"GREED, ETHICS AND PUBLIC POLICY"

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I am delighted to have been chosen to present this lecture in honor of Eliot Richardson. Although I did not have an opportunity to work with Eliot--he was appointed by Republicans and I by Democrats--our careers intersected at several points. We liked and respected each other. He was a versatile man and a serious dedicated public servant. It's an honor to deliver a lecture that bears his name.

I confess that my first reaction to being asked to talk about "ethics and integrity in public service" was the question whether this was a high priority topic in March 2003. I have moved back and forth between the public and private sectors over a long career and have thought about ethical issues in both contexts. At the moment, it seemed to me that the ethical problems that most urgently needed attention were in the private sector. The spectacular corporate scandals of the turn of the 21st century exposed the seamy side of capitalism and yielded shameful examples of greed, abuse of stockholder and employee trust, bending accounting rules, outright lying, and dereliction of duty by executives and corporate boards. In this context APSA's request for a sermon on the ethical challenges facing public servants seemed almost trivial. It suggested public servants pleading, "Don't forget us! We may not get stock options or seven figure bonuses, but, hey, we have ethical problems, too!"

On reflection, however, I realized that my initial reaction stemmed from construing the question of ethics in public service too narrowly. I was thinking only about officials abusing their power to enrich themselves monetarily or steer government business to their relatives and cronies. This kind of ethical problem is endemic in many countries, where petty bribery is an accepted way of paying public functionaries, and big time corruption flourishes at the highest levels. But I don't think this is our kind of problem. In the United States, public servants on the take are mercifully rare and usually apprehended by legions of inspectors general and other watch dogs of the ethics rules. Indeed, at the federal level, American concern to prevent even the appearance of financial conflict of interest has arguably been excessive. It has led to disclosure and divestiture rules so complex and downright silly that they deter some talented people from taking public service positions. To be sure, the occasional congressman or political appointee breaks the rules and ends up resigning under a cloud or even being indicted. But these lapses do not constitute a problem worthy of a lecture with Eliot Richardson's name on it.

The more I thought about the subject, however, the more I realized that there are indeed serious ethical issues facing public officials at the highest levels of our national government that have a lot in common with the ethical issues facing corporate executives. The recent private sector scandals that have received so much attention involved withholding or falsifying information for personal gain. In the public sector, the stakes are not primarily financial reward. They are votes, public approval and retention of power. But some of the temptations are the same--to fudge the numbers, shade the truth, and downplay potential risks of a course of action.

Moreover, I believe ethical dilemmas in the public and private sectors arise out of the some of the same conflicts. For example, successful leaders in both spheres must have similar personality traits. They must be optimistic, competitive, willing to take risks, and able to communicate complex issues understandably. When they get to the top, they face similar pressures. They must make quick decisions, when stakes are high, information is limited, and outcomes extremely uncertain.

The interaction of the personality traits needed for effective leadership, on the one hand, and the pressure of complex decisions in the face of limited information, on the other, creates similar ethical dilemmas for corporate leaders and high public officials. In both sectors, the temptations to shade the truth or minimize the risks are greatest when the stakes are highest. Moreover, if some highly placed individuals yield to these temptations, the credibility of the whole sector is at stake. If investors lose faith in the accuracy of corporate reporting, markets cannot function to allocate capital to its most effective uses and the whole nation's standard of living suffers. If citizens lose faith in the integrity of public officials, democracy is at risk.

Hence, what I would like to do today is explore some of the ways in which the public and private sectors resemble or differ from each other with respect to the nature and causes of these kinds of temptations to present misleading information, and what some of the remedies might be. Admittedly, I am focusing on a small part of a more general ethical problem--how to control the politics of greed and selfishness. But this broader problem is not an ethical problem facing public servants in their professional roles. It is a more fundamental or systemic problem facing our capitalist democracy.

