Currents

Under New Management

Yes, faithful reader, *Regulation* is under new management. Some of you may have noticed *Regulation*'s new subtitle, "The Cato Review of Business & Government," but otherwise we have tried to maintain the appearance, format, readability, relevance, and quality of a magazine that we have long admired. The American Enterprise Institute and its distinguished former editors deserve the credit for developing *Regulation* into one of the leading and most lively periodicals on a range of subjects that might otherwise be buried in technical articles and law journals. *Regulation* made an important contribution to the shared understanding that led to the substantial reduction in economic regulation during the Carter and Reagan administrations. We owe Christopher DeMuth and Carolyn Weaver of AEI our special thanks for their goodwill and cooperation in this "friendly takeover."

Regulation will continue to focus on regulation, antitrust, and trade policy. Our goal is for articles on these subjects to be both scholarly and readable. The only initial change in format is that most of the articles in each issue will be on a common subject, such as the Clean Air Act in this issue. The next several issues will focus on mandated benefits, a review of 100 years of antitrust, and major recent developments in trade policy. Anyone who wishes to reach a policy audience with new research or a new perspective on these or other subjects is encouraged to submit a manuscript for our review. We also welcome letters from our readers, especially those that have a different perspective from the notes and articles published in prior issues. All manuscripts and letters should be sent to:

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We promise a quick acknowledgment of the receipt of your manuscript, a careful review, and thorough editing.

For several reasons, there will be many demands for reregulation and new forms of regulation in the 1990s. Those who want to understand this development should read *Regulation*. Those who want to shape this development should write for *Regulation*.

Tree Huggers and Bean Counters

On occasion, as in this issue, our own point of view will be apparent.

'Tis the season, apparently, for the wearing of the green. A *Newsweek* special report (7/21/89) concluded that environmental issues are now "beyond benefit-cost analysis." After announcing that "our stand on the planet is that we favor its survival," *Time* (12/18/89) concluded that "the laissez-faire, free-market rules that allowed the industrial countries to prosper must now be suspended." Wow! How can anyone who also favors the survival of the planet (presumably most of us) disagree with these conclusions? Now that the megamagazines have pronounced on this issue, what more might a jump-started policy magazine contribute?

First, *a decent respect for the facts would indicate that the survival of the planet is not at stake.* Most environmental conditions in the United States have improved over the past twenty years. The proposed revisions to the Clean Air Act would make only small improvements to conditions that may be unsatisfactory but are not intolerable. The current level of smog, for example, is often ugly, but its primary health effect is to limit the potential for heavy exercise by some people on some days in some urban areas. (See the article by Kenneth Chilton and Anne Sholtz.) Similarly, the primary effects of acid rain are to make some northeastern lakes too acidic for fish and, maybe, to inhibit the growth of mountain red spruce. (See the article by J. Laurence Kulp.) And the health effects of ambient levels of toxic air pollution are too low to measure directly. (See the article by Frederick H. Rueter and Wilbur A. Steger.) Several global conditions of more recent concern that are not addressed by the Clean Air Act should also be placed in perspective. The average global temperature appears to have increased about one-half degree centigrade over the past 100 years, but the temperature variation during this period does not appear to be related to the level of carbon dioxide pollution. The "ozone hole" over the Antarctic is a perplexing phenomenon, but it has not yet caused any known adverse effects. (See the article by S. Fred Singer on these two issues.) There may be reason to be concerned about a future deterioration of each of these conditions, but there is little basis for the apocalyptic rhetoric that usually precedes and distorts new environmental legislation and regulation.

Second, *increasing the efficiency of environmental strategies will also increase the level of environmental quality.* For this reason, those who value environmental quality most highly should be the strongest supporters of efficient environmental strategies. Most current environmental legislation, unfortunately, is a maze of inefficient provisions that have the effects of internal tariffs—protecting old investments against new investments, declining regions against growing regions, and, in one case, eastern coal against western coal. The consequences of these provisions are that we spend much more than is necessary to achieve any given level of environmental quality and that the quality of the environment is lower than desirable. As a rule, these provisions were introduced to serve specific bureaucratic, regional, and sectoral interests and piggybacked on the broad national demand for increased environmental quality. There may be no way to pass environmental legislation without such provisions, but those who oppose efficient environmental strategies should be recognized as serving some unrelated special interest.

