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# The Case for Doing Nothing

## The only plausible argument for bailing out banks crumbles on close examination.

Jeffrey A. Miron | August/September 2009 Print Edition

The first thing to note about the financial crisis is that the federal government never had any business intervening in the personal decision of whether you want to own a home. There is no rational economic argument, or any argument I know of, that says the market of buying and selling homes is imperfect in some way, requiring government action. Construction firms have plenty of incentive to build homes and sell them. People who have the wherewithal have plenty of incentive to buy homes if they so choose. For the government to intrude into homeownership was an off-budget, nontransparent, backdoor attempt at redistributing income. And when the policy became a way of transferring income to people who couldn't afford those homes, it was doomed to failure.

This provision of risky debt to low-income homeowners was exacerbated by a second misguided federal policy: the longstanding practice of bailing out private risk taking. Although this has gone on for decades in the U.S. and other countries, the Federal Reserve played a special role during the tenure of former chief Alan Greenspan. The Fed's implicit and almost explicit policy before the housing crash was to say to the financial markets: "Don't worry about the fact that there's a bubble. We'll lower interest rates and keep them low enough to prevent a collapse in asset prices." This logic, broadly applied, was commonly called the Greenspan Put. The Federal Reserve was basically selling the market an option for getting out comparatively unscathed when things turned bad. The result has been a widely held assumption that market actors would not have to bear the full losses from their own risky behavior.

When people try to pin the blame for the financial crisis on the introduction of derivatives, or the increase in securitization, or the failure of ratings agencies, it's important to remember that the magnitude of both boom and bust was increased exponentially because of the notion in the back of everyone's mind that if things went badly, the government would bail us out. And in fact, that is what the federal government has done. But before critiquing this series of interventions, perhaps we should ask what the alternative was. Lots of people talk as if there was no option other than bailing out financial institutions. But you always have a choice. You may not *like* the other choices, but you always have a choice. We could have, for example, done nothing.

### Unfair in the Short Term, Inappropriate in the Long Term

By doing nothing, I mean we could have done nothing *new*. Existing policies were available, which means bankruptcy or, in the case of banks, Federal Deposit Insurance Corporation receivership. Some sort of orderly, temporary control of a failing institution for the purpose of either selling off the assets and liquidating them, or, preferably, zeroing out the equity holders, giving the creditors a haircut and making them the new equity holders. Similarly, a bankruptcy or receivership proceeding might sell the institution to some player in the private sector willing to own it for some price.

With that method, taxpayer funds are generally unneeded, or at least needed to a much smaller extent than with the bailout approach. In weighing bankruptcy vs. bailouts, it's useful to look at the problem from three perspectives: in terms of income distribution, long-run efficiency, and short-term efficiency.

From the distributional perspective, the choice is a no-brainer. Bailouts took money from the taxpayers and gave it to banks that willingly, knowingly, and repeatedly took huge amounts of risk, hoping they'd get bailed out by everyone else. It clearly was an unfair transfer of funds. Under bankruptcy, on the other hand, the people who take most or even all of the loss are the equity holders and creditors of these institutions. This is appropriate, because these are the stakeholders who win on the upside when there's money to be made. Distributionally, we clearly did the wrong thing.

From the perspective of long-run efficiency, the question is also relatively straightforward. By the end of 2005, it should have been apparent that the U.S. economy was fundamentally misaligned. We had significantly overinvested in housing and significantly underinvested in factories, plants, and equipment. In effect, we needed a recession: a period to readjust the balance between the different types of capital.

More broadly, failure is an essential aspect of free markets. Failure shows capitalism is *working*, because it means resources are moving from bad uses to good uses.

There are other long-term problems with the bailout approach. Bailouts create moral hazards going forward, meaning market players will be more inclined to take excessive risks. Bailouts encourage inappropriate goals, such as propping up insolvent banks. Bailouts give the government ownership stakes in these institutions, which means that politics, not economics, is going to decide where these firms invest in the future. And bailouts set the wrong precedent for other industries.

**The Only Plausible Argument**

There is therefore only one reasonable argument for choosing bailouts over bankruptcy. Bailouts might make sense if bankruptcy imposed an externality—an unwelcome spillover effect. The argument for that goes as follows: When a given bank fails, it loses intermediation capital, or the ability to make loans. Any given bank knows a particular sector of the economy, a particular region of the country, or a particular kind of loan market. So if that bank fails, that specialized knowledge gets destroyed; therefore, at least in the short term, no one can easily make that kind of loan.

If that happened to one bank, you'd say it was no big deal; there are plenty of banks that have lots of knowledge. But if one large bank fails and defaults on obligations to lots of other banks, forcing some of them to fail, you might worry that contagion could lead to *a lot* of intermediation capital disappearing in a short period of time.

That story sounds somewhat plausible. But it has two key weaknesses, one theoretical and one empirical.

The theoretical weakness is that if a bank fails but its assets and its employees are bought by another bank, there is no reason for the intermediation capital to disappear. It just gets transferred to someone else. If you think that the good ideas for making productive loans are in the brains of the people of the failed bank, those people are probably going to go work at some other financial institution—a hedge fund, an insurance company, another bank. So you're not necessarily going to lose all the intermediation capital as a result of the failure. Indeed, the failed bank's employees may be put to work in more productive ways.

