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Separation of Bank and State: The Bailout Meets Federal Budget Law

J.W. Verret

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By J.W. Verret*

“Many persons...are strongly opposed to the United States Bank on moral ground...and view with dismay its prodigious means of corruption; and shudder with abhorrence at the free and audacious use it has made of those means...”¹

William Leggett, Essays in Jacksonian Political Democracy, 1834

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 will argue that existing budget laws, and laws 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 TARP bailout. This perspective should

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¹ WILLIAM LEGGETT, DEMOCRATICK EDITORIALS: ESSAYS IN JACKSONIAN POLITICAL ECONOMY (1834)).
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 effectively 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 will argue 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 (for the most part 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 results 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, AIG, was also one of the larger 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 34% in exchange for the funds it injected into Citigroup. 600 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 both 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 sweetener as a lender of last resort, to encourage private firms to re-orient 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 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 obligations in 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. To the extent that the bailout will take the form of equity investment, or otherwise involve the sorts of strings that will indicate control, this article will show some changes in federal budget law, the national debt ceiling statute, and accounting 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 bailout. In itself that could be expected to limit the market

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distortions of bank policy as well as distortions on bank bond premiums premised on too-big-to-fail cushions.3

This article argues that the paradox of government ownership, and the government’s obligations flowing from that ownership, can be at least minimized in three unique ways. The three methods all center around the central principle that, much like private sector companies that use minority equity investments to control other companies, and much like the U.K. 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 federal budget, the national debt ceiling, and the financial statements of the United States. This methodology would permit the government to 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 three budget 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 if 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 is supported by both an unconflicted assessment of the government’s own accounting principles, as well as use of private sector accounting principles which hold force in this unique circumstance where the government is acting like a private sector investor.

Furthermore, the U.S. government should include the operations of TARP recipients in the federal budget process. In particular, it should eliminate tax payments owed by TARP recipients to the Treasury from current budget scoring under Congressional Budget Office Rules, and it should alter budget scoring as TARP recipients run up negative earnings. This would give Treasury and Congress a shared incentive to privatize bailout recipients.

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 requires a periodic vote of Congress to extend, and it 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 helps to limit the log-rolling phenomenon examined in the public choice literature that takes place in budget votes. Furthermore, the periodic vote on the debt ceiling is subject to filibuster, to which the annual budget resolution is

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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 they can be hard fought even though 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 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 and delay, likely by a long period of time, 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, although the author’s work with various members of Congress suggests that they are possible. Even if they are implemented, they may not fully minimize the costs of government ownership in private sectors entities described in this article. The budgetary policy 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 a mere $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

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 Treasury’s purchasing equity in troubled banks under the Troubled Assets Relief Program (“TARP”). In order to execute its mandate under the Emergency Economic Stabilization Act (“EESA”) to ensure the health of the nation’s banking system, the Treasury Department purchased controlling interests in hundreds of the nation’s largest banks, GM and Chrysler, as well as the insurance conglomerate American International Group (“AIG”) and GMAC, the financing arm of General Motors.4 Under the Making Home Affordable Program, 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.5

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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. That plan was quickly shelved, and the Treasury Department immediately began a number of different programs. As part of that bailout, Treasury took preferred equity in TARP recipients, and subsequently initiated a plan to convert those non-voting preferred shares into shares convertible into voting common equity. Treasury’s initial experiment in holding common equity took place at Citigroup, in which it took a controlling 34% voting stake.

The automotive industry also subsequently garnered TARP support when, in December, 2008, 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. The Obama Administration rejected the initial proposals and instead created the Automotive Task Force to negotiate a new viability plan and later manage the equity investments the government took in those companies.

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 Treasury. Treasury’s net investment in GM and Chrysler totaled $79 billion, and investments in Citigroup stood at $50 billion. 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 Treasury under the TARP as of September 30, 2009. As such, this paper will focus particular attention on those four companies. This paper will also analyze Fannie Mae and Freddie Mac in conjunction with TARP recipients even though technically their conservatorship preceded TARP.

The Government’s Control Through TARP

A substantial line of authority supports the proposition that either the power to control a company or actual exercise of control is sufficient. In In re Walston and Co, 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 option to acquire stock. This was despite the fact that the creditor did not participate in the actual management of the business and held no actual stock. 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 also supports the notion the percentage of stock ownership is not alone determinative. 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.

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, 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 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 capacities of the companies, challenged the companies to look forward, and created models of ‘potential enterprise value.’” The Auto Task force was an especially active participant in the proceedings that saw replacement of the CEO and half of the board of directors, bankruptcy filings, debtor-in-possession financing, and wholesale financial and business restructuring.

In AIG and GM, U.S. 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, justifies the description of the U.S. government as a dominant shareholder.

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12 A.A. Sommer, Jr., Who’s “in Control”—SEC, 21 BUS. LAW. 559, 564 (1966) (citing 7 S.E.C. 937(1940)) [hereinafter Sommer].
13 Sommer at 564 (citing 7 S.E.C. 937(1940)).
14 Id. at 565 (citing 154 F. Supp (S.D.N.Y 1957)).
16 The Congressional Oversight Panel, 111th Cong., Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Auto Industry 104 (Sep. 9, 2009).
17 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 SIGTARP’s Quarterly Report to Congress issued on October 21, 2009, 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; and TARP assets would cover the next $5 billion in losses, with FDIC ($10 billion) and the Federal Reserve bank of New York responsible for any remaining requirements.
In the case of AIG, a trusteeship model was formally implemented. By placing its investment in AIG under control of a separate Trust, the Federal Reserve has indicated that it does not control AIG. On January 16, 2009, the Federal Reserve Bank of New York, acting in consultation with the Treasury Department, entered into an agreement with three private individuals named as Trustees and placed the authority to vote the government’s shares in AIG in the hands of the Trustees.

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.” Section 2.04 (f) of the trusteeship agreement further states that “in 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.”

Two substantial reports released by GAO discuss the U.S. shareholding in AIG and in the auto companies. Regarding federal government oversight of AIG, 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.” The Federal Reserve and the Federal Reserve Bank of New York (FRBNY) have 20-25 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. 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. Instead of reflecting a hands-off approach to governance, however, the GAO found that Treasury and the FRBNY “continue to have their own relationship [with AIG management] and conduct their own monitoring of AIG operations.”

On June 1, 2009, after Chrysler’s reorganization had been approved by a bankruptcy court, President Obama announced that the U.S. would be supporting a similar approach with General Motors and would be converting existing and new loans to both companies.

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20 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 regarding voting of AIG shares. AIG Trusteeship Agreement, supra note, at section 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.
21 Id. at section 2.04(b)
22 Id. at section 3.03(a).
24 Id.
into common equity. 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.” The Treasury Department’s statement on the GM Restructuring says that it intends to manage its investment in Citigroup in a “hands off, commercial manner.” 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, and yet there is no mechanism by which those principles can be enforced by a third party, nor are there any penalties for their violation.

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. For example, the TARP provisions allow Treasury to nominate two “preferred directors” to the board in the event that a TARP firm misses six consecutive quarterly dividend payments. Treasury’s preferred shares also retain the right to vote on any mergers or exchange activity and on new issuance of shares. 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.

Much of this paper will consider the implications of the government’s ownership in TARP recipients, Fannie Mae, Freddie Mac, and AIG together. As such, 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 may be examined separately.

III. Economic Theory and Evidence of Government-Owned Companies

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27 Id.
28 SIG TARP Report, supra note, at 111. Listing the following core principles in the Treasury’s White Paper, including to i)seek to dispose of its ownership interest as soon as practicable, ii) reserve the right to set upfront constraints to protect taxpayers, promote financial stability, and encourage growth, iii) protect the taxpayer’s investment by managing its ownership stake in a hands-off, commercial manner, iv) vote on core governance issues, including the selection of a company’s board of directors and major corporate events or transactions.
The final objective of this article will be 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 of 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.

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 outright nationalization. A government agency using shareholder power over private companies has two unique freedoms: i) the ability to bypass the administrative law process, the separation of powers and judicial review that constrain regulatory discretion, and instead simply require the board to initiate corporate policy changes favored by the Treasury, and ii) the ability to bypass the federal budget process, and transparency to the voters that work to constrain transfers to political interest groups, and instead require the bank to make those transfers in the form of increased lending and artificial interest rate caps entirely off the federal budget.

