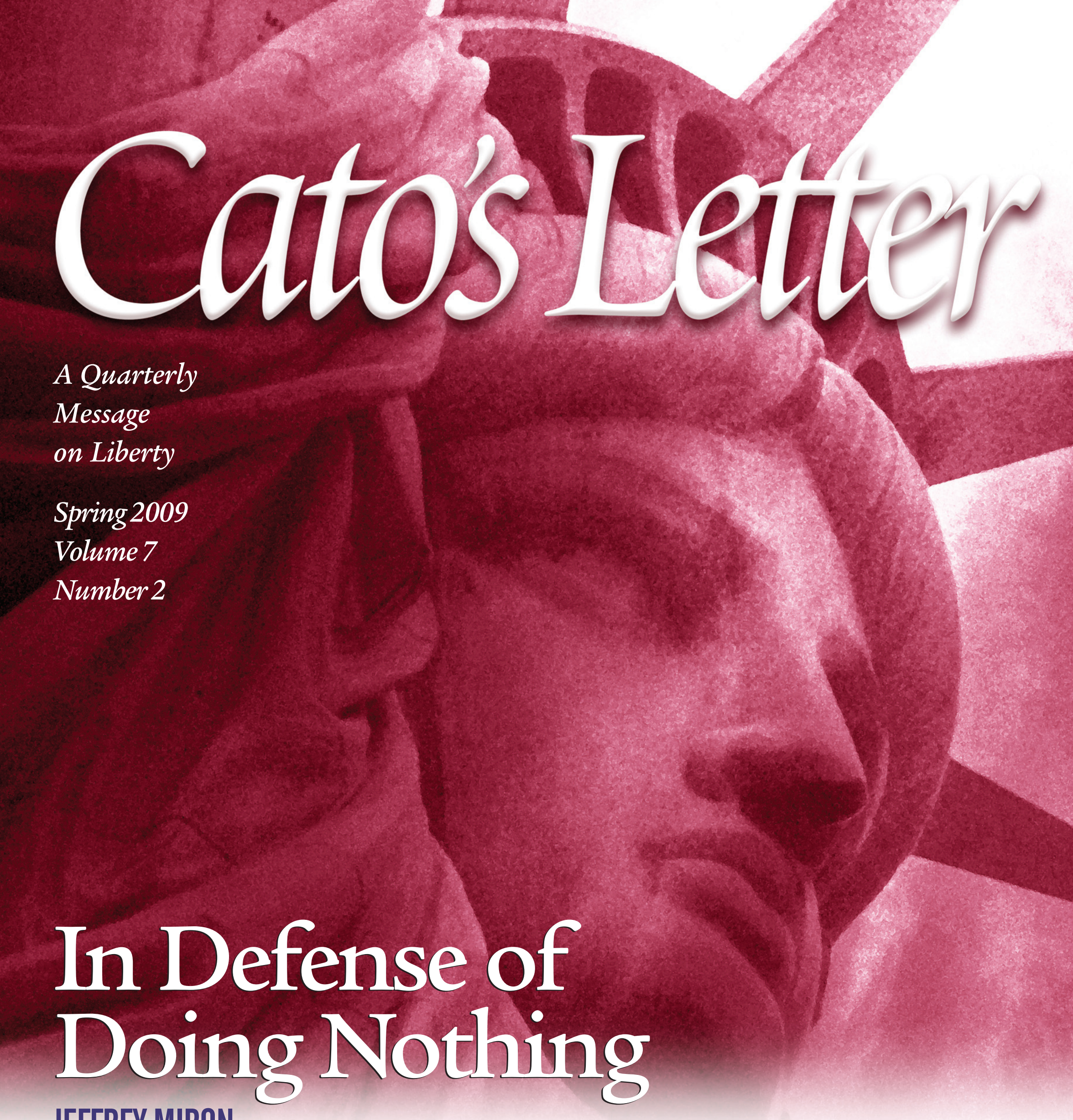

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In Defense of Doing Nothing

JEFFREY MIRON

Not so long ago, the U.S. economy was the envy of the world. As of September 2007, we had experienced 24 consecutive quarters of positive GDP growth. The stock market stood at historically high levels, and inflation and unemployment were low and stable.