The empirical problem with the claim that bank failures destroy intermediation capital is that there isn't strong evidence to support it. Some evidence does show a correlation between bank failures and declines in output. But since declines in output should lead to bank failures, we don't know which is causing which. Thus, there isn't much quantitative data showing that bank failures lead to a large excess loss, over and above what you would expect when a negative shock hits the economy.

Because housing prices have declined, some people and institutions are worse off. Maybe it's the first bank in the chain that takes most of the hit. Or maybe the first bank passes some of the hit along because of its counter-party claims to some other bank. But that hit has to be taken. And in the U.S., it was a big hit indeed—plausibly several trillion dollars in housing wealth. The size of that loss doesn't demonstrate a spillover effect; it just shows that somebody has to experience the loss that the economy has already taken.

**Twisted Incentives**

The problem isn't only that the bailout wasn't necessary in the first place. The bailout may have made the credit situation worse. When banks hear that the Treasury Department is dangling hundreds of billions of dollars out there to purchase their toxic assets, what are they going to do? Sell their assets for 20 cents on the dollar, or hold onto them in the hope that the government will eventually buy them for 80 cents on the dollar?

The moment Treasury Secretary Henry Paulson got in front of the cameras last fall and announced that we were on the brink of catastrophe, Wall Street was bound to freeze, because bankers wanted to figure out how much money was available and how they could get some. Let's not realize any losses we don't have to realize, they figured, because Treasury's going to bail us out.

Of course, the bankruptcy approach is itself messy, and there are some legal issues concerning whether existing procedures apply to bank holding companies or just banks. But what the administration should do now is stop giving banks money and start being open to the bankruptcy approach when existing law allows it. Further, the administration could push Congress harder to expand and clarify the FDIC's receivership authority. As long as regulators keep giving banks money, nothing is going to clean the mess in the financial sector.

The latest government program, the Public-Private Investment Program, is just another handout to the banks. It sets up a system where a small amount of private money is combined with a small amount of government money and a big loan guaranteed by the government to buy the toxic assets from the bank.

So what are the incentives to private-sector actors? Well, they're putting hardly any money in. If it turns out that the toxic assets they bought aren't worth anything, they haven't lost much. If the assets are worth a lot, they make some money. Either way, the Treasury Department is guaranteeing everything. Reasonable estimates indicate that these toxic assets are not worth very much, so this is just another way of transferring resources to the banks by buying their toxic assets at inflated prices.

That's not the only area where the Obama administration has twisted incentives. President Obama's mortgage plan uses $275 billion in tax funds to help homeowners refinance and lower rates, to subsidize payments from borrowers to lenders, to get lenders to modify loans, and so on. It gives another $200 billion to the government-created home mortgage companies Fannie Mae and Freddie Mac. This is exactly the wrong approach.

The aim is to reduce foreclosures, so the delinquent or nearly delinquent borrowers can stay in their homes. That sounds like a laudable goal, but it ignores a fundamental reality: This money is coming from somebody else. So what the plan is doing is penalizing relatively responsible homeowners or renters—everybody who pays taxes—and rewarding those people who should have known, or at least should have had some inkling, that the loans they were being offered were too good to be true. This program creates exactly the wrong incentives for people deciding whether to borrow and whether to be homeowners.

More generally, it continues the policy of promoting homeownership. We got in this situation because the government wanted to promote homeownership. Until we create a situation where people make decisions based on their own resources and have to think about bearing the consequences of the decisions they make, the root cause of the financial crisis will only get worse.

**Shrinking the Pie**

Add in Obama’s $787 billion stimulus and his $3.6 trillion budget, and a picture emerges of an administration totally unapologetic about its designs to expand the size and scope of government. There is no question that the people advocating this spending want much more government intervention with respect to unions, energy, health care, infrastructure, and other areas. The crisis has given them the opportunity to ram through a bunch of things they’ve been pursuing for a long time.

As a matter of accounting, they are almost certainly understating the budgetary implications of their programs. Their assumptions about economic growth are optimistic relative to those of private forecasters. Furthermore, many of the items in the stimulus package that were supposed to be temporary are not going to be temporary. Thus, my guess is that deficits will be much bigger than the administration predicts.

The stunning thing about Obama’s spending proposals is that there’s almost nothing you could defend from the perspective of efficiency. It’s all about redistribution--not redistribution to the poor but redistribution to Democratic interest groups: to unions, to the green lobby, to the health care industry, and so on. At some point these everescalating government interventions will affect the size of the economic pie. If we start looking more like France, with more than 20 percent of GDP controlled by the federal government, output growth and economic freedom will all suffer.

The fundamental problem underlying the financial crisis was government policy. Instead of undertaking enormous new policies, we should try to fix or eliminate bad policies and focus on efficiency rather than redistribution. Doing nothing new and simply working with pre-existing procedures would have been much better than anything we’ve done so far.

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