most Americans, both political leaders and average citizens, however, believe that there have been immense and even fundamental transformations of the system of governance. Shock at the large-scale downturn in the economy prevented any significant reactions to initial efforts to ameliorate the crisis, to the extent that some of the implications did not appear to be internalized well. As the magnitude of public expenditure involved in the bailouts and in support for the banks has become more apparent, there has been growing public concern and dismay.

The amount of money involved in the federal government's recent bailout programs is indeed massive. Likewise, the direct intervention of the federal government, using this money, in the management of the productive economy has been significant, and seems to represent a marked deviation from the usual pattern of American governing. By buying portions of General Motors and AIG, and by taking stakes in a number of major banks, the federal government came closer to nationalizing industries than at any time since World War II.

That said, the federal government did not exercise the power that it might with its involvement with the various industries. Newspapers have published numerous editorials about the need for the federal government to use its powers in the boardroom, but until now government has not taken that more extreme step, despite a number of interventions that already appear extreme to many citizens. The federal government has to some extent become situated between the need to influence the economy and the tradition of minimal federal intervention in the economy.

This apparent contradiction demonstrates a good deal about the political culture of the United States and also about the institutional structure of American politics. Producing real change in the American political system, even when faced with a major crisis, is difficult. Further, even if there are temporary transformations of the patterns

of governance, the institutional system has a good deal of resistance to change and may revert to type as soon as the crisis is over. Indeed, there is some evidence of a return to some of the earlier patterns of governing although the crisis is hardly over, indicating the usual pattern of path dependence noted for most governments. Finally, this failure to produce more effective change in the system is a reflection of the partisan gridlock in American politics and the difficulties in creating any sort of consensus about public policies (Brady and Volden 2005).

## **GOVERNANCE FAILURES**

A good portion of the responsibility for the current economic crisis could be laid at the doorstep of government, especially the federal government. This paper refers to governance failures in which the design of institutions and procedures to regulate the economy and society have proven inadequate for the complexity of the challenge. These failures manifested themselves at one time, but they developed over several decades and represent the gradual deterioration of state capacity for control (Painter and Pierre 2008).

Although the Bush administration was generally associated with weakening regulation of the private sector, one of the major regulatory problems that facilitated the crisis was a product of the Clinton administration. In particular, in the mid 1990s the long-standing federal law preventing banks from engaging in nonbanking financial transactions, such as brokering stocks and bonds, was repealed. This also meant that specialized investment banks and ordinary banks could merge to create unified financial service firms. This consolidation of activities may have been desirable for these firms, but it exposed ordinary citizens to much greater risk as their checking accounts were now to some extent linked with risky hedge funds.

The other major governance failure during this time, and perhaps more strongly during the Bush administration, was the failure of the regulatory regime to keep pace with the continuing transformations of the financial instruments bought and sold in the market. At the most fundamental level, the subprime mortgage lending industry grew with almost no regulation from the federal government or from the states. This lack of regulation affected not only the people who purchased these loans but also the investors who bought the derivatives and credit swaps that were based on them.<sup>1</sup>

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1. Subprime mortgages were home loans sold to buyers offering below-prime interest rates, at least for the first several years. After that time, either the rates increased or a large "balloon" payment was required or both. Typically these loans required little or no down

Therefore, when these loans began to go bad, the entire financial structure was undermined because of the many other instruments that were based on them.

In addition to the specific governance failures manifested during the Clinton and Bush years, some more general aspects of American government can also be associated with the broader governance failures that helped precipitate the economic crisis. One of the most important of these has been the fragmentation of government in the United States. In particular, the fragmented regulatory structure appears to be poorly matched to the increasingly integrated financial sector that it regulates. The financial sector is regulated at the federal level by the Securities and Exchange Commission, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Department of the Treasury, and the Department of Justice. There is also a certain amount of financial regulation at the state level, with differences across states. The absence of a coherent regulatory framework almost certainly contributed to the development of the economic crisis.