And third, *the level of environmental quality should be based on a balance of environmental and other values.* The proper question is whether the incremental benefits of a proposed measure are higher than the incremental cost. Most of the debate about the Clean Air Act, unfortunately, avoids this balance of values by focusing only on whether a proposed standard is feasible or fair. The "economics" of this issue, however, cannot ultimately be avoided, because neither the EPA nor the state and local authorities are prepared to enforce a standard for which the apparent benefits are much lower than the perceived costs. Our political process selects environmental standards that will not be enforced and authorizes inefficient means to meet these standards. The actual implementation record, however, is messy but more encouraging: the gradual reduction of most pollutants at a reasonable cost.

And, oh yes, a pox on both the tree huggers and the bean counters. We have little tolerance for the tree huggers, who talk mystically as if the "ecosystem" has its own values known only to them and contend that all other values are subordinate. (On reflection, even the tree huggers should recognize that they cannot avoid tradeoffs, because not all desirable environmental conditions come in the same package: for example, nuclear energy, for all its problems, may be the most efficient way to reduce carbon dioxide emissions.) Similarly, we have little tolerance for the bean counters, who seem indifferent to environmental values because they are more difficult to measure. In our case, we value the quality of the shared environment, a wide range of private goods and services, and the freedom to organize most of our life by market exchanges and other consensual relations. Moreover, we value environmental quality more the higher our wealth in other goods and services. And we suspect that our values are not very much different from those of most people. The current debate on environmental policy, unfortunately, has been polarized by the rhetoric of a holy war. In a rhetorical contest limited to poets and accountants, the poets will win even when the accountants are correct. The potential for good environmental policy may depend on reshaping the rhetoric of the environmental debate to reflect a broader set of shared values.

W.N.

Gramm-Rudman and Crème de Cassis

Economists have much to be humble about, especially about our limited ability to look around the corner of time. Given this fair warning, let me venture a policy forecast: conditions at the beginning of this decade portend a strong divergence in regulatory trends between the United States and Europe.

For several reasons, the United States appears likely to face some reregulation, tighter regulation, and new forms of regulation.

First, the opportunities to serve special interests through the federal fisc have been substantially reduced. The combination of the Gramm-Rudman deficit-reduction process and President Bush's "no new taxes" pledge, however porous in each case, has sharply limited the opportunities for new or expanded spending programs. The Tax Reform Act of 1986 eliminated many tax preferences and reflected a perspective that will be skeptical of new proposals for discretionary tax provisions.

The demands for redistribution through the political system, however, have not been reduced. As a consequence, both the administration and Congress will be tempted to increase the regulation of domestic and international trade to meet these political demands. The next stage of the American welfare state is most likely to be implemented by mandates on employers to provide medical insurance, pensions, assistance to disabled workers and customers, parental leave, child care, severance pay, etc. Some such measures have recently been approved, and more are in the congressional mill. The demands to serve specific industries and regions may increase the use of discriminatory domestic regulation and trade restraints. In contrast with on-budget transfer payments, the costs of these regulatory transfers is hidden in product prices and factor earnings, and the distribution of these costs is quite arbitrary.

A second reason for increased regulation is that for several industries, the reduction in economic regulation initiated during the Carter and Reagan administrations has been jeopardized by a failure to reform the remaining government role in these industries. The S&L debacle is only the most visible consequence of this failure to deregulate intelligently. The deregulation of deposit rates beginning in 1980 was not followed by the necessary changes in the federal deposit insurance system, a condition that has not yet been corrected. This condition has already led to a huge taxpayer cost to refinance the deposit insurance fund, a high failure rate of both commercial and savings banks, and some reregulation of the asset portfolios of savings banks. Depository institutions are likely to face more regulation, not less, until there is a major reform of the deposit insurance system.