31 The consequences of moving the debt of private banks onto the public budget can be severe. For instance, when the U.K. moved the liabilities of two bailed-out banks in which it owns a control stake, 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 and Laurence Norman, Bank Bailouts, Sinking Revenue Fray U.K.’s Ledger, WALL ST. J., Feb. 20, 2009, at A10.
32 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%. Steven M. Davidoff and David Zaring, Government by Deal, at 24 available at http://ssrn.com/abstract=1306342.24 Davidoff and Zaring offer four reasons which may have informed the decision to leave some equity outstanding: 1) support Treasury’s position that it did not have to consolidate the GSEs onto the federal budget, 2) keep the GSEs from having to adopt government accounting rules, 3) permit 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) keep the government from becoming liable for the GSEs retirement liabilities. Id. at 25. 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 Hagerty and Joann 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
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 paper. Another distinct concern in this context are the distortionary 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 paper will analyze how to use laws governing the Federal Budget Process, laws limiting the National Debt, and Government Accounting Principles to achieve three goals i) present a more accurate picture of the government’s obligations to users of government financial reports and ii) 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 iii) 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 aren’t 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.33 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 monotone however, and changes as the relative tradeoff, facing the large shareholder, between extracting private value and losing their proportional value invested in the firm changes for shareholders with larger percentage ownership.34 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 to lower agency costs in oversight of firm managers.35 The unique incentives facing government ownership in the circumstances

35 For the argument that the incentives to extract private value are the more powerful incentive for large shareholder, See Sanford J. Grossman and Oliver Hart, One-share, one-vote, and the market for corporate control, 20 J. of Fin. Econ. 175-202 (1988). See also Andrei Shleifer and Robert W. Vishny, A Survey of Corporate Governance, 52 J. of Fin. 737-783 (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 Bebchuk, Reinier Kraakman, and George Triantis, Stock pyramids, cross-ownership, and dual class equity: The creation and agency costs of separating control from cash flow rights, in CONCENTRATED CORPORATE OWNERSHIP (Randall K Morck ed., 2000).
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 in private companies.\(^{36}\) The United States however largely abandoned government investment in private companies after a significant period in the 1840 of explicit use of mixed enterprises as instruments of public policy.\(^{37}\) One of the reasons for the government’s interest in taking a controlling investment in private companies is to utilize that 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 paper, 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.\(^{38}\)

Alcian and Demsetz argue that firm ownership of productive assets offer 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.\(^{39}\) 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.\(^{40}\) Theory developed to appreciate the implications of

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\(^{37}\) *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. 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.

\(^{38}\) But the same dynamic has been studied in the related area of off-budget public sector 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, *Evaing Debt Limitations with Public Building Authorities: The Costly Subversion of State Constitutions*, 68 Yale L.J. 34 (1958). 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 AND THOMAS J. LORENZO, UNDERGROUND GOVERNMENT: THE OFF-BUDGET PUBLIC SECTOR (Cato Institute, Washington D.C., 1983).


\(^{40}\) One of Alcian and Demand’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. Alcian and Demsetz, supra note , at 777.. The claimant with the right to residual earnings will have the best incentive to monitor team inputs to meter the marginal productivity of inputs to the team’s output. *Id.* at 782. But this requires an ability to discipline individual team members with the power to revise or terminate their contracts. *Id.* at 782. 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.
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?” Peltzman opens by noting that, initially government owners will 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. As such, government owners can be expected to use the pricing system to confer benefits on voters and interest groups. 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. 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 the government could through changes to tax and subsidy policy.

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 will also be muted. One pre-requisite to a shareholder’s ability to act as an efficient monitor is its ability to sell its bundle of rights, including interest in residual claims and right to monitor. This helps to create a market that, if liquid, can help to reveal the expected present market value of the team’s future production. But there are a few constraints which limit a government’s ability or interest in selling its investment, one of which would be its inability to continue to use the entity for off-budget transfers if it sold its investment. That’s 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, the pressures that will limit that option for other firms, particularly those like Citigroup and 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 in private firms that limits the ability to ever actually privatize the firm is that it can represent a shift in institutional design in mid stream. 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

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42 Peltzman, *supra* note, at 112.
43 Peltzman, *supra* note, at 112.
45 Peltzman, *supra* note, at 120.
47 Alcian and Demsetz, *supra* note, at 783.
48 Peltzman, *supra* at 120.
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’s Department’s position on Fannie Mae is an example of how the government emphasizes the national interest mission of a private business. 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 it.

Another criticism for government owned firms is that the threat of bankruptcy or takeover, which would otherwise discipline management, is not present in government run firms. This criticism supplements the view that governments will re-orient the company’s objective from profit maximization to other goals like employment maximization. When the government’s interest is only partial many of these problems remain. One key reason for this is that governments tend to bailout firms in which they have an equity stake with greater frequency. 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 of Government Owned Firms**

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50 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. OF PUB. POL’Y, 270(July 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 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 is 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.


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. 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. One study uses comparisons across 36 countries to reveal that governments tend to lend more generously, compared to private banks, during election years. 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. This study also found that companies in certain political regions lend 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.

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54 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 and J. Harold Mulherin, The Government as Shareholder: A Case from the United States, 40 J.L. & ECON. 1 (Apr., 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. The comparison is limited, only 7 of the 17 had shares traded publicly at the time of seizure. Id. at 10. 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 Mulherin target to determine effect of government ownership on growth are American Potash, American Bosch, General Aniline and Film, Rohm & Haas, and Schering. One was an engine parts manufacturer, another was a commercial solvents manufacturer. The median number of employees as these firms was 2,810. Id. at 10. By contrast, the median number of employees at 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 Mulhern inquiry. The unique thing about both the banking and automotive industries is that they serve as a 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 challenge from the bank.


58 Other studies have shown that state owned banks held more heavily, by a factor of ten, to state and local governments. Sapienza has also found that government run banks in Italy lend at rates approximately 20 to 50 basis points lower than private banks. Id. The case of India’s bank nationalization is instructive. See Shawn A. Cole, Financial Development, Bank Ownership, and Growth. Or, Does Quantity Imply Quality? 23 (Harvard Business School Finance, Working Paper No. 09-002) available at http://ssrn.com/abstract=1158078. In 1980, India nationalized all private banks with a deposit base about Rs. 2 billion. Those banks were subject to direct control of the federal government, with the entire board of directors nominated by the ruling party. Between the nationalization of 1969 and 2000 there were twenty one private bank failures in India, Banarjee. Cole and Duflo found that during this time the cost to the government of making depositors in those banks whole was less than the cost of recapitalizing the public sector banks, after adjusting for scale. Abhijit V. Banerjee, Shawn Cole, and Esther Duflo, Banking Reform in India (June 2004), available at http://econ-www.mit.edu/files/779. The identified goal of the Indian nationalization was to increase the scope of banking and lending in rural areas. This rural focus was intended to benefit lower income groups, and by association the agriculture industry. The effect of the Indian nationalization was that nationalized banks grew more slowly than private banks in the 1990s, and
Other work directly compares the efficiency of government owned firms against private firms. Boardman and Vining point to a large body of literature which studies the efficiency of government owned firms verses private firms.\(^{59}\) They construct a model which 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.\(^{60}\) 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.\(^{61}\) 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.\(^{62}\)

Various studies on privatization of state owned enterprises offer a useful comparison for

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\(^{59}\) They note 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 vs. privately owned firms in more competitive environments.


\(^{60}\) Boardman and Vining, *supra* note , at 17

\(^{61}\) Boardman and Vining, *supra* note , at 23.

the costs of government ownership, particularly as many of those studies indicate that privatization makes state owned firms run more efficiently. 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 indicated 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 distortionary effects of government ownership. 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.