Individual financial regulatory agencies also have substantial internal fragmentation that may limit their capacity. Although not directly a cause of the financial meltdown, Bernard Madoff's disastrous Ponzi scheme is a clear example of this problem. It was not caught by the Securities and Exchange Commission, even though its staff had all the information they needed to detect the fraud. Different parts of the puzzle were held by a number of divisions within the main office, as well as in two regional offices, but they never shared the information (SEC 2009).<sup>2</sup> The tendency of organizations (or departments within organizations) to hoard information is hardly a new phenomenon (Stinchcombe 1990), but it appears to have had a significant impact on governance failures.

In short, regulatory failures, along with more general governance failures, had been accumulating within the U.S. federal government for some time. These failures might have remained benign for many years, but the numerous changes within the economic sector itself exposed them. These problems were at the heart of the economic crisis and are also at the heart of the more recent attempts to reform economic governance and to revitalize U.S. economic regulatory programs. Although these have been major

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payment, unlike conventional mortgages. They were sold primarily to first-time buyers who did not have sufficient credit to purchase a conventional mortgage, and were premised on house values continuing to increase rapidly so that when the rates changed there would be sufficient equity in the house to extract for the payments. When house prices did not rise, this house of cards began to collapse.

2. This is analogous to the intelligence failures that were associated with the attacks of September 11, 2001. In this case it was separate divisions of the same office, as well as different regional offices.

governance failures, they also represent opportunities for government to respond favorably and to produce more effective governance (Khadamian 2009).

## **GOVERNANCE RESPONSES IN THE UNITED STATES**

The initial responses of the American government to the economic crisis occurred toward the end of the Bush administration. When it became evident in the fall of 2008 that the collapse of several major financial institutions was possible, the administration began to consider its options and the implications of the collapse for national economic policy and institutions. The Bush administration, which was receiving the lowest approval records for any American president in history, was thus confronted with a major challenge while having very little legitimacy with the public. Nevertheless, the federal government proceeded with a seemingly bold plan to attempt to stem the decline.

From a policy perspective, the federal government's response to the crisis has involved a range of instruments and strategic choices. Perhaps the most noticeable aspect of these choices has been the shift away from indirect regulatory instruments toward much more direct government interventions. Unlike many shifts in governance over the past several decades, the change here has been away from softer instruments toward more intrusive ones. Further, it has reversed a long movement away from a strong central state and returned to a stronger role for the central government.

### **PUBLIC INVESTMENT IN, AND LOANS TO, PRIVATE FIRMS**

In the context of American political traditions, the most remarkable aspect of public sector intervention in the economy has been the government's purchase of large parts of major corporations. In the past, the federal government had either created its own public corporations (for example, the Tennessee Valley Authority) or propped up failing firms with loans (for example, Chrysler). In this crisis, however, the federal government bought large blocks of stock in General Motors, AIG, and several banks. There were also a number of major loans to banks, but these were less remarkable.

In the first instance, the Treasury purchased preferred stock in several government-sponsored enterprises that were in serious danger of going bankrupt. These were the mortgage lenders Fannie Mae and Freddie Mac,<sup>3</sup> which as crucial elements in the sec-

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3. Fannie Mae is the Federal National Mortgage Association, and Freddie Mac is the Federal Home Loan Mortgage Corporation. They both provide liquidity for private lenders in order

ondary mortgage market were important for attempting to maintain liquidity in the mortgage market. The housing market is central to the entire economy, and the numerous problems associated with subprime lending made support for the housing market all the more important.

This purchase of stock was a significant departure from the norm of economic management in American government, but in some ways the shift was not so remarkable. In particular, these purchases were conceptualized as short term, with the intention that the firms would as soon as possible be returned to fully private control. Further, despite numerous criticisms, the federal government did not become involved in the management of the firms in any significant manner. Owning the stock might be seen to give the government a seat or two in the boardroom, but it eschewed taking those positions in favor of providing direction indirectly and maintaining the appearance of separation between government and the private sector.

Although the initial outlay of funds was substantial, there is already some evidence that it may not only have propped up the firms but may also have generated some profits for the federal government. This positive outcome was not really anticipated when the decisions were made, although the programs were designed so that this would be possible. In addition, the programs were designed so that the firms involved had incentives to repay their loans and to get the federal government out of their business as soon as possible.<sup>4</sup> The problem from a policy perspective has been that there was no regulatory program in place to control these organizations (especially the banks) once the money was repaid.