Similar problems face the airlines and communications industries. The deregulation of domestic aviation led to a large increase in the number of flights, but there was no significant increase in the capacity of airports and the air traffic control system. The consequence was a substantial increase in airport congestion and flight delays and, more recently, some selective tightening of fares. The pressure for some reregulation will probably continue until there is a major reform of the process for allocating congested airspace and airport capacity. Similarly, the long process of deregulating the communications industries has not been paired with a complementary change in the process for allocating the electronic frequency spectrum, limiting the entry of both new firms and new technologies. For different reasons, there has already been some reregulation of the rail rates to "captive" shippers.

A third reason for increased regulation, one that may be temporary, is that good times lead to new demands. The political argument for economic deregulation was to reduce inflation and increase productivity, an argument that was qualitatively correct even if overstated. The substantial reduction in inflation, a record peacetime recovery, and prospects for the end of the cold war, however, have changed the focus of American politics, in part by forcing the opposition party to raise new issues. The demand for environmental quality, for example, is clearly more than proportional to income—over time, across groups within the American population, and across countries. Continued good economic conditions, therefore, will increase the demand for measures to improve safety and the environment—measures that have typically, but not necessarily, been regulatory rather than fiscal. This effect, of course, would change if U.S. economic conditions deteriorate. Bad times sometimes focus the mind but more often lead to other types of bad policies. No one should wish for bad times to avoid increased regulation.

From our perspective, the prospect for increased regulation in the United States is discouraging but should not be regarded as certain. We maintain a wistful hope that clear thinking and strong evidence make a difference, even in Washington. And the increasing concern about international competitiveness will discipline the demand for regulation that increases the relative costs of U.S.-based firms. Those of us who are concerned about the prospects of increased regulation face a daunting but clear task:

- Put the federal fiscal house in order, so that political demands are not artificially channeled into new regulation.
- Reform or privatize the deposit insurance system, the air traffic control system, the allocation of the frequency spectrum, etc., so that poor government performance of these complementary services is not an excuse for reregulation.
- And be prepared to respond to the genuine de-

mands for increased safety, environmental quality, etc. by the most efficient means. *End of sermon.*

The prospects for a very different regulatory future in Europe are based on an important decision by the European Court of Justice in 1979. In that case, the European Court ruled that French crème de cassis could be sold in Germany even though its alcohol content (17 percent) was lower than the German standard for fruit liqueur (32 percent). In later cases, the court ruled that Belgian beer and French pâté could also be sold in Germany and that German noodles could be sold in Italy. The European Commission has endorsed this "country-of-origin" principle for product standards and is determined to extend this principle to services, except in those cases where a single European-wide standard is promulgated from Brussels. A broad application of this principle, for example, would allow an Italian lawyer to practice in Britain, Dutch truckers to serve German customers, and British companies to offer insurance in France, as long as they meet the standards of their home government.

The long-term effects of this country-of-origin principle would be profound and may not be recognized by the Europeans. In the absence of any change in national standards, trade in goods and services will flow to that country where the regulations best serve the interests of consumers. Over time, this institutional competition among national regulations is likely to lead to a convergence of national regulations on the least onerous standard. This could lead to a lower average level of regulation than in the United States, where the product and service standards are generally federal or set by the state of purchase.

This will be so unless, of course, the process of spontaneous coordination is overridden by political harmonization of the national standards. As in the United States, companies that have specialized in meeting a more restrictive standard may try to use the developing political processes of the European Commission to limit competition from companies producing to a less restrictive standard. And these appeals will be reinforced by the Eurocrats in Brussels who seem to believe that all good outcomes must be planned, uniform, and directed.