Direct nationalization offers more concrete control for the government. Unions are the stakeholder most likely to seek influence in a government owned firm. 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. Study of nationalization and privatization thus is useful in considering Treasury’s equity holdings, but the best analogy for the semi-nationalization created by the Treasury’s TARP

66 See Aaron Tornell, Privatizing the Privatized, in THE SECOND ROUND OF REFORMS 5 (A. Krueger ed., 2001) (see also as National Bureau of Economic Research Working Paper No. W7206), available at http://ssrn.com/abstract=202743. 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 the privatization, which would then create a constituency that would support market oriented policies and thereby increase the Conservatives’ chance of re-election. See Bernardo Bortolotti and Mara Faccio, Government Control of Privatized Firms, Review of Financial Studies 15 (ECGI - Working Paper No. 40/2004), available at http://ssrn.com/abstract=536683. 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 U.S. 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 of profitable firms if the public budget is in severe stress. Id. at 18. 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 that privatization is more likely when the government is suffering from severe budget deficits. Alexander Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance, Bank of Finland Institute for Economies in Transition, 12 (BOFIT Discussion Paper No. 12/2002), available at http://ssrn.com/abstract=1015707. 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.
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. 67 Those governments’ residual holdings gave them the ability to also influence major corporate policy decisions. 68

It is also interesting to note that nearly two thirds of privatized firms in Europe during the great privatization wave of the 80s and 90s were characterized by this form of powerful residual government control. 69 This indicates that once banks have come under government control for the purposes of running them as enterprises, even if they can be later 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. 70 One study found that more fully privatized firms tended to be more profitable than those in which governments have powerful residual equity holdings, with Market to Book and Return on Equity ratios negatively correlated with a decreased level of privatization. 71

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. But two unique 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

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67 See Bortolotti and Faccio, supra note , at 1. See also, Getting Tough on Golden Shares, FINANCIAL 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. Though these shares represented minority positions in those firms, the ability to veto mergers gave state investors a powerful voice in the company’s decision-making.

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 i) the right to appoint members to corporate boards ii) the right to consent to or veto acquisition of interests in the privatized companies, and iii) other rights to consent to ordinary management changes. See Bortolotti and Faccio, supra note , at 10. Those European governments with the right to appoint directors frequently appointed government officials to the board. Id. at 12.

68 See Bortolotti and Faccio, supra note , at 1.

69 See Bortolotti and Faccio, supra note , at 3.

70 One might ask why constituents of the corporation would lobby for policies which may threaten the long term profitability, and by extension 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 do not know who they are ahead of time. And so, as an interest group, they are unable to organize to protect their interest.

71 See Bortolotti and Faccio, supra note , at 23.
were ignored by private markets due to the government’s backing, Fannie and Freddie were forbidden from filing financial statements with the SEC starting in 2003 due to revelations of earnings manipulations and accounting fraud. And yet, during the years that investors had no access to filed financial statements, their demand for Fannie and Freddie debt continued unabated.72 Fannie and Freddie were originally chartered by Congress as federal agencies, but 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.73 Members of Congress expected Fannie and Freddie to subsidize low income borrowers.74

The market for corporate debt imposes a certain discipline on a company’s management by requiring higher interest payments if it perceives a company’s business position as overly risky.75

Some argued that the best way to deal with the moral hazard problems of guaranteeing Fannie and Freddie debt was simply to increase regulation of the GSEs.76 And yet, as Chairman Greenspan observed at the time, increased regulation of an implicitly government guaranteed enterprise only enhances the market’s perception that the government is all the more willing to guarantee their debt.77 Indeed, prior to the revelations of accounting irregularities at the two GSE’s, its dedicated regulator performed the sort of inspections and audits typical of a financial regulator without uncovering any problems.78

In order to deal with these challenges, this paper will examine a new solution through using government financial statements, government budgetary laws governing the appropriations process, and the method of determining the statutory debt ceiling to counter the government’s incentives to use its investment in private companies to off-balance sheet subsidies. This solution will seek to achieve three goals: i) limit the government’s incentive to bail out troubled firms, particularly by methods that involve taking a controlling equity position ii) give the government an incentive to close out its

72 Wallison, supra note 5.
73 Wallison, supra note 2.
74 Wallison, supra note 3.
75 Wallison, supra note 4. When the government guarantees the private institution’s debt, however, this discipline is muted. The financial institution can continue to borrow money and invest it in riskier projects without a need to balance that against an increasing interest rate for the funds it borrow itself or a need to offer up more collateral for the debt. This is because private markets tend to regard U.S. backed private debt similarly to U.S. debt itself, and investors assume that Treasuries carry no risk of default. Thus government backed private debtors can continue to borrow at what are interest rates effectively subsidized by the federal guarantee. This was particularly true for Fannie and Freddie, even in spite of the fact that the government explicitly warned that it would not guarantee the GSE’s debt, though it eventually did so. Id. at 5. In effect, the markets called their bluff, and the markets ended up being right. When risk and reward are disjoined, incentives for well informed and prudent management of risk are abandoned. In Fannie and Freddie’s case, this took the form of improper hedging of interest rate risk. Id. at 8. The perverse incentives created by this government backing do not only impose costs on the guaranteed firms. They also enhance systemic risk within the financial system. Id. at 9.
76 Id. at 6.
77 Id. at 6.
78 Wallison, supra note 7.
position in bailed-out entities in which it ends up taking equity and iii) 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 in 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, RBS and Lloyd’s, by way of equity injections in much the same manner as the U.S. Yet the U.K. accounted for that bailout in a distinctly different manner from the United States. This article will look into the reasons for the U.K.’s approach as justification to argue against the current U.S. method of bailout accounting. Further, New Zealand recently undertook a wholly new method to account for its government owned corporations. As such, their policy shift will also be examined. That such closely analogous common law, advanced economy analogues would account for their bailouts so differently from the United States calls the current U.S. approach into question.

The United Kingdom took a 100% interest in Northern Rock, an 84% interest in Royal Bank of Scotland, and a 43% equity interest in Lloyds Banking Group. To purchase the RBS shares, HM Treasury reports having paid 46 billion pounds. It paid 23 billion pounds for its shares in Lloyds and 20 billion pounds for its ownership of Northern Rock. In November 2009, Treasury announced that future capital injections of up to 39 billion pounds were anticipated for the two banks.

Much like the U.S. approach, the British bank recapitalization took the form of capital injections in exchange for preferred stock. 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. 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. The ONS noted that the public financial sector corporations on the U.K.

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81 See NAO Report, supra note , at 44.
82 See July 2009 ONS Report, supra note , at 61.
83 Id.at 62.
84 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 July 2009 ONS Report, supra note , at 62. These estimates are used in the Maastricht Treaty measures to determine Financial Stability Pact compliance for eurozone
balance sheet would now include RBS, Lloyds, Northern Rock, and Bradford and Bingley. It estimated that the effect on public sector net debt would be an increase of 1.5 trillion pounds. This was roughly equivalent to 70-100% of the U.K. GDP.

In its decision to classify these four companies as public sector concerns, the ONS relied on European System of Accounts 1995 (ESA95), part of the body of rules which governs European Public Sector Accounting. That standard requires the U.K. to consolidate onto the national debt the debt of companies over which it exercises effective control. Listed as factors 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 Feb. 2008) were that, according to its agreement with the Bank of England, it had to obtain permission from the BOE before entering into a corporate restructuring, making substantial changes to the nature of the business, making dividend payments, and acquiring or disposing of certain types of assets. The ONS noted that as of 2008 the government’s ownership and rights to appoint directors made the classification question even more clear.

The U.K. Office for National Statistics determined that RBS and Lloyds, and their subsidiary companies, should be classified as public sector entities starting October 2008 based on its judgment that the government had the ability to control the banks’ general corporate policy through the conditions associated with the agreements related to the bank recapitalization of those banks. Those agreements included provisions including restrictions on the declaration and payment of dividends or distributions, restrictions on

members, and also used to measure Gross National Income to determine an EU members required contribution to the EU Budget. Id. at 4. The U.K. government also bases its fiscal policy objectives on the National Accounts Estimates promulgated by the ONS. Id.

See July 2009 ONS Report, supra note, at 1.

Id.

Id. at 5.

Id. at 5.

ESA 95 notes that control is the basis for consolidating private companies into the public sector, defining control as “the 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 directors.” July 2009 ONS Report, supra note, at 6. 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 is method for determining whether to consolidate partially government owned companies into the public sector balance sheet as “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 enables any part of the public sector to determine general corporate policy, either individually or collectively.” Id..

July 2009 ONS Report, supra note, at 15.


director pay, and obligations relating to lending. Even when Lloyds redeemed its preference shares from the government in June of 2009, and its dividend restrictions were lifted, the ONS still maintained its classification as a public sector entity for these purposes due to the other restrictions remaining in effect.

The factors on which the ONS relied in requiring consolidation of private bank debt into the U.K.’s debt largely mirror the restrictions include in the preferred shares and capital injection agreements of TARP recipients in the U.S. The ONS did note, however, that it would not consolidate the operations of RBS and Lloyd’s into the public sector current budget. This paper will argue that the U.S. should follow the U.K.’s lead in consolidating BOE debt into the national debt. It will also argue, however, that the U.S. should take a different approach from the U.K. and also consolidate BOE activities into the federal budget. In part, the disparity can be explained by the need to enhance checks and balances, a concern not present in the U.K.’s unitary parliamentary government.