In summary, the level of involvement of the federal government in private firms since the economic crisis began has been unprecedented. There were a number of earlier instances of the federal government lending money to the private sector, but this direct involvement has been exceptional. That said, this remained an arm's-length involvement so that statements about the meddling of government in management could be kept to a minimum.

## PUBLIC SPENDING

The problems of deficit and debt associated with the bailout of the economy and the stimulus package are obvious. These problems help, however, to make apparent a

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to maintain the capacity to offer mortgages to would-be home owners.

4. In particular, the compensation to top executives was more limited while companies were in receipt of the federal funds.

more fundamental problem of governance: the incapacity of American government for the past decade to control public expenditure and to manage an effective political economy. President Clinton was able to run a balanced budget for several years and to impose some limits on public expenditure (Shick and LoStracco 2000). The balanced budget was not his success alone; Congress cooperated in restraining expenditure and not reducing taxation.

The Bush administration was perhaps the most disastrous for public budgeting in the United States. Despite the War on Terror and the Iraq and Afghanistan wars, this administration passed a massive tax reduction, apparently in the vain hope that economic growth would produce sufficient tax revenues even at the lower rates. That did not, of course, materialize, and the largest deficits since World War II (relative to GDP) were the result. Other policy initiatives aimed at reducing expenditure (such as privatizing Social Security) were not successful, and the high deficits persisted.

This failure of fiscal probity during the Bush years was not a result of his actions alone, but required the active involvement of Congress. In terms of governance issues, the role of Congress was perhaps more egregious, given that a significant amount of the spending that continued was done through earmarked expenditures that benefited individual legislators' constituencies rather than serving a broader public purpose. American government has had a continuing problem with the private use of public power (Lowi 1979), but this problem appears to have grown over the past several decades.

This and other governance problems partially reflect the increasing polarization of American politics and the difficulties in reaching the consensus needed for stable and effective governing (Peters 2005). For example, part of the logic for the tax cuts for some Congressional Republicans was to "starve the beast"—to deny the government adequate funds to govern effectively (McCaffrey 2008). The dominance of ideology over the real governance needs of the American political system has produced a continuing problem for politics in the United States and its government and threatens to undermine governing effectiveness even more than it did in the past.

One may hope that the governance failures outlined here might lead to a more cooperative form of governance. That hope seems largely unfulfilled at present, given the lack of cooperation between the parties on efforts to recover from the economic crisis. In most Congressional votes since President Obama took office and the Democrats took control of Congress, there have been few if any Republican votes in favor of the President's proposals, even though the policies being considered were very similar to those implemented by the Republican Bush administration. To some extent, ideology and partisanship appear to have become more important than problem-solving in defining the responses of the U.S. federal government to the economic crisis.

## INSTITUTIONAL CHANGE

As noted earlier, fragmentation of policy making and regulation has been a significant factor contributing to the economic crisis. Even if there had been adequate regulation of the financial sector, as there was not, it might have still been ineffective given the difficulties in having the regulators work together. This problem is long-standing but has become increasingly unviable given the integration and complexity of the financial sector. This lack of integration has caused problems both in monitoring financial institutions and in designing policies to regulate them.

Almost from the outset of the crisis, economic policy making in the United States became increasingly centralized. In the Bush administration, the secretary of the Treasury became the point man on economic policy and attempted to pull together the various strands of governing. The Federal Reserve System became, and has remained, a central actor in this effort. In institutional terms, this is important because, legally and in practice, the Federal Reserve has maintained a politically independent stance. Its purpose is to provide an independent monetary authority that can ignore political pressures and make decisions based entirely on economic criteria.

As economic policy making has evolved during the past year, the Federal Reserve and its chairman have become central actors in the policy process, even though the president remains in control of the policy. This is another significant transformation of the arrangements for governing the American economy. Indeed, part of the centralization of the policy process in response to the economic crisis has been to increase presidential involvement in economic policy. In the United States there has always been a troika (the director of the Office of Management and Budget, the chair of the Council of Economic Advisors, and the secretary of the Treasury), or a troika plus one (the chair of the Federal Reserve), advising the president on economic policy, and now the latter is becoming more and more important.