The economic future of the European Community will depend critically on the mix between spontaneous coordination and political harmonization. And the outlook is not yet clear. Institutional competition in a free-trade area is likely to lead to a levelling-down of average regulations and tax rates. Political harmonization, in contrast, would probably increase the average level of regulation and taxes. In the near term, maybe for a decade or so, my guess is that market forces, supported by the country-of-origin rule, will prevail. The European Commission has the authority to promulgate community-wide regulations but has been slow to act, and any political harmonization of tax rates is constrained by the necessary approval of each member government. The 1990s may prove to be the decade of Europe.

For an American, this comparision poses a special irony. At the same time that American politicians are pressing for mandated employer-provided benefits similar to those in Europe, developments in Europe may leap-frog American conditions in the direction of increased internal competition and lower economic regulation. This story, however, is not yet complete. See this column for further installments.

W.N.

The S&L Debacle: How It Happened and Why Further Reforms Are Needed

The massive insolvencies of hundreds of savings and loan associations in the late 1980s have been a searing experience for everyone concerned. They have required the commitment of tens of billions of dollars of general revenues to honor government guarantees of deposit insurance to insured depositors; the healthy majority of the S&L industry has been tarnished and will be taxed heavily; a major federal agency has been ignominiously abolished; and the reform of deposit insurance and depository regulation for banks and thrifts must now be addressed.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989, enacted in August to deal with these problems, makes only a few of the necessary reforms, and it takes a few unnecessary backward steps as well. Further improvements are vital.

To understand the necessary reforms, though, one must understand the origins of the debacle and the steps that have already been taken.

The Origins of the Crisis

Before 1980 the thrift industry was a relatively sleepy industry that had caused few public policy problems. It was regulated by the Federal Home Loan Bank Board, which also provided deposit insurance through the Federal Savings and Loan Insurance Corporation. (Some thrifts, though, were insured by state-sponsored funds or by the insurer for commercial banks, the Federal Deposit Insurance Corporation; the FDIC-insured thrifts—the "mutual savings banks," located mostly in the Northeast—largely avoided the debacle of the 1980s.) This structure had been established during the banking reforms of the 1930s. The industry was largely focused on residential mortgage lending, which was a "safe" product—safe in the sense that borrower defaults on home mortgages are rare, except in the most dire of economic circumstances. The industry was largely mutual (rather than stock-ownership) in organization, dominated by small institutions. Its executives were "pillars of the community" who promoted thrift and encouraged home ownership. It was no accident that Jimmy Stewart's George Bailey was the head of a savings and loan in Frank Capra's 1946 film "It's a Wonderful Life."

There was one flaw, however. The industry was making 30-year mortgage loans but financing them with short-term deposits. As long as interest rates stayed stable, this pattern of "borrowing short and lending long" was a good way to make a living. But if interest rates rose sharply, this practice meant losses, because the S&L's income was fixed to the interest receipts on the portfolio of long-lived loans made in previous years; but it had to pay higher interest rates to retain its deposits.

This problem first arose in 1966. Congress "fixed" it by extending the deposit interest rate ceilings ("Regulation Q"), which had previously applied only to commercial banks, to thrifts as well. With thrifts now unable to compete among themselves on the basis of interest paid on deposits and with depositors' having few good alternatives, this "patch" worked—for a while.

By the late 1970s, however, as interest rates again rose sharply, the Reg Q patch was no longer adequate. Depositors now had a good alternative that would pay market rates of interest: money market mutual funds. Consequently, thrifts faced a Hobson's choice: If they tried to pay market rates of interest, they would run losses; if they did not, they would lose their depositors.

Congress responded with two major pieces of deregulation legislation: the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Act of 1982. These acts accomplished three things: (1) Thrifts were authorized to diversify their portfolios; they could make other kinds of consumer loans, commercial real estate loans, commercial loans, and even direct investments in real estate or other ventures. They were also authorized to make adjustable-rate mortgages (which had previously not been possible for federally chartered thrifts). At the same time, many states were authorizing even wider investment powers for their state-chartered (but federally insured) thrifts. (2) Thrifts were authorized to offer consumer checking accounts that would pay interest, and the Reg Q ceilings were phased out. (3) The maximum insured deposit amount was raised in 1980 from $40,000 to $100,000.