Leadership Traits

Effective leaders in both sectors tend to have four personality traits in common. First, an effective leader is a born optimist. Gloomy people don't push themselves to do hard things or succeed in motivating others to do them. On the battlefield, in the sports arena, in the project team meeting, or on the political campaign, an effective leader has to believe the challenge can be met and the problem can be solved. A leader has to radiate the confidence needed to convince others to follow. Moreover, as a leader moves up, whether on the corporate ladder or in public life (or both), that optimism is continuously reinforced. People at the top tend to have even more confidence than they started with. Wags in the Reagan era used to point out that of course the President was an optimist. A small town sportscaster, turned B-picture actor, who ends up as president of the United States, has had his in-born optimism revalidated a thousand times over. Like a football coach who has won the Super Bowl, anyone who has arrived at the position of cabinet officer, senator, or CEO, has had many occasions to think, "I believed it would turn out right--and it did!"

Second, effective leaders are risk-takers. It is not enough to be optimistic about life in general. Leadership requires being able to plunge ahead when others are cautious, frightened, and holding back, even though success is far from guaranteed. Moreover, leaders who get to the top have gambled and won quite a few times already, and may be inclined to take bigger risks than they might have done earlier in their careers.

Third, successful leaders are fiercely competitive people. They love winning, and they hate losing. Just ask their siblings! Leaders are miserable on the bench. They want to be in the game even if they are injured or exhausted. They push themselves harder than most, because they care more about winning--whether it's the Big Game or the Big Deal. And, of course, by the time they get to the top, they are accustomed to winning and find it harder than others to accept defeat.

Finally, leaders in both the public and private sectors are great persuaders. They have a talent for simplifying issues and skipping the nuance. They know how to communicate the essence of what they think should be done in ways that will cause others to cheer and fall in line. They have done it before and are confident of their ability to do it again.

Of course, there are other important characteristics that contribute to successful leadership in any sector. Leadership takes a reasonably high level of intelligence--although perhaps not too high!--and a lot of physical stamina. Good looks certainly help. A memory for names and faces is a big asset. Managerial skills--such as knowing how to delegate and to build a team--help leaders climb the corporate ladder and are essential to running any large organization, whether it be a university, a city or a cabinet agency. But managing is not the same as leading, and it is the four traits of leaders mentioned above that seem to me to contribute to difficult ethical dilemmas.

High-level decision-making: public and private

The decisions that must be made by leaders of big companies and high-level public officials tend to be complex--lots of moving parts. Moreover, the outcomes are often extremely uncertain.

In the private sector, there is no question that the modern large-company executive has an essentially impossible job. Technology is more complex than it used to be and changes continuously. Financial transactions are more intricate. The global economy requires dealing with multiple cultures and languages. Instant global communications have intensified competition and accelerated the pace of decision-making. The modern CEO can't know everything he needs to know to make decisions. He has to rely on the knowledge and honesty of a lot of other people, many of them in far-away places. Its always hard for him to be sure he is getting the straight story and the relevant information, especially since the people down the line have strong motivations to put their best feet forward.

Public sector decision-makers deal with even more complex decisions. My personal experience in the federal government left me with a strong sense of how complex federal decisions are and how hard it is to assemble the relevant information. Indeed, the OMB Director's office may be the ideal vantage point for observing the extraordinary complexity of the federal government. OMB is the cross-roads of the government--the last stop before the president on budget, regulatory and any other types of decisions The director cannot be on top of all the details, and has to trust a lot of other people to give her the straight story and good advice. One hopes to be able to grasp the essential components of the most important decisions and lay them out accurately and understandably for the president.

Moreover, most high level decisions, public and private, are made in the face of enormous uncertainty. Despite the ever-increasing volume of data, the development of sophisticated models, and the explosion of computer capacity for analysis, ability to predict the behavior of complex systems is limited. Despite enormous sums invested in weather prediction, for example, modern meteorological forecasts, while increasingly accurate, are far from perfect. The global economy is an incredibly complex system, which is impacted by forces ranging from weather to war to human psychology. Predicting economic change will remain problematic for the foreseeable future. Geo-political events are an even greater challenge.