As well as emphasizing the role of senior officials in governing the economy, the crisis also led to the creation of a number of “czars” responsible for one or another aspect of the crisis, such as overseeing the program subsidizing the purchase of new automobiles. These officials represent a significant departure from using agencies as the means of implementing programs and focus accountability on the individual. This strategy also tends to minimize the control of Congress over the programs and alters the distribution of powers within the federal government.



## **INTERNATIONAL COOPERATION**

The large-scale international involvement of the United States was another feature of the response of the federal government to the economic crisis. Although globalization is as real for the United States as for the remainder of the world, federal policy has not always reflected that reality. However, there have been attempts almost from the beginning of the current economic crisis to coordinate policies with the other major industrial countries. This coordination was evident even during the Bush administration, which until then had adopted largely unilateralist positions on most aspects of foreign policy.

With the Obama administration, the international dimension of the response to the economic crisis has been accentuated. There have been numerous efforts to coordinate policy responses with trading partners and to find common solutions to the problems. These efforts have not been without their difficulties, largely because of fundamentally different approaches to the role of government in the economy. Despite those differences, some common solutions have been possible, and the degree of policy linkage among countries has increased to attempt to counter the problems produced by the linkages of their economies.

The G-20 summit in Pittsburgh in September 2009 represented an institutionalization of continuing cooperation among the major economies in managing their reactions to the crisis and, with good fortune, perhaps preventing a recurrence. Cooperation on economic policy is hardly new for the countries of the European Union, but it is a significant change for the United States. If this process of cooperation does continue, then the long-standing autonomy of U.S. economic policy may be reversed. Politically, this perceived loss of autonomy for the United States will not be acceptable to many citizens, especially conservatives in the Republican party.

## **FEDERALISM**

One of the less obvious consequences of increased federal involvement in the economy is some further centralization in the federal system of government in the United States. The federal stimulus package was yet another federal grant program that had strings attached and that has had the consequence of moving greater power to Washington. This centralization has been the general pattern over at least the last half century (Zimmerman 2008), but the stimulus package certainly continued the trend. It did not permit the states to make their own decisions about how to spend the money.

The strings attached to stimulus funds caused at least six southern governors to

refuse, if only for a limited time in most cases, to accept them. Funds offered to the states were directed primarily to education, social services, and to some extent public works. This is, of course, just the package of programs that ideological conservatives oppose, and the governors who objected to the arrangement wanted the money simply to be given to the states as a general-purpose grant. As well as maintaining accountability, the funding was designed this way because these purposes would place the money into circulation most quickly.

Conflicts over the use of federal funds have intensified since the financial crisis began. In particular, the health care debate in 2010 has produced efforts on the part of at least 19 states to nullify the federal law. The governance failures of the fiscal crisis appears to have created increasing distrust in the capacity of government to provide effective governance.

## SUMMARY AND CONCLUSIONS

The economic crisis might have been expected to provoke a major response by the American government. At a superficial level, there have been a number of changes in government and in its programs. Perhaps the most important of these changes have been the institutional changes, both those that have been implemented and those that are still being considered. Centralization of control over the economy is in part a natural political reaction to crisis, but in this case it also represents a more specific response to the fragmentation of regulations in the United States. Creating a more unified approach to regulating the economy may not rectify all the problems encountered in economic policy, but it may be a good start given the existing fragmentation in the system.

The other major change in economic policy has been the greater involvement of the federal government in private-sector organizations. By purchasing stock in a number of private enterprises and making major loans to others, the federal government made a greater financial intervention in the private economy than at any previous time. These loans are being repaid, with interest, so this may have been only a short-term intervention, as was planned. It may, however, have opened the way to a continuing active role for the federal government in the economy, which may become another continuing source of policy conflict between conservatives and liberals.

Although there have been numerous policy initiatives in response to the economic crisis, these responses may not have had a significant and continuous impact on governance in the United States. Even the more extreme manifestations of these responses may be short-lived, and they have not altered the country's basic political economy.

All governments have some level of path dependency, but this represents substantial persistence in the face of crisis. The institutional foundation of the United States has been sufficiently strong to maintain itself in these circumstances.

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