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Say No to Bailouts and Moral Hazard

- Daniel J. Mitchell

The Bush-Obama policies of bailouts and regulation have been bad for taxpayers, but they've also been bad for the economy.

A vibrant and dynamic economy requires the possibility of big profits, but also the discipline of failure. Indeed, capitalism without bankruptcy is like religion without hell.

Yet that's what politicians from both parties have created. Profits are private and losses are socialized, so is anyone surprised that Wall Street responds to these incentives with imprudent risk?

Especially when the government adopts bad policies that cause a housing bubble, such as easy money from the Federal Reserve and corrupt subsidies from Fannie Mae and Freddie Mac.

Let's use a personal example. How would you behave if you were sent to Las Vegas and told that you could keep your winnings and other people would take care of your losses? With that type of incentive structure, you would have little reason to be responsible.

Some people argue that America had no choice but to bail out Wall Street and the financial services industry. Republicans say bailouts were necessary and Democrats make the same argument.

Either through ignorance or corruption, they falsely assert that company-specific bailouts were necessary to recapitalize the financial sector.

Nonsense. It is a relatively simple matter for a government to put a financial institution in receivership, hold all depositors harmless, and then sell off the assets. Alternatively, the government can pay a healthy institution to absorb an insolvent institution.

This is what America did during the savings & loan bailouts 20 years ago. It's also what happened with IndyMac and WaMu during the recent financial crisis. And it's what the Swedish government basically did in the early 1990s when that nation had a financial crisis.

This is known as the "FDIC-resolution" approach and it does cost money to protect depositors, so taxpayers take a hit. But the financial sector is recapitalized – and there is no moral hazard of rewarding businesses and investors that made mistakes.

If this policy makes sense and has worked before, why does the crowd in Washington prefer bailouts? At the risk of being cynical, the politicians don't like the FDIC-resolution approach because it means no giveaways for shareholders, bondholders, and senior managers. And that would require stiff-arming big campaign contributors.

But the story gets even more depressing. Not only did they fail to use the transparent and non-corrupt FDIC-resolution process, the politicians went one step farther with the Dodd-Frank bailout bill that imposes lots of red tape on the economy and actually exacerbates the too-big-to-fail problem.

Not surprisingly, this bill also did nothing to fix the misguided government policies, such as Fannie Mae and Freddie Mac subsidies, that helped cause the financial crisis.

So what does all of this mean? Unfortunately, we'll probably have more bailouts in the future, so this "bailout application form," which circulated about a year ago as a joke, may soon become a reality.