The Case Against the Bailout
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I will elaborate on the following points.

1. Today's economy differs from that of the 1930's. Then, it may be that the financial sector may have contributed to the downturn elsewhere. Today, the financial sector is the downturn.

2. The bailout blends finance with government. It is the Fannie Mae and Freddie Mac model, writ large. As we saw with Freddie and Fannie, when you blend finance with government, the firms have an incentive to manipulate the government and government has an incentive to meddle with the firms.

3. Trying to tweak the bailout to try to redistribute the pains and gains so that taxpayers come out better and shareholders/executives come out worse is beside the point. If you put lipstick on a pig, it's still a pig.

4. The housing market is out of balance, in part due to excess home borrowing. Until it is in balance, no one will know what mortgage securities are worth. Attempts to prop up home borrowing, by freezing foreclosures for example, are counterproductive.

1. It's not the 1930's.

In the 1930's, the economy had many fewer industries than it has today. If the auto industry slumped, there was no computer industry to pick up the slack. Much of the economy was still agricultural, and the farm economy was in the process of transition. The dust bowl and advances in transportation displaced many farmers, who joined the ranks of the unemployed.

Today, we have a very diverse real economy. Some sectors are in a downturn, but many other sectors are not. The ability of any one sector to bring down the rest of the economy is much reduced.

In the 1930's, the U.S. financial sector was underdeveloped, so that the collapse of banks may have seriously impaired the ability of the economy to perform. (I say "may" because this issue is still debated. I myself am persuaded that the collapse of banks destroyed borrower-creditor relationships and thus spilled over into the real economy. What persuaded me was the research of an academic economist named Ben Bernanke.)

Today, the U.S. financial sector is overdeveloped. Ken Rogoff noted "financial firms accounted for roughly one-third of American corporate profits in 2006." Our economy is devoting too many resources to finance, and the retrenchment that is now taking place, while painful for individuals, is probably better for the overall balance of the economy.

In short, in the 1930's the failure of banks very probably was a bad thing. Today, the consolidation of the financial sector is probably a good thing, or at least a necessary adjustment.

2. The bailout blends finance with government.

With Freddie and Fannie, blending finance with government was problematic. Larry Summers, who served as Treasury Secretary under President Clinton, was as eloquent about the pitfalls as were many conservatives.
The other night at a post-seminar dinner, someone asked me why Fannie Mae paid big executive salaries to political hacks who knew nothing about finance. I replied that this was perfectly rational from the shareholders’ point of view. When a company's profits depend entirely on privileges conveyed by the government, it behooves the company to focus on stroking and lobbying government. For Fannie Mae, the return on investing in political hacks was enormous.

Conversely, the blend of government and finance allows politicians to interfere with internal management decisions at firms. Thus, in the years leading up to this crisis, politicians imposed both formal and informal "affordable housing" goals on Freddie and Fannie, sending the two agencies plunging into the subprime mortgage market.

The bailout is going to lead to the same two-way influence peddling. When we hear that the details of the plan are to be worked out, what we know is that the financial institutions are going to be the ones who have the most stake in those details. An orgy of lobbying is bound to ensue.

For example, suppose that mortgage securities are going to be grouped into classes and then auctioned. It is easy to imagine a bank pressuring Congressional leaders to have its securities reclassified into a group that will fetch a better price.

Conversely, we are already seeing attempts by Congress to dictate emmployee compensation, foreclosure policies to firms with troubled loans, and other issues that would otherwise be internal management decisions in the private sector. Once they have this power, Congress is unlikely ever to give it up.

3. If you put lipstick on a pig, it's still a pig.

Ignore the politicians and pundits who say that there are ways to protect taxpayers or punish shareholders/executives. Not that there aren't ways to tweak the bailout to do this. But those are petty issues, quite beside the point.

The central issue with the bailout is that it creates a tight interlocking between Big Finance and Big Government. What matters is the consequent destruction of liberty and economic dynamism. The distribution of pecuniary gains and losses is not as important.

4. The housing market is out of balance.

In both the homeowner segment and the rental segment, we see high vacancy rates. That means that we have an excess supply of housing units. Housing construction needs to decline further, and prices need to fall more.

An even larger imbalance in the housing market is that we have the wrong people in the wrong houses. I am referring here to home borrowers, meaning people who are nominally owners but who put down so little money for their purchase that they are better described as living in borrowed homes. Until we get people out of houses that they cannot afford, the market will not be in balance.

In theory, there are alternatives to foreclosure. Someone else could buy the home and rent it back to the home borrower. In areas where home prices have fallen, the lender could reduce the mortgage balance in proportion to the price decline. Etc.

In practice, I think that all of these alternatives are counterproductive. They undermine the price signals in housing markets, which will make housing illiquid for many years.
If we want to help troubled homeowners, we can set up a "pity fund" for them. That can be a lot less costly than a bailout, and it can be administered in a way that targets more benefits to the deserving and fewer benefits to the undeserving. I will elaborate in a subsequent post.

Hillary Clinton says, *Let's keep people in their homes*. I say, *Let's Not*.

The goal should be to get home borrowing replaced by either renting or home ownership. Once that happens, house prices will be reliable, rather than artificial. That in turn will make buying a home, providing a mortgage loan, and trading securities backed by mortgage loans far less risky than they are today.