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. 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 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 of the government’s assertion that it would not guarantee private firm debt, which would itself perhaps increase interest rates of sovereign debt. If this is true, it is a policy goal favored by the analysis in this article. Government’s tend to give added backing to bailed out entities, and consolidation would offer yet another incentive to the government not to bail out an entity in the first place.

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, where the Treasury would use the argument of consistency of reporting to mandate that the company adopt certain accounting policies, thus furthering government control over the company. 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 policies put into place by the government to limit its ability to direct management of state owned enterprises argued

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92 Id.
93 July 2009 ONS Report, supra note, at 78-79.
94 July 2009 ONS Report, supra note, at 72.
96 Newby, supra note, at 167.
97 Newby, supra note, at 139.
in favor of separating the two in financial reporting.\textsuperscript{98} Otherwise consolidating the two may provide an inappropriate means of monitoring the relationship between the government as investor and the business running under some measure of independence. These advocates instead argued for using the equity method to record the government’s ownership.\textsuperscript{99} 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 U.S. 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 New Zealand accounting standards board found that where a trust is guided by a fiduciary duty to the trust beneficiary, that beneficiary is likely in control of the assets held by the trust.\textsuperscript{100} 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 of the AIG Trust.

One of the distinctions found in the various areas of the law where shareholder control becomes operative relates to the question of whether the actual exercise of control is required, or whether merely having the potential, the power to control that has not yet been exercised is sufficient. In the New Zealand case, the government determined that the potential to control was sufficient to trigger control and require consolidation.\textsuperscript{101}

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 stand alone companies was whether to utilize the equity method or full consolidation.\textsuperscript{102} New Zealand decided in 2001 to abandon use of the equity method in favor of full consolidation for its government owned enterprises.\textsuperscript{103}

These two countries demonstrate the unique nature of the U.S. government’s approach to accounting for its holdings in BOEs. The debt and budget laws and systems governing the United States are unique, due in part to its three branch government system. Yet the U.S. government’s decision not to consolidate its holdings in any way is without precedent.

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” and “to borrow money on the credit of the United States.” In order to facilitate its legislative function of overseeing the debt, Congress passed the Debt Ceiling Statute. The debt limit statute is Congress’s way of fulfilling these two required

\textsuperscript{98} Newby, supra note , at 116
\textsuperscript{99} Newby, supra note , at 117.
\textsuperscript{100} Newby, supra note , at 177.
\textsuperscript{101} Newby, supra note , at 178.
\textsuperscript{102} Newby, supra note , at 85. The differences between those two methods of accounting for ownership in subsidiaries is described more fully in Section VII, Financial Statements of the United States.
\textsuperscript{103}, supra note , at 204.
Constitutional functions to oversee the borrowing and payment of the public debt. If government deficit spending requires borrowing about a specified debt limit, called the debt ceiling, Congress must enact a law to raise that ceiling. At present, the government’s debt ceiling statute states that “The 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 than $12,394,000,000,000, outstanding at one time, subject to changes periodically made in that amount as provided by law through the congressional budget process….”

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 the Administration return to Congress periodically to obtain authorization for additional borrowing. The list of items included in the referenced chapter does not enumerate debt issued by companies controlled by the United States Government. But this article will argue that it should include the debt held by companies which are controlled by the government.

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 beating that their stock price took.

Some have argued that properly estimating for government assets is just as important as government debt. For instance, accounting for changes in assets held by the government can give an appropriate estimate of tax reductions in the future. Even if that were the case, the valuation of assets of TARP banks may require some alternative to the existing methods, since mark to market accounting reforms were informed by political pressure from Congress and fed by concerns about market volatility rather than accurate financial reporting. 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. One policy reason not to net the debt against the assets of TARP recipients when consolidating them into the debt ceiling estimate is that is could leave the government with an incentive to keep some firms under government control, in the event that assets

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31 U.S.C.A. § 3101

Krishnakumar, supra note , at 136.

See Bebchuk & Spamann, supra note 3.

exceeded debt at those firms. From a constitutional perspective, the Federalist papers
evidence the founders’ fixation with paying off, and minimizing, debt held by the
government. Very little attention is paid to assets held by the United States. 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. 110

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 balance budget and budgetary reform legislation aimed to reduce the
size and growth of the national debt. 111 During the 1960s, Congress used votes over
increases in the debt ceiling to push for budgetary reform from executive branch. 112
Members of Congress felt the sting of the debt ceiling votes quite acutely, and were
subject to harsh criticism during re-election for votes to increase the debt ceiling. 113
Debt ceiling increases were frequently voted down as a result of this pressure. 114
Pressure was felt so acutely that, for a short period, the House passed the Gephart rule, which
automatically 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. 115

In 1985, a bi-partisan group of Representatives used the vote on the debt ceiling to push forward the
Gramm-Rudman-Hollings Deficit Reduction Act, which sought to control spending by
setting pre-determined budget deficit ceilings for the next 5 years. 116

In particular, during
the period from 1995 to 2001 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. 117

The proposed Balanced Budget Constitutional
Amendment from the 1990s would have also used the national debt ceiling as its

110 “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. 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. At the Convention, delegate Sherman urged that “The national debt & the want of power somewhere to
draw forth the National resources, are the great matters that press.” James Madison, Debates in the Federal Convention of 1787; H.Doc. No. 398 at 240, (1927).
111 See Krishnakumar, supra note , at 138.
112 Krishnakumar, supra note , at 152
113 Krishnakumar, supra note , at 153.
114 Krishnakumar, supra note , at 153 (citing H.R. 12641, 95th Cong. (1978) (vote to raise debt ceiling to
849 billion which was voted down 167-288)).
115 Id., at 153.
116 Id. at 155.
117 Id. at 156.
enforcement mechanism. One such iteration would have required a 3/5 vote of each house of Congress to approve an increase in the debt ceiling.

One of the results of consolidation would be to eliminate inter-entity balances for the duration of the consolidation. 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.

Krishnakum presents an interest group theory in support of the debt ceiling statute that is even more applicable in the case of controlled bank debt than in the more general case she analyzed. Krishnakumar builds her analysis on work by Posner, Arrow, and others arguing that decisions we 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 opportunity to vote on each individual item. Average citizens, whose interest is 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. Krishnakumar in part relies on Arrow’s theorem that decisions made my majority vote are not truly majoritarian because they are more a function of the rules governing presentation, debate, and the voting structure of policy choices. Krishnakumar also notes that party and Committee control of the budget process leads to logrolling in budget decisions, such that decisions about subsidies to individual interest groups 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 one 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.

The debt ceiling’s requirement that Congress hold a recorded vote to increase it periodically helps to 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 aren’t able to influence the budget process is because they don’t yet exist. Most of the generations of taxpayers who will eventually pay off the national debt through taxes aren’t yet born or aren’t yet old enough to vote. Even the generation of younger voters who may have an interest in the future deficit would be overpowered

118 Id. at 156.
120 Newby, supra 87, at 120.
121 See Krishnakumar, supra 96, at 161, citing footnotes 158 through 162.
123 See Krishnakumar, supra note , at n 159-162 (citing to Daniel A. Farber & Philip P. Frickey, The Jurisprudence of Public Choice, 65 TEX. L. REV. 873, 903 (1987)).
124 Krishnakumar, supra note , at n. 162 (citing Neal E. Devins, Budget Reform and the Balance of Powers, 31 WM. & MARY L. REV. 993, 994, 997 (1990)).
125 Krishnakumar, supra note , at 162.
by the more cogently formed interest groups with a stronger interest in government subsidies.

Evidence suggests that yes votes on the debt ceiling are used against incumbents in election campaigns, and evidence also suggests that members of Congress are reluctant to vote yes on the debt ceiling. Indeed, that concern was the purpose behind the Gephart Rule. The abolition of the Gephart rule was eventually the result of influence by centrist members who themselves were interested in using the disciplinary power of the debt ceiling vote to keep spending down. Krishnakumar also notes that debt ceiling votes fall under the authority of the Ways and Means Committee rather than the Budget Committee, which limits the influence of the parties on that vote.

Krishnakumar observes that the debt ceiling vote actually functions as an anti-log rolling vote. Individual interest groups lose their cohesion in lobbying for an increase in the debt ceiling, because none of them can link that overall vote to their particular spending increase from among the thousands of spending compromises that make up the budget process. 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. 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. Where they could link their own spending increase to supporting their cause, their support of runaway debt may 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.