Things look different today. The U.S. economy is in recession, as is the economy of most every nation in the world. Many forecasters predict a domestic downturn on par with that of 1981–1982; some talk of another Great Depression.

Meanwhile, we've experienced a huge range of interventions in the economy. We've seen the bailout of the Wall Street banks and the passing of a massive stimulus bill. We've seen coordinated interest rate cuts, expansions of deposit insurance, and government ownership stakes in banks. The stated aim of these policies when they were debated was to stave off a credit crunch and recession, but we got both anyway. Now, the claim is that they will prevent a bigger credit crunch or recession than we would otherwise experience. I'm not so sure.

Jeffrey Miron is a senior fellow at the Cato Institute and director of undergraduate studies in the department of economics at Harvard University. He spoke at the 21st Annual Cato Institute Benefactor Summit on March 5, 2009.

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Today, I'll make the case for doing nothing. More precisely, I will argue that had the federal government not undertaken any new policies in response to the economic downturn, we would be better off than we are now. I will further argue that if a stimulus was necessary, it should have come from tax cuts and scaling back failed government programs, not new government spending.

WHAT WENT WRONG?

What caused the economic crisis? Although securitization, failures at rating agencies, and greed on Wall Street all played a role, at the root of the crisis, ultimately, were misguided federal government polices.

The first of these was the attempt to expand homeownership. Let me begin by saying that government has no business taking a stand on how many people should or should not own homes, just as it has no business trying to influence how many toaster ovens we buy. There is no plausible market failure in the production of housing or in people's decisions about whether to buy homes. Yet government has been interfering for decades.

> "There is no plausible market failure in the production of housing, nor in people's decisions about whether to buy homes."

A partial list of policies designed to increase homeownership includes the Federal Housing Administration, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, the Community Reinvestment Act, the deductibility of mortgage interest, the homestead exclusion in the personal bankruptcy code, the tax-favored treatment of capital gains on housing, the HOPE for Homeowners Act, and, most recently, the Emergency Economic Stabilization Act—also known as the bailout bill.

The U.S. government's pro-housing policies did not have major deleterious effects for decades. The reason is likely that the interventions in part substituted for activities the private sector would have undertaken anyway, such as providing a secondary market in mortgages.

Over time, however, these mild interventions began to focus on increased homeownership for low-income households. In the 1990s, the Department of Housing and Urban Development ramped up pressure on lenders to support affordable housing. In 2003, accounting scandals at Fannie and Freddie allowed key members of Congress to pressure these institutions into substantial risky mortgage lending. By 2003–2004, therefore, federal policies were generating strong incentives to extend mortgages to borrowers with poor credit characteristics. Financial institutions responded and created huge quantities of assets based on risky mortgage debt.

This expansion of risky credit was especially problematic because of the second misguided federal policy, the long-standing practice of bailing out failures from private risk-taking. Bailouts have occurred often and widely, especially in the banking sector. In the context of the recent financial crisis, a crucial example is the now infamous "Greenspan put," the Fed's practice under Greenspan of lowering interest rates in response to financial disruptions in the hope that expanded liquidity would prevent or moderate a crash in asset prices. In the early 2000s, in particular, the Fed appeared to have made a conscious decision not to burst the housing bubble and instead to "fix things" if a crash occurred.

"The expansion of mortgage credit made sense only so long as housing prices kept increasing, but this could not last forever."

The banking sector's history of receiving bailouts meant that financial markets could reasonably have expected the government to cushion any losses from a crash in risky mortgage debt. Since government was also exerting pressure to expand this debt, and since it was profitable to do so, the financial sector had every reason to play along. It was inevitable, however, that at some point a crash would ensue. The expansion of mortgage credit made sense only so long as housing prices kept increasing, but this could not last forever. Once housing prices began to decline, the market had no option but to suffer the unwinding of the positions built on untenable assumptions about housing prices.