Many of the integrity challenges in both sectors seem to me to arise out of the collision of necessary leadership personality traits with the complexity of decisions and the uncertainty of outcomes.

Private Sector Integrity

A free market capitalist system is based on two premises: harnessing self-interest to the common good and providing accurate information to consumers and investors. There isn't much doubt that a market system in which all participants pursue their own financial well-being is the most productive, efficient way to organize an economy--subject to some important caveats about excessive market power, protecting the vulnerable, and preventing cost shifting. But the system only works effectively if consumers know what they are buying and investors have credible information about the performance of firms. Accurate information enables investors to shift capital into its most productive uses and ensures that the economy works efficiently. Hence, writing the information rules for companies and keeping them current is one of the great policy challenges of a capitalist system. Many of the integrity challenges facing corporate executives involve the temptation to bend those rules to enhance their own monetary rewards.

The four personality traits of leaders intensify the problem. Naturally optimistic corporate executives are always tempted to paint a rosy picture of the company's situation and prospects. In part, this is because their own compensation depends on the stock price and hence on sustaining investor confidence. In part, it is because they really believe that things are likely to turn out better than others are predicting. They are inclined to minimize downside risks. They don't want to admit that a deal is going sour or market share is falling, because they can’t stand losing. They are confident that if they can use their proven skills to persuade customers, investors and even their own board members that the company is in good shape or about to turn the corner, it will turn out to be true. The problem is compounded by excessive focus on short-term earnings, corporate compensation overly tied to stock prices, and media hype that turns successful CEOs into cult heroes, at least temporarily.

The stock market boom of the 1990's raised the stakes for those tempted to bend the rules to unbelievably high levels and lulled investors into unaccustomed credulity. The increasing complexity of financial transactions--such as the emergence of what Warren Buffet calls "exotic" derivatives--made it harder for regulators, investors and even corporate board members to detect malfeasance.

As recent spectacular bankruptcies have shown, the market delivers swift punishment to those who get caught bending the rules, but collateral damage to investors, employees, and retirees is enormous. Moreover, when investor confidence in the validity of corporate information is undermined, the innocent tend to suffer at least some of the punishment along with the guilty.

In 2003, we are picking up the pieces and strengthening the rules. Prosecutors are going after known malefactors who can be shown to have broken the law. Legislators, regulators and market participants are working hard to tighten and clarify the accounting rules, improve corporate governance, and find ways of holding executives and board members, especially audit committees, personally responsible for the veracity of their information. All of this activity is costly and time-consuming, but necessary to restoring confidence in the market system. I serve on two corporate audit committees, and I can assure you we are paying attention. My guess is that confidence in corporate information will be restored--at least until a new generation forgets the lessons of the 1990's and another raging bull market raises the stakes to new heights.

Information Integrity in the Public Sector

Meanwhile in the public sector, similar problems exist and are not as easy to correct. Public officials with personality traits similar to successful CEO's must make complex decisions with highly uncertain outcomes. Optimistic leaders exaggerate the beneficial effects of their own policy proposals. They minimize downside risks, resist admitting mistakes, and rely on their proven powers of persuasion to convince voters that blame lies elsewhere and things will turn out better than they seem at the moment. Like CEOs, public sector executives presiding over large bureaucracies suffer from the tendency of subordinates to tell the boss what they perceive the boss wants to hear. They paint a rosy picture of operations in the field, in part to further their own careers and in part because they, too, are leaders on the way up with tendencies to optimism and denial. The Vietnam War provided several decades of examples (French as well as American) of predictions of immanent defeat of the Communists and failure to admit setbacks. Nevertheless, as Daniel Ellsberg has pointed out, most of the decisions to escalate the American war effort were made, not because Commanders-in-Chief unrealistically believed the escalation would guarantee victory, but simply because they didn’t want to admit defeat.

I won't belabor the obvious point that the stakes are very high in the geopolitical arena right now. The temptation is very great for our national leadership to do what leaders tend to do--give out over-optimistic estimates, minimize downside risks and rely on the power of over-simplified rhetoric to persuade a cautious public.