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 of the cost of learning. 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. 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 DJIA just after their initial vote against it. One can expect future bailouts might be structured similarly to this one, since there will always be pressure to take equity in bailed out companies with the

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126 Krishnakumar, supra note, at 162.
128 Krishnakumar, supra note, at 167.
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 in which the decision of when to divest of equity is left to the executive branch, then 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 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 passed in clean form. Of the few debt ceiling votes that include substantial amendment, all of the rider amendments have directly related to the national debt, such as balanced budget provisions and the Gramm-Rudman-Hollings Act.

Critics of the debt ceiling argue that it risks perilous consequence if the President and Congress are not able to come to a consensus on the debt ceiling in that the U.S. may go into default on its debt obligations. Abramowicz argues that the debt limit statute is dangerous because it creates the threat that Congress will default on its debts, thereby giving Congress excess leverage in negotiations with the President. It is precisely this threat of serious consequence 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 also points out that, in the eighty six year history of the debt ceiling, the U.S. has never defaulted on its debt. 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. This however buys the administration only a small window of time. If however the Treasury Secretary had the option of divesting of its holdings in government controlled private businesses, it would...

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129 Id. at 172.
130 Id. at 173.
131 Id. at 175.
132 Michael Abramowicz, Beyond Balanced Budgets, Fourteenth Amendment Style, 33 TULSA L.J. 561, 579 (Winter1997).
133 Krishnakumar, supra note , at 175.
open a much larger window for Treasury to delay the required vote on the debt ceiling. In that way, it would encourage the government to divest of its interest. With the analysis in section I of this article about the costs of government ownership in private businesses and the limitation on government’s interest in divesting, the pressure of the debt ceiling can serve a useful function in limiting the costs of continued government ownership.

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 be helped by the rush of financial panic, and the timeline for the next debt ceiling vote would be brought substantially forward. There is a surplus of literature detailing the economic effects of government bailout on moral hazard, and one of the conclusions most commentators agree with is that governments have a hard time committing to not bailing out institutions, which itself leads institutions to take risks that ultimately pressure governments to later bail them out. Including the debt of bailed out institutions in the debt ceiling might, however, offer an element of credible commitment that could not only limit actual instances of government bailout but also the distortionary effects on market behavior that the potential for government bailout encourage, particularly in the financial services sector.

In addition, the debt ceiling statute serves as a backstop to the budget process, and helps to limits some of the weaknesses in budget laws. 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 over the budget process at the expense of diverse floor deliberation. There is also an important procedural difference between votes on the budget resolution, discussed in the next section, 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. This helps to buttress the procedural protection of the Senate that are 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 its corollary cloture process requiring 60

134 A related, but still distinct, argument concerns consolidation of the Social Security Trust Fund into the National Debt measure. Consolidation in this sphere is in part a question of making the financial statements more accurate depictions of the government’s liabilities, which is part of the policy debate in the social security consolidation question. Many economists explicitly ignore the trust funds in determining national debt, for instance, because the trust funds are currently run at surplus and reflect inter-government borrowing. Also, this notion implicates measurement of crowding out effects because it goes to the public/private spending distinction which is an implicit element of that debate. But in part the objective of my argument to consolidate is in discouraging government from taking controlling equity in private companies, which is not a standard part of the policy question in determining how to account for the social security trust. As such, arguments about consolidating the social security trust, though important, are distinct from the issue of consolidating government controlled corporations.


136 Krishnakumar, supra note , at 152.

137 See e.g. Martin B. Gold, SENATE PROCEDURE AND PRACTICE 144(Rowman and Littlefield Publishers Inc. 2004)
votes to proceed is one of the defining features of the Senate. In effect, highly contentious issues can require a 60 vote threshold for approval rather than a mere majority. That general rule is, however, subject to a number of exceptions. One of those exceptions in the Rules of the Senate is that budget resolutions and budget reconciliation amendments, and motions to proceed to consideration of those amendments, as well as questions of germaneness on appropriations amendments are all non-debatable. The result is that the filibuster does not operate for consideration of the budget and appropriations process. Another restraint imposed on typical Senate procedure is that rulings of the presiding officer on points of order relating to budget issues require a 60 vote majority to overturn, rather than the simple majority usually required. This also limits the ability of individual Senators to challenge Senate Leadership and enforce the unique deliberative process of the Senate.

VI. The Federal Budget Laws as Accountability Mechanisms

The Congressional Impoundment and Control Act of 1974 set the initial groundwork for the modern federal budget process. It requires Congress to adopt an annual budget resolution that sets revenue, spending, surplus or deficit, and debt totals among 20 categories of government activities. Congress relies on the Congressional Budget Office to offer the economic projections that underlie Congress’ Budget, and the President submits his own budget annually as well with the help of the White House Office of Management and Budget (OMB).

Article I, section 9 of the U.S. Constitution provides that “[n]o money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and account of Receipts and Expenditures of all public Money shall be published from time to time.” The budget process that fulfills this requirement is largely governed by the Congressional Budget and Impoundment Control Act of 1974 (The Budget Act) and supplement by the Balanced Budget and Emergency Deficit Control Act of 1985 (The Balanced Budget Act). These Acts amended internal rules of the House and Senate and set a framework for the ongoing budget negotiations that take place between the President, the Senate, and the Congress. The budget process serves two important functions. It aims to set an agreed metric for estimating government receipts, expenditures, debt, deficits, and surpluses within which contentious budget negotiations between the President, the Houses of Congress, and political parties can take place. The budget process also aims to provide an accurate and transparent measure of government spending so that economic actors can use that data to make predictions about the national economy.

139 Id. at 146.
141 Id. at 19.
142 Committee Report, supra note , at 11.
The Budget is adopted by concurrent resolution of both houses, which means it is not sent to the president for signature and thus not public law.\textsuperscript{143} It is nevertheless quite significant, as it does trigger a special regime of rules called fast track procedures that limit the reach of House and Senate Rules typically used to delay legislation.\textsuperscript{144} The Federal Budget is drawn up by the House and Senate Budget Committees using the President’s Budget Request, submitted by the Office of Management and Budget, reports from the CBO and reports from other Committees.\textsuperscript{145}

The Balanced Budget Act established maximum deficit amounts.\textsuperscript{146} If the deficit exceeds these statutory amounts, the Act required the President to issue a sequester order that would reduce all non-exempt federal spending by a uniform percentage. This requirement was subsequently superseded by the Budget Enforcement Act of 1990, which established two control mechanisms on spending: outright caps on discretionary spending and a pay-as-you-go requirement for direct spending and revenue legislation. Those provisions were set to expire in 2002.\textsuperscript{147}

The Balanced Budget Act also made significant changes to Senate procedure to require a three fifths vote, rather than a mere majority, to waive points of order. The effect of this change is that in the event budgetary caps or pay-go restrictions are still in effect, a three fifths vote would be required to waive the spending limit.\textsuperscript{148}

The Budget Act created the Congressional Budget Office (CBO) to serve as the scorekeeper for Congress by reviewing the annual economic forecast, formulating the baseline for budget projections expected assuming no change in spending, reviewing the President’s annual budget submission to Congress, scoring all spending reports from Committees and Congress in accordance with budget laws limiting the amounts Committees are permitted to appropriate, and preparing reports in compliance with the Unfunded Mandates Reform Act.\textsuperscript{149} CBO estimates are also important for how Congressional committees interact with each other. For instance, during most budget years Senate Committees will receive budget reconciliation instructions contained in the budget resolution passed by Congress in the form of directives to alter that Committee’s spending allocations such that spending by that Committee’s bills does not exceed a certain amount.\textsuperscript{150} Accurate CBO projections of the cost of Committee bills is vital to ensure the Committee conforms to the budget reconciliation instruction. The Executive branch also prepares a budget and financial statements. The President’s Budget describes

\textsuperscript{143} Id. at 11.
\textsuperscript{144} Id.
\textsuperscript{145} Id. at 12.
\textsuperscript{146} Id. at 9.
\textsuperscript{147} Committee Report, supra note, at 10.
\textsuperscript{148} Id. at 14.
\textsuperscript{149} Id. at 8.
\textsuperscript{150} See e.g. Martin B. Gold, SENATE PROCEDURE AND PRACTICE 144 (Rowman and Littlefield Publishers Inc. 2004) (“The Senate Committee on Finance shall report a reconciliation bill…that consists of changes in laws within its jurisdiction sufficient to reduce revenues by not more than…for the period of fiscals years 2003 through 2013”).
how the government spent and plans to spend the money it collects on a cash basis. 151 By contrast, the Financial Report of the United States Government is an accrual based statement used to show the cost of operations, the sources used to finance those costs, how much the Government owns and owes, and the outlook for social insurance programs. 152