This interpretation of the financial crisis therefore puts primary blame on federal policy rather than on Wall Street greed, inadequate regulation, failures of rating agencies, or securitization. These other forces played important roles, but it is implausible that any or all would have produced anything like the recent financial crisis had it not been for the two misguided federal policies. Wall Street greed, for example, certainly contributed to the situation, if by "greed," one means profit-seeking behavior. Many on Wall Street knew or suspected that their risk exposure was not sustainable, but their positions were profitable at the time. Further, markets work well when private actors respond to profit opportunities, unless these reflect perverse incentives created by government. The way to avoid future crises, therefore, is for government to abandon polices that generate such incentives.

BAILING OUT THE BANKS

The Treasury's bailout plan was an attempt to improve bank balance sheets and thereby spur bank lending. The justification offered was that, as of early September 2008, major banks were facing imminent failure because their mortgage-backed assets had declined rapidly in value.

No one disputes that several

banks were in danger of failing, but this does not justify a bailout. Failure is an essential aspect of capitalism. It provides information about good and bad investments, and it releases resources from bad projects to more productive ones. As noted earlier, housing prices and housing construction were too high at the end of 2005. This condition implied a deterioration in bank balance sheets and a retrenchment in the banking sector, so some amount of failure was both inevitable and appropriate.

Thus, an economic case for the bailout needed to show that failure by some banks would harm the economy beyond what was unavoidable due to the fall in housing prices. The usual argument is that failure by one bank forces other banks to fail, generating a credit freeze. That outcome is possible, but it does not mean the Treasury's bailout plan was the right policy.

To see why, note that allowing banks to fail does not mean the government plays no role. Federal deposit insurance would prevent losses by insured depositors, thus limiting the incentive for bank runs. Federal courts and regulatory agencies (such as the FDIC) would supervise bankruptcy proceedings for failed institutions. Under bankruptcy, moreover, the activities of failing banks do not necessarily disappear. Some continue during bankruptcy, and some resume after sale of a failed institutions or its assets to a healthier bank. In other cases, merger in advance of failure avoids bankruptcy entirely. Private shareholders and bondholders take the losses required to make these mergers and sales attractive to the acquiring parties. Taxpayer funds go only to insured depositors.

The bailout distracted attention from the fact that government was the single most important cause of the crisis. More broadly, the bailout will continue to encourage perverse actions by institutions that are eligible for the money, such as acquiring toxic assets that the Treasury might buy or taking huge risks with Treasury capital injections.

The Treasury bailout of 2008 also initiated a government ownership stake in the financial sector. This means that, going forward, political forces are likely to influence decisionmaking in the extension of credit and the allocation of capital. Government might (again) push banks to aid borrowers with poor credit histories, to subsidize politically connected industries, or to lend in the districts of powerful legislators. Government pressure is difficult for banks to resist, since government can threaten to withdraw its ownership stake or promise further injections whenever it wants to modify bank behavior. Further, bailing out banks sets a precedent for bailing out other industries. Thus, the long-run implications of the bailout are unambiguously bad.

Ironically, the bailout itself may have exacerbated the credit crunch. The announcement that the Treasury was considering a bailout likely scared markets by suggesting the economy was worse than markets recognized. Likewise, the announcement may have encouraged a credit freeze because bankers did not want to realize their losses or sell their institutions to acquiring firms if government was going to get them off the hook. The bailout introduced uncertainty because no one knew what the bailout meant: how much, what form, for whom, with what restrictions, and for how long.

> "The stimulus was not about improving economic efficiency but about distributing funds to favored interest groups."

THE STIMULUS

The American Recovery and Reinvestment Act of 2009—better known as the "stimulus"—represents a massive transfer of resources away from the private sector to politically connected interest groups. The funds will come from our taxes and flow to the education sector, the health care sector, the creation of "green jobs," and federal contractors and unions.

