# Hiding in Plain Sight

By Editor Test *Thu, Jun 7, 2012*

*Balkanization, conflicted corporate governance, and failed public-private hybrids are three prevalent structural problems that defy solutions.*

In the month of June, RIJ tackles the topic of government. Although not much is happening in the presidential campaign, there's plenty of action at the regulatory level that's pertinent to the field of retirement income.

There's the looming deadline for compliance with 401(k) fee disclosure rules, the dispute over harmonized regulation of financial advisors and brokers, and the prospect of an exemption for deferred income annuities from RMD rules, among other things.

But these questions are peripheral to three of country's largest and most intractable political problems: Balkanization, conflicted corporate governance, and failed public-private hybrids.

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**"Balkanization" (Too many governments).** Where I happen to live, in the densely populated East, you can drive 10 miles and pass through six or seven boroughs, townships, school districts and towns. Since 1980, they've bled together into one teeming sprawl, yet they've retained their own duplicative governments, services, and tax regimes.

As in many other places, our central city, once the busy capital of a regional empire, is in steep decline. Its former vitality—families and businesses—has bled to the surrounding suburbs, where the taxes are lower and there's no ancient infrastructure in need of replacement.

Recently, the city fathers hatched a plan to revive downtown with a new hockey arena. But now that an entire city block has been cleared for the arena, the surrounding suburban communities are reconsidering their agreement to help pay for it. Meanwhile, the urban core has been reduced to rubble, waiting for construction that may never begin.

Our region—where a capital city itself is in receivership—suffers from a lack of wise planning because interests are so fragmented. In the financial industry, we emphasize the necessity of a plan, and the wisdom of consolidating our assets with one advisor. In our communities, we have too many different plans, and no plan.

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**The "public" corporate structure (No governance to speak of).** Although many great people do many great things at public companies, the public company model is increasingly a victim of destructive incentives, ineffective boards, impotent shareholders, and a self-defeating short-term focus.

The managers of public companies serve at least three masters: their shareholders (number one); their customers; and their employees. The conflicts of interest that inevitably arise from this arrangement are unavoidable. But how can you put shareholders' interests first and not shortchange the customers or the employees?

Several large publicly-held companies helped lead the country to its biggest financial crisis since the Great Depression. Yet, thanks to the corporate veil and limited liability, none of the executives has been held either financially or legally accountable.

In the life insurance industry, demutualization, which was so tempting during the 1990s, yielded bitter fruit in the 2000s. Public ownership is a misnomer, and the governance model for public companies is broken. Enron taught nothing. Sarbanes-Oxley was ineffective. As for the SEC and FINRA, the best that can be said is that they are hopelessly undermanned and outgunned.

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**Hybrid institutions (schizophrenic governance).** Hybrid structures like Fannie Mae and Freddie Mac or Medicare sound appealing at first because they're more politically acceptable to establish than all-private or all-public institutions. But they're too vulnerable to moral hazard to succeed in the long run.

When the country wants to provide a needed public service (like subsidized health care for seniors) but the government doesn't want to crowd out private enterprise, it sets up a hybrid service like Medicare, where the public sector pays private medical providers. But moral hazard quickly creates the temptation, among the providers of care, the users of care, and the insurers, to milk the system. The inevitable result: runaway costs.

When the government wants to subsidize housing but doesn't want a huge obligation on its own balance sheet (like millions of home mortgages), it insures the obligations of a private stock company, like Fannie Mae. What eventually follows, as we saw in the financial crisis, is moral hazard, leading to the privatization of profits and the socialization of costs.

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These self-interfering problems, which hide in plain sight, are so entrenched, so integrated with daily life, that we can barely recognize them, let alone begin to solve them. It requires a flight of utopian fantasy even to imagine what an alternative reality might look like, let alone agree on a plan for realizing it. The hope of reaching any public consensus on anything, these days, seems naïve.