The Budget Enforcement Act of 1990 established a budget control process that distinguishes between discretionary spending controlled by annual appropriations and direct spending controlled by substantive legislation. The BEA also gives the President the option of adjusting the maximum deficit amount in his budget report to Congress to account for changes in economic conditions. 153 The BEA includes three substantive budgetary enforcement mechanisms: adjustable deficit/surplus targets, discretionary spending caps, and pay-go rules. 154 In February of 2010 Congress voted to extend the BEA in a vote attached to the vote to extend the debt ceiling. 155 The new version of pay-go rules adopted include a number of exceptions including relating to the AMT, the estate tax and Medicare reimbursements to doctors. 156 Pay-go rules mandate that increases in direct spending or decreases in revenues so that the deficit is not increased or the surplus diminished. 157 In the event that OMB determines that pay-go has been violated, sequestration procedures go into effect which limits new spending on designated programs. 158 Scoring by the CBO is also used to determine whether a Committee has met instructions from the Budget Committee, or reconciliation instructions, to change laws to conform to provisions in the Budget. 159

The Budget Resolution considered by Congress is not a statute and does not have legal effect. 160 During some years, however, the Budget Resolution can be a powerful driver of eventual appropriations and debt legislation. The Appropriations Committee, and its various subcommittees, are generally bound by their proportionate authorized discretionary spending caps, found in the Budget Resolution, in considering legislation. 161 There are a number of accounting gimmicks that can be used to avoid the discretionary caps, although those gimmicks are not without limitation.

The Budget Enforcement Act provides a number of mechanisms to enforce budget rules. For instance, any member can raise a budget point of order to object to any amendment or piece of legislation on the grounds that it is not within the limits set out by the

152 Id. at 3.
153 Schick, supra note , at 23.
154 Schick, supra note , at 24.
156 Id.
157 Schick, supra 128, at 50.
158 Id. at 52.
159 Gold, supra note , at 145.
160 Schick, supra note , at 32
161 Id. at 34.
A budget point of order may be waived only by a 3/5 vote. Over the last 20 years, Congress has passed a variety of budget spending caps for short term periods, some of which firewall specific areas (i.e. defense spending caps, non-defense spending caps, highway spending caps, etc.). In 1994, Congress also enacted a pay-as-you-go rule in the Senate which would require that any spending causing an increase in the deficit from 1994 to 2004 require a 3/5 vote to waive pay-go rules. The pay go rules also can require the President, through OMB, to enforce a sequestration order to pay for any changes to programs which increase the deficit by an across the board reduction in non-exempt discretionary funding in the event that OMB determines that a spending provision violates a budgetary spending restriction. The original pay-go rule was set to sunset in 2002.

The EESA legislation provides a method for estimating the cost of TARP troubled asset purchases and troubled asset guarantees. This accounting method would not apply to AIG or to the GSEs however, but it would apply to the automotive companies and banks taking TARP money. It provides that the cost of TARP assets and guarantees will be estimated at cost and using an appropriate discount rate in accordance with Federal Credit Reform Act of 1990 (2 U.S.C. 661a(5)). For the purposes of pay-go rules, the EESA provides the mechanism for scoring on an emergency basis, which blunts the pay-go restriction.

In implementing the EESA’s directive to estimate cost of TARP for the federal budget on an at-cost basis in the investment securities, the Congressional Budget Office, the Treasury Department and the Office of Management and Budget took different views on how to arrive at the final estimates. Treasury recognized the TARP expenditure at cost, and took a significant hit to the budget deficit in the year in which it was distributed but expected that when banks repaid TARP funds they would be able to recognize a deficit reduction or perhaps even a surplus. The Congressional Budget Office, however, considered that because most TARP funds were expected to be repaid the equity investments in TARP recipients should be recorded on a capital basis with adjustment for the risk that some of it would not be repaid. As such, their estimate was that for every dollar expended on TARP the cost to the taxpayer was roughly 25 cents.

162 Committee Report, supra note , at 16.
163 Id. at 19.
164 Id. at 19.
165 Id. at 20.
167 See Emergency Economic Stabilization Act of 2008 ("EESA"), Pub L No 110-343, 122 Stat 3765 § 204(stating that “[a]ll provisions of this Act are designated as an emergency requirement and necessary to meet emergency needs pursuant to section 204(a) of S. Con. Res 21 (110th Congress), the concurrent resolution on the budget for fiscal year 2008 and rescissions of any amounts provided in this Act shall not be counted for purposes of budget enforcement.”).
government recouped an amount greater or less than that amount, CBO planned to later adjust that estimate. In 2009, the White House Office of Management and Budget took a still different approach, estimating that each dollar in expenditure would result in a cost of 3 cents to the taxpayer, hence the White House 2009 Budget included a $250 billion reserve for the $750 billion in authorized TARP expenditures. Though there are differences in the methods whereby the White House, Treasury Department, and CBO estimate the cost of TARP, we can see that they share a decision not the consolidate the operations of TARP recipients onto the federal budget and the statements of the United States.

Even if an at-cost estimate were appropriate for budgetary purposes at the time the EESA was under consideration, the EESA was not implemented in a manner consistent with its original intent. The EESA was intended to provide for a market based auction mechanism to facilitate private purchases of troubled assets. Immediately upon authorization of funding under the EESA, however, Secretary Paulson took an entirely different strategy, and using the nebulous definition of troubled asset he used most of the EESA authorization to fund injections of capital directly into TARP recipients in return for preferred equity that contained powerful covenants, which was later extended by Secretary Paulson to the autos and, in the case of Citigroup, converted into voting common equity.

The EESA also requires that the CBO and OMB provide regular reports on the cost of TARP, and that the President’s Budget include a supplemental section detailing the cost of TARP, as calculated using the at cost method specified by the EESA. This method, again, is not appropriate for the way in which TARP was actually implemented. As such, the consolidation method or the milder equity method may prove more appropriate. Further, inclusion in a supplemental report is not the same as inclusion above the line in a financial statement.

The Congressional Budget Office currently includes much of the debt of Fannie and Freddie Mac in their estimate of the federal budget. They do not, however, consolidate

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171 Greg Mankiw’s Blog, Which Budget Deficit? http://gregmankiw.blogspot.com/2009/02/which-budget-deficit.html. By contrast, the Tennessee Valley Authority’s debt is typically consolidated as debt by OMB on the President’s Budget, though it is not included in the debt ceiling calculation. Government Accountability Office, Tennessee Valley Authority Information on Lease-Leaseback and Other Financing Arrangements (GAO-03-784) (June 2003), available at http://www.gao.gov/new.items/d03784.pdf. See also Orszag statement on Fannie from Sept 2008, available at http://www.cbo.gov/ftpdocs/95xx/doc9574/07-22-GSEs.htm. This is despite the fact that the statutory language for the TVA explicitly requires them to be self financing, unlike the guarantees that TARP recipients have received and Treasury’s statements that banks failing the stress tests, and failing to ameliorate that failure by obtaining private capital, would be eligible for supplemental funding from Treasury. Government Accountability Office, Tennessee Valley Authority Information on Lease-Leaseback and Other Financing Arrangements at 5 (GAO-03-784) (June 2003), available at http://www.gao.gov/new.items/d03784.pdf; See also http://www.ustreas.gov/press/releases/tg123.htm. The Bonneville Power Administration is accounted for similarly to the TVA entities, expenses are netted against their revenue to show the net impact. Schick. supra note , at 42.


173 See Congressional Budget Office, A Preliminary Analysis of the President’s Budget and an
the full operations of the GSEs into the federal budget, nor do they consolidate any of the operations of other BOEs. The CBO addressed the question of TARP company debt in a recent budget update. It cited to a 1967 Presidential Commission on Budget Concepts Report asserting that the public budget should include “transactions that are within the federal sector and not subject to the economic disciplines of the marketplace” and that, while ownership and control were important questions in considering what items to include in the federal budget, the question nonetheless required consideration of other factors. The CBO drew a comparison between the case of Fannie Mae/Freddie Mac and the other TARP companies, noting that the government exercised significant control over Fannie and Freddie but it remained unclear whether it would do the same over TARP recipients.