Some proponents argue that the stimulus money was needed to embark on projects that are not being supported by the market but should be. This is the "market failure" argument for government spending. In fact, federal spending is already too high in most areas. From the $15 billion we spent on the failed Big Dig in my town of Boston to tens of billions we spend per month fighting in Iraq, there's plenty of ill-conceived government spending to be cut. The spending that was included in the stimulus bill went in many cases to sectors that are neither facing especially high unemployment nor experiencing the worst declines in activity (e.g., health care, education, alternative energy development).

The stimulus was not about improving economic efficiency but about distributing funds to favored interest groups. If the administration was really concerned about education, for example, it should have promoted policy changes that improve outcomes while saving money, such as reduced restrictions on who can become a teacher. The administration instead chose to shovel money to the teacher's unions.

Part of the stimulus bill came in the form of tax cuts, but these were mainly one-shot cuts aimed at redistribution rather than improved economic efficiency. Although shifting money to private citizens and away from government is a good thing, repeal of the corporate income tax would have improved

Continued on page 7

Cato Scholar Profile: TUCKER CARLSON

TUCKER CARLSON *is a senior fellow at the Cato Institute. Previously, he was the host of MSNBC's* Tucker, *and before that, PBS's* Tucker Carlson: Unfiltered *and CNN's* Crossfire.

You're a veteran cable news host, most recently of MSNBC's *Tucker*. Now that you have the freedom to go beyond the sound bite in making your arguments, what do you plan to say?

I have no intention of giving up the sound bite. It has served me well for a long time. The last thing Washington needs is more windy, imprecise answers to things. If everyone in politics was forced to speak in clear, short sentences, I suspect you'd see far less nonsense coming out of Congress.

So I plan to make the same case I've always made: for personal liberty; against collectivism in all its forms. And I plan to make it in the same way I always have, except with fewer commercial breaks.

Tell it like it is. Is there bias in the media?

Of course, and there always has been. Most journalists are lifestyle liberals, but their biases extend beyond politics. They favor the new over the old, the trite over the deep, the simple and dramatic over the complicated and nuanced. It was this way 30 years ago when my father was in journalism. Thirty years from now those biases will almost certainly remain. What has changed is the undisguised partisanship. Reporters didn't used to be allowed to root openly for a candidate, much less weep with joy on television when he won. Unfortunately that changed with Obama.

You're in the process of writing a book. Can you give us a preview?

I'll be spending the next several months cataloging all the many ways the modern state has made us less free. Once you give politicians the power to decide what sort of toilet you're allowed to use—and we have—there's virtually nothing they can't make you do, as the Obama administration is swiftly making clear. I can't promise an uplifting read. Bracing is what I'm aiming for. But I do think it's worth describing the problem in detail, unpleasant as it may be.

Continued from page 5

long-run incentives and created the foundation for economic growth in the future. Alternatively, the stimulus could have taken the form of lower employment taxes, which would have encouraged more hiring.

PEERING INTO THE LOOKING GLASS

President Obama's new budget is at least honest; it is an unapologetic attempt to restructure the U.S. economy and expand the role of government.

The budget forecasts that have come from the administration appear extremely optimistic. In particular, the extra revenue being projected from repealing the Bush tax cuts understates the dynamic response of the economy to this higher rate. Faced with higher taxes, people will cut back on their work or withdraw from the labor force. On the spending side, the new initiatives will surely cost many times as much as projected; that is the iron law of government spending. Combined, if Obama enacts half of what he has slated, we will see trillion-dollar deficits for years to come.

The stunning thing about the proposed budget is that nothing announced looks like it will improve the efficiency of the economy. Nothing looks like it's in the direction of freedom or liberty. Nothing looks like it has any faith whatsoever in markets. It's all about rewarding interest groups: unions, the green lobby, the education lobby, and the health care sector.

To sum up, the crisis was at its most fundamental level the result of government policies, not market failures. The government policies adopted have been misdirected, at best. The lesson for policymakers is therefore clear; it is better to do nothing than to make things worse. In economics, as in medicine, the dictum is "first, do no harm."

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