THE PUBLIC POLICY

Standing Athwart Nationalization

By John Berlau on 6.25.09 @ 6:06AM

My organization, the Competitive Enterprise Institute, has frequently been accused of being "in denial" regarding important issues. It's a charge we most often wear as a badge of honor, because most often, our accusers are too quick to jettison important facts and/or principles that we feel must shape the public policy debate.

The latest accusation of "denial" is on a different issue -- bailouts and government takeovers -- and targeted at a different CEI scholar -- me. The accuser is also different from usual: *National Review*. But like the other "denier" charges leveled against us through the years, the *NR* broadside scuttles principles that should be at the forefront of the policy discussion. These are the principles of property rights, private ownership, and the rule of law that all libertarians and conservatives -- and especially *NR* -- should hold dear.

On Tuesday, I had criticized here an unsigned *NR* editorial supporting President Obama's call for a "resolution authority" that would give the government broad powers to seize nonbank firms deemed a threat to "financial stability." I wrote that "conservatives' only choice in responding to Obama's 'resolution regime' to follow *National Review's* onetime motto of 'standing athwart" and 'yelling stop,'" even if *NR* was on board Obama's train pushing for these expanded powers.

NR staff reporter Stephen Spruiell responded to my piece one day later. Spruiell states kindly that he "like[s"] and "agree[s] with me [90] percent of the time," and I should say this respect is reciprocal, as Spruiell has written some perceptive pieces on housing policy. But he then asserts that I seem "to be in denial about the degree to which government guarantees have mad the market profoundly less sensitive to credit risk." He also charges that I fail "to address the magazine's argument, which is that the creation of a *well-designed* [emphasis in Spruiell's piece] resolution authority might be the best way to counteract the moral hazard created by the bailouts."

Actually, that was not really the magazine's argument in the original unsigned editorial. Then, the editorialists unambiguously praised the Obama plan, concluding that "the administration's approach gets at least one big thing right." This statement implied strongly that Obama's initiative on this matter *was* well designed. It's all to the good if *NR* is now backing away from its original stance, and is giving the actual details of the plan more scrutiny, but Spruiell and the other editors should admit this change in position.

And the Obama proposal definitely deserves more scrutiny. As I noted previously in the *Spectator*, the administration's white paper puts no limits on the type of firm the government could seize. On page 19, the paper defines a "Tier I financial holding company" that would be subject to seizure as "any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed."

This is eminent domain on steroids. It would be the arbitrary decision of politicians as to what businesses pose a "threat to financial stability." Already, parties scrutinizing the Obama proposals are circulating such as, "How widespread must the potential threat be to be considered a Tier 1 FHC [subject to seizure]? Is it sufficient to pose a threat only to a *region* of the country?"

Spruiell writes that I "should acknowledge" that "too big to fail" and "moral hazard" "is a problem." But I and my colleagues already have said this since the bailouts were first proposed. Unlike *NR*, I opposed the first rounds of bailouts here in the *Spectator* in September, and I proposed suspending mark-to-market accounting as an alternative (which was partially done in April and has coincided with a slight but significant recovery in the banking sector that the billions in bailouts never achieved previously).

What Spruiell and the other *NR* editors need to acknowledge is what should be the fairly obvious point that broad government power to nationalize industries is a separate and distinct "problem," no matter how much money it could conceivably save taxpayers. I actually don't think the resolution authority will save taxpayers any money; in fact it will end up costing them, given the additional billions the government has put into Fannie Mae, Freddie Mac, and American International Group since it took ownership in these entities. (The *NR* editorial made much of the distinction between conservatorship, which the Bush administration practiced in taking over Fannie and Freddie, and receivership, in which the government actually sells of an entity's assets to the private sector. The Obama white paper, however, makes this a moot point on page 77, when it explicitly gives the Treasury Department the choice "to establish conservatorship *or* receivership. [emphasis added].")

But even if the nationalization authority could save taxpayers $1 billion or even $1 trillion dollars, it is still a terrible idea. One destructive act cannot be fixed by another act that is equally if not more destructive. A doctor could remove the pain of an ingrown toenail by simply amputating the foot, but this would cause much more long-term problems. And if we give to the Obama administration or any administration this power to seize firms where, unlike with banks, there is no nexus to an insurance program the government provides, it will be the equivalent of cutting off a "foot" or even a limb of the American free enterprise system. Why should we think nationalization should work out here better than any place else where it has been tried?

Indeed, the nationalization of AIG, which came two days after the bankruptcy of Lehman Brothers, now appears to be a bigger factor in the meltdown than the Lehman bankruptcy was. As Cato Institute economist Alan Reynolds wrote in *NR*: "Financial stock prices fell dramatically as soon as it became known that the loan to AIG ... would be tied to expropriation of 80 percent of equity. Share prices [collapsed] for financial firms that seemed vulnerable to that sort of government help."

Finally, contrary to Spruiell's assertions, my suggestions of revisions to the bankruptcy code for financial firms is neither "backing away" nor a "third way" from my opposition to both nationalization and bailouts. It's what Congress has always done in light of new circumstances

among businesses and is explicitly empowered to do by the Constitution's providing for it to write "uniform laws on the subject of bankruptcy."

The differences between judicial bankruptcies and "resolutions" organized by the president, such as Chrysler and General Motors, are manifold. The bankruptcy court does not carry ownership stakes in the bankrupt entities, just as the courts do not now own retailers Eddie Bauer and Circuit City and other firms in traditional bankruptcy. Decisions are made by federal judges who, while not perfect, do not have to worry about pleasing constituencies for re-election.

As for Spruiell's concern that "enhancing the bankruptcy code won't do much good if market players remain convinced that government will always save large firms from bankruptcy," conservatives just have to mobilize the public to tell their congressmen "no more bailouts" at tea parties and other events. Indeed, "bailout fatigue" may have stopped planned "rescues" of commercial real estate firms, who are discovering that traditional bankruptcy still works. As I wrote here, the orderly April bankruptcy of General Growth Properties, the second largest mall owner in the country, shows that traditional bankruptcy proceedings even for large firms still work out better for taxpayers and the economy than bailouts do.

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