If the budget accounting for TARP took a different approach, and instead included a provision that was either based on a modified equity approach or a consolidation approach, the incentives to reprivatize bailed-out entities could change. At present, Congress needs to go through the Administration to direct any off-balance sheet subsidies that may be taking place at TARP recipients. But if the effect of holding TARP companies were instead adjusted such that Congress were faced with a tradeoff between

Update of CBO’s Budget and Economic Outlook (Mar. 2009), available at http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf. “As a result of the degree of management and financial control that the federal government currently exercises over Fannie Mae and Freddie Mac, CBO has determined that the two corporations should now be included in the federal budget. In January, CBO estimated the subsidy cost for their existing business when the takeover occurred (200 billion recorded in 2009) and the estimated subsidy cost for new activities (Nearly 40 billion for 2009 and smaller amounts thereafter). Since January, however, the condition of the two entities has turned out to be worse than expected; as a result, CBO has increased its estimate of the present value of future losses for Fannie Mae and Freddie Mac by $52 billion for 2009-most of which stems from loans and guarantees inherited at the time of conservatorship-and by $28 billion for their activities between 2010 and 2019. See Congressional Budget Office, The Troubled Asset Relief Program, Report on Transactions Through June 17, 2009, at 6, available at http://www.cbo.gov/ftpdocs/100xx/doc10056/06-29-TARP.pdf.

The conservatorship of Fannie Mae and Freddie mac, government sponsored entities that guarantee mortgages and mortgage backed securities, is somewhat analogous although not completely parallel. Even though both institutions were created by the federal government and had longstanding links with the government, before conservatorship, each was considered a private company owned by shareholders; now the government own warrants for nearly 80 percent of the value of each institution. Moreover, both are currently subjected to a degree of control that sometimes places the government’s policy objectives ahead of corporate financial goals. The Congressional Budget Office has therefore concluded that their operations should be considered federal. As a substantial shareholder, the government could exert significant control over the operations of GM, AIG, and Citigroup, but it is not clear that it will. For example, although the government own most of AIG’s stock, it does not directly control any seats on the company’s board of directors and it is not actively determining company policy. GM’s situation could evolve somewhat differently; news reports suggest that the federal government will appoint some members of the Board and could take a more active part in setting company policy. However, the Administration has indicated that it does not plan to be an active participant in managing the carmaker’s operations. CBO does not currently believe that the full activities of GM, AIG, and Citigroup should be recorded as part of the federal budget. However, changes in the nature of the government’s ownership or degree of control over those companies could provide sufficient basis for revisiting this issue and concluding that the financial transactions of one or more of those companies should be reflected in the budget.” Committee Report, supra note , at 3.
on-balance sheet appropriations it could control and off-balance sheet subsidies it did not, that may provide an incentive to Congress to use political leverage to encourage the President and Treasury to sell off its holdings in private firms.

Another important consequence of consolidation would be to remove the government controlled company’s estimated tax payments from revenue estimates as intra-entity transfers. Citigroup, for example, would still pay taxes to the Treasury, but the government would no longer be able to record tax receipts from Citigroup as revenue. Pay-go and other rules are estimated using a scoring system in which the baseline is estimated by the CBO, and the government’s revenues and expenditures are then scored against the status quo. The effect of new legislation is then estimated, or scored, and the net effect of that legislation is measured against the baseline. Thus if the initial baseline did not include tax receipts from controlled bailed out entities, and Congress felt constrained by pay-go rules, it could increase the baseline revenue projections merely by privatizing the bailed out firms and returning their estimated tax payments to baseline projections.

Consolidating the operations of TARP recipients in the baseline projections would also have an effect on agency incentives, particularly the Treasury Department. If Treasury’s allocation were measured against a baseline that changed in response to operations of TARP recipients, then Treasury would have an incentive to ensure that TARP recipients remained profitable. In fact, to the extent that Treasury administrators have an incentive to maximize their budget, they may begin to approach the incentives a private sector actor may face, although muted by the overall incentives of the White House to maximize political support over maximizing agency budgets.

Tagging to the debt ceiling would also present a similar dynamic to the Federal Reserve in its ability to manage monetary policy, and would therefore give the Fed an incentive to consider privatizing owned entities. If the Federal Reserve felt it needed an increase in the statutory authorization for the debt ceiling to conduct a change in monetary policy that required an increase in outstanding Treasury Bonds, it would have an incentive to privatize bailed-out institutions like AIG as an alternative to pushing Treasury to lobby for an increase in the debt ceiling.

Determining a budget estimation method to accomplish that objective is tricky. For instance, at present some of the TARP recipients show net losses, but other TARP recipients show net profits. In that event, if the net effect of an alternative accounting method would be to create a surplus, legislators may be tempted to use that surplus to offset spending that pay-go would otherwise restrict and would therefore have an incentive to maintain ownership of the entity. Though that would be a drawback to the policy objective of privatization supported by this article, it would be preferable to the status quo, for the continue the surplus Congress may then also have an incentive to

177 Schick, supra note, at 56.
178 Schick, supra note, at 56.
ensure that the firm remained profitable in order to maintain the surplus, which could blunt some of the economic evidence discussed in the preceding section of this article.

VII. 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. The Federal Financial Management improvement Act of 1996 directs agency auditors to report on whether agency financial statements comply with federal accounting standards. In 1990 the OMB, Treasury Department, and GAO, three agencies claiming (and disputing the others’) lead responsibility for promulgating federal financial accounting standards created the Federal Financial Accounting Standards Advisory Board (FASAB). FASAB issues a number of pronouncements which those agencies, and all agencies of the federal government, are then expected to follow in implementing particular accounting policies for their agencies. 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. 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 nations debt and asset position in the financial statements of the United States, put together by the Department of the Treasury every year, the governing pronouncement is FASAB Statement of Federal Financial Accounting Concepts 2: Entity and Display. That Statement helps to define entities which should be included on the federal government’s financial statements. The purpose of that inquiry is to ensure that in deciding which entities to include in the United States’ financial statements, it is necessary to ensure that the federal government has some control over deployment of resources and some accountability for the entity’s performance, the entity’s scope is such that inclusion would provide a meaningful representation of operations and financial condition, and there are likely to be users of those statements who would find the information useful in their own resource allocation decisions and in holding the government entity accountable.

FASAB statements are intended to guide OMB in setting the government’s rules for financial statement preparation. This guidance is intended to ultimately help hold the

180 Schick, supra note, at 263.
181 Id. at 263.
182 Id., at 258-59.
184 See Treasury Report, supra note , 62.
186 Id. at 80.
government accountable for its taxing and spending decisions by presenting accurately
the effects of new policies on the budget.\footnote{187} FASAB outlines a number of informative
criteria for determining whether to consolidate an entity into the federal government’s
books, including some of which hold particular relevance in this context:\footnote{188}: (i)whether it is
owned by the federal government; (ii) whether the government has the ability to select or
remove the governing authority, particularly if there is to be a significant continued
relationship to carry out a public function; (iii) whether the government has the authority
to veto, overrule, or modify governing body decisions or otherwise significantly
influence normal operations; (iv) whether and the extent to which the government retains
implicit or “moral responsibility” for the entity’s debt.

FASAB makes clear that the Federal Reserve System is not considered part of the federal
government because of the Federal Reserve’s operational independence from the
executive branch.\footnote{189} 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. The fiduciary duty
of the trustees is in fact specifically defined as being to the best interest of the Treasury.

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.\footnote{190} 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 “The 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 to the
indicative criteria…The existence of those rights does not make the bailed out entity part
of the Federal Government Reporting entity or any other entities that are part of the
federal government.”\footnote{191} This blanket statement is offered with little analysis for 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.\footnote{192} But even

\footnote{187} FASAB, supra note , at 81.
\footnote{188} Id. at 92.
\footnote{189} FASAB 2, supra note , at 93.
\footnote{190} FASAB, supra note , at 93.
\footnote{191} Id. at 94.
\footnote{192} By contrast, The United Kingdom 1989 Companies Act offers a clear rule on consolidation of financial
reporting for its private sector analogue to GAAP. The indicative criteria it lists for consolidation of a
subsidiary investment, based on Article I of the EU 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. The U.K. definition does not exclude powers
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 U.S., consolidation would reshape 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, and the statement of changes in cash balance. A number of consequences beyond the financial statements of the United States would be changed by consolidation. Those would include budget statements, audits of operating performance by the GAO, and systems and control reports.