I will stick to the economic and budgetary arena where I have more personal experience and the analogies to private sector ethical temptations are closer. Let me make clear that I am not suspicious that public officials intentionally manipulate basic economic data--price indexes, unemployment rates, tax collections, spending rates, and the like. That may happen in some countries, but I don't believe it happens here. Our data are often inadequate because of limitations on the resources devoted to collection and analysis, but my experience in government has given me a lot of respect for the integrity of the technical folks who collect and publish basic economic and budgetary data.

The current controversy over budget projections is a fine example of the ethical dilemma facing public servants. Budget decisions, both on the spending and revenue sides are hard to reverse and can have very long-term consequences, so they have to be based on projections. Proponents of particular policies are always tempted to buttress them with rosy budget forecasts--Democrats are as tempted to minimize the costs of spending programs as Republicans are to minimize the revenue losses from tax cuts. The separation of powers provides some protection against misleading forecasts put out by presidents. Indeed, I believe that one of the greatest contributions of the Congressional Budget Office has been to contain the optimism of presidential budget forecasts by providing an alternative set of estimates. But CBO is subject to congressionally imposed rules about how it makes its own forecasts--rules that generally minimize future deficits. For example, the 2001 tax cut was alleged by its proponents to be affordable on the grounds that even CBO was projecting surpluses of $5.6 trillion over ten years of which the tax cut would only use up about $1.3 trillion. What was not made clear was that the projected surpluses were greatly exaggerated by the fact that the projection rules mandated unrealistic estimates of future spending growth and likely extensions of existing tax provisions and the cost of the tax cut was greatly underestimated because of a bizarre set of improbable sunsets and ignoring internal inconsistencies (like the alternative minimum tax) that would be costly to fix. Moreover, no one mentioned that just beyond the ten-year window the budget situation would worsen dramatically as the baby-boom generation retired.

In any event, the economy slowed, the stock market (which was generating extraordinary capital gains tax revenues) crashed, and war and terrorism necessitated unforeseen expenditures. Less than two years after the rosy forecasts of early 2001, we are facing huge continuing deficits again, even under the optimistic CBO projection rules. Ever-optimistic proponents of tax cuts are using this recent history to argue for more cuts on the grounds that the numbers have proven unreliable, so why not take an even bigger risk!

I don't want to get into a partisan argument about tax policy here. My point is only that public sector leaders are as prone as private sector ones to present over-optimistic numbers, to minimize risks, to put important caveats in obscure footnotes (if anywhere) and to oversimplify the policy choices. Somehow, we need to mount an effort to focus attention on alternative estimates that show what might happen if the economy proves less robust, if expiring tax provisions are extended, spending grows at more rapid rates and known problems are addressed. Analysts also have to get across that some features of the future (such as war, weather, and the rate of economic growth) are quite uncertain, while others (such as the impact of a rapidly-aging population on budget costs) are much less so.

Budget projections are, of course, only one example of a broader problem that challenges both the public and the private sectors. Strict adherence to GAAP accounting rules does not help businesses make big decisions amid great uncertainty. They, like the government, have to make the best projections they can and allow for the risks of being wrong. Risk management has become a sophisticated effort, especially in the financial services industry. It involves continuously updating projection models as conditions change and stress-testing those models to see how robust the projections are in the face of possible contingencies. Some of the techniques--and attitudes--of professional risk-managers could help public servants avoid some ethical pitfalls.

I do not believe that the answer in either sector lies in choosing less optimistic, more risk-averse leaders. Rather it lies in requiring more information and asking more probing and skeptical questions. In the private sector, that job falls on corporate boards, regulators and, above all, investors. In the public domain, the task cannot be left solely to politicians of the opposing party, because their motives are always suspect. A far more thorough job must be done by independent analysts, the press, and an increasingly well-informed public. In other words, we <u>all</u> have to take on this problem.