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 account 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 tax citizens to pay off their debts. And 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, in 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. 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, evidence indicates that the issuance of SFAS 94, the current rule requiring

that an owner might hold by, for instance, its concomitant status as a major creditor or regulator of the entity. Newby, supra note , at 155.

FASAB, supra note , at 110.

Id. at 110.

See Boskin, supra note , at 25.

Maurice Moonitz, The Entity Approach to Consolidated Statements, 17 THE ACCOUNTING REVIEW 236, 237 (Jul., 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.”).
consolidation of majority owned subsidiaries, resulted in a substantial decrease in market share value for those firms affected by the accounting rule change.\textsuperscript{197} 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.\textsuperscript{198} In 1971, APB No. 18 was issued, which required companies 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.\textsuperscript{199} Under the equity method, a investor company would recognize its proportionate share of the investee’s GAAP income along with an offsetting increase in the investment asset and would recognize dividends as a decrease in the offsetting asset.\textsuperscript{200}

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, where 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.\textsuperscript{201} This resulting in many companies taking a 49\% interest in subsidiaries to avoid full consolidation, dubbed the “49\% solution.”\textsuperscript{202} 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.\textsuperscript{203} 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 ownership, indicating that sub-majority control would be sufficient to require consolidation.\textsuperscript{204}

\begin{itemize}
  \item \textsuperscript{197} Inder Khurana, \textit{Market Effects Associated with SFAS No. 94 Concerning Consolidation Policy}, 66 \textsc{The Accounting Rev.} 611 (Jul. 1991).
  \item \textsuperscript{198} The Financial Accounting Standards Board's (FASB) has been trying to reconcile the 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. 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). Al L. Hartgraves and George J. Bentson, \textit{The Evolving Accounting Standards for Special Purpose Entities and Consolidations}, 16 \textsc{Accounting Horizons} 245, 248 (Sept. 2002).
  \item \textsuperscript{199} \textit{Id.} at 249.
  \item \textsuperscript{200} \textit{Id.} at 249.
  \item \textsuperscript{201} \textit{Id.} at 250.
  \item \textsuperscript{202} \textit{Id.} at 250.
  \item \textsuperscript{203} Beresford, Journal of Corporate Accounting and Finance 52, \textit{available at} http://www3.interscience.wiley.com/cgi-bin/fulltext/113441390/PDFSTART.
  \item \textsuperscript{204} Hartgraves and Bentson, \textit{supra} note 1, at 250. In 1999 FASB issued a proposed Statement of Financial Accounting Standards (SFAS), Consolidated Financial Statements: Purpose and Policy: Revision of
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. 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. 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 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.

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

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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. See Patrick A. Casabona and Alex Ashwal, The Concept of Control in Consolidated Financial Statements, Convergence of U.S. and International Accounting Rules, 26 Rev. of Bus., (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 Advisory Board, Consolidated Financial Statements: Policy and Procedures (1995).


Id., at 305.

Id. at 305.
Critics of proportionate consolidation assert that it is inappropriate in the absence of an explicit guarantee from the parent for the investee’s debts. 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. 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 that consolidation of debt rather than of assets is the central reason users of financial statements may favor the proportionate consolidation method. Other accounting research demonstrates that bond risk premiums tend to lack the information to incorporate implicit guarantees of subsidiary debt. Statements from the Treasury Department during the bank stress tests of 2009 indicate 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. 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. And 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 that 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. It seems clear however that whatever minor influence the government might gain would be dwarfed by the influence it possesses through the analysis in Section 1 of

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208 Id. at 303.
209 Id. at 305.
211 See Bauman, supra note , generally.
213 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 and Spamann, supra note 3.
214 Newby, supra note , at 213.
this article, and the independence of GAAP promulgated by the private sector could easily be maintained.\footnote{One issue which 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 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.\footnote{Newby, supra note , at 190.}}

\textit{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, members of Congress in exercising their constitutional oversight duties, taxpayers in holding members elected officials accountable, and economists who make predictions about the future of the economy.\footnote{See Roger W. Spencer and William Yohe, Federal Reserve Bank of St. Louis, The Crowding Out of Private Expenditures by Fiscal Policy Actions, 15 (October 1970).}

Economists as early as Adam Smith argued that government labor was less productive than private labor.\footnote{Id.} 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, which would deter private investment.\footnote{Spencer, supra note , at 17(citing John Maynard Keynes, \textit{THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY}, 120 (New York, Harcourt Brace and Company, 1936).} 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 “With 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.”\footnote{Spencer, supra note , at 17(citing John Maynard Keynes, \textit{THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY}, 120 (New York, Harcourt Brace and Company, 1936).} 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 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.\footnote{Boskin, supra note, at 13.
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.\textsuperscript{221} 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.\textsuperscript{222} 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.\textsuperscript{223}

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.\textsuperscript{224} 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.\textsuperscript{225}

Many studies of government deficits focus on nominally reported amounts, although a few economists have argues for adjustments. Feldstein argues in favor of adjusting for the unfunded liabilities of Social Security.\textsuperscript{226} Boskin argues for including the effect of government lending and guarantees.\textsuperscript{227}

The effect of government spending on private investment is hotly debated.\textsuperscript{228} Some economists argue that Ricardian equivalence will induce. For instance, one group of economists demonstrate that if all government debt were eliminated in OECD countries, real interest rates would fall by 163 basis points, and potentially higher depending on assumptions about number of consumers that are liquidity constrained.\textsuperscript{229} They include an assumption of a positive birth rate which tends to reduce any element of Ricardian equivalence in crowding-out models.\textsuperscript{230} They also conclude that the roughly 20\% increase in debt/GDP ratio of large OECD countries over the period from 1975-1996

\begin{itemize}
  \item \textsuperscript{221} Committee Report, \textit{supra} note \textsuperscript{4}, at 4.
  \item \textsuperscript{222} \textit{Id.}
  \item \textsuperscript{223} \textit{See} Boskin, \textit{supra} note \textsuperscript{4}, at 14; \textit{see also} Barth, James R., George Iden and Frank S. Russek, \textit{Do Federal Budget Deficits Really Matter? III CONTEMPORARY POLICY ISSUES 79} (Fall 1984-1985).
  \item \textsuperscript{224} Boskin, \textit{supra} note \textsuperscript{4}.
  \item \textsuperscript{225} \textit{See} Boskin, \textit{supra} note \textsuperscript{4}, at 6.
  \item \textsuperscript{226} Martin S. Feldstein, \textit{Social Security, Induced Retirement and Aggregate Capital Accumulation}, \textit{J. OF POLITICAL ECONOMY} 905 (1974).
  \item \textsuperscript{229} Hamid Faruquee, Douglas Laxton, and Steve Symansky, \textit{Government Debt, Life-Cycle Income and Liquidity Constraints: Beyond Approximate Ricardian Equivalence} (International Monetary Fund Working Paper, Dec, 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.).
  \item \textsuperscript{230} \textit{Id.} at 22.
\end{itemize}
resulted in a loss of roughly 2.9% in annual GDP growth. The growth in the government’s debt/GDP ratio over the last 5 years would seem to indicate a 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 as well as the Federal Open Market Committee of the Federal Reserve Board use these inputs to guide investment and policy decisions for thousands of member banks, clients, and investment professionals.

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.

Some economists argue that fiscal policy actions, or increased government spending financed by government borrowing designed to stimulate economic growth fail to accomplish their objective because additional government borrowing crowds out of the market an equal, or even greater, volume of borrowing that would have financed private investment. Crowding out is given 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. Other economists have urged that if crowding out does in fact occur, it is less likely when the economy is operating at substantially less than full employment.

VIII. 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 government’s 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 federal budget laws and 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

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232 Id. at 13.
233 Id. at 24.
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 carve an exception with little justification for bailed out entities. But a consolidation mechanism for government control over bailed out entities is essential to maintain the transparency objective of government financial statements.

Budget accounting, as an integral part of the budget process, looks forward and actually governs spending behavior. As it relates to the budget process at the federal level, this process also 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 door appropriate, 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 activities of bailed-out entities should be consolidated into the budget through changes in government revenue scoring. 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 realign 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 out firms in the first place.

To the extent that there has been some limited debate about consolidation of off balance sheet entities, it 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 markets 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 beneficiary 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 are as uncredible now as they were when they were made. The best way to limit the distortionary 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.