These economic deregulation actions were largely sensible, though the raising of the insured amount is now considered controversial—an issue to which we shall return below. But they needed to be accompanied by stepped-up levels of safety and soundness regulation and/or expanded use of economic incentives, so as to augment the regulatory system that was in place but that was geared to the simpler and safer world of the home mortgage. Unfortunately, several years passed before the importance of either action was recognized.

This need for regulatory tightening can be traced to three major changes in the thrifts' operating environment. First, their expanded investment authority meant new *opportunities* for taking risk; thrifts were no longer restricted to the safe home mortgage. Second, the lifting of the Reg Q ceilings increased the *capabilities* for thrifts to attract the deposits to fund the new investments; also the increase in the insured amount lowered the transactions costs of attracting these deposits. Third, the thrifts' losses of the early 1980s greatly increased their incentives for risk-taking, since their net worth (the residual of assets less liabilities, frequently called "capital") had been largely or entirely eliminated. With their ownership stakes diminished or gone, thrift owners had much to gain and little to lose from risk-taking; the FSLIC would bear most or all of the "down-side" consequences of risk-taking, since the FSLIC was the guarantor to the depositors.

In sum, the opportunities, capabilities, and incentives for "moral-hazard" behavior had greatly increased.

Unfortunately, no one in the Washington policy community (or elsewhere, either) at the time saw that this explosive combination of conditions was present. Instead, everyone was mesmerized by the hemorrhaging of the thrifts (because of their interest rate mismatch) and the need to find a way to allow them to return to prosperity; and, besides, the thrift industry had never posed safety-and-soundness problems before. Also, this was an era of deregulation, and many in Washington could not distinguish between economic regulation and safety regulation. In fact, the number of the regulatory field-force examiners and supervisors actually decreased between 1981 and 1984. Further, net-worth standards were actually lowered in 1980 and again in 1982. And the accounting system—never good to begin with, because the standard accounting framework tries to trace historical costs (rather than to

capture current market values), thereby allowing firms frequently to overstate asset values and thus overstate net worth—was changed to allow thrifts even greater leeway in overstating asset values and net worth.

Although the Washington policy community may not have understood the potentially explosive conjoining of opportunities, capabilities, and incentives, hundreds of thrift executives did. Also, new thrift owners came into the business, with few of the old-line traditions, values, or reputations. And so the thrift industry grew rapidly in the mid-1980s: it made many new loans and investments and financed them with FSLIC-insured deposits. In all too many instances the new assets were poorly underwritten and based on excessive optimism, carelessness, or deliberate risk-taking. In some instances there were fraud and criminal violations.

Three idiosyncratic events made a potentially bad situation even worse. First, the drop in the price of oil in the mid-1980s caused a severe economic decline in the Southwest and a plummeting of commercial real estate values. Thrifts, especially in Texas, that had lent heavily on commercial real estate projects in the area were devastated. Second, the Economic Recovery Tax Act of 1981 had made commercial real estate an especially tax-favored investment and encouraged many new projects, often financed by thrifts; the Tax Reform Act of 1986 reversed course, causing many of these projects to become uneconomic and, again, devastating many thrifts. Third, a change in the regional regulatory headquarters for the Southwest, from Little Rock to Dallas in 1983, caused bureaucratic confusion, disruption, and delay in regulatory enforcement—at just the wrong time and in just the wrong place.

The Regulatory Response

After a recognition lag of a few years, federal safety regulation of thrifts tightened between 1985 and 1988. The Federal Home Loan Bank Board raised thrifts' net-worth standards (albeit slowly), restricted the growth of poorly capitalized thrifts, limited thrifts' ability to take direct ownership positions in ventures, and more than doubled the number of the field-force supervisors and examiners. A new emphasis on safety and soundness pervaded the regulatory system. Unfortunately, these regulatory improvements could not cure the problems of the bad loans and investments that had already been made, and the insolvencies they would cause; but these changes were necessary to restrict further speculative behavior.

As the numbers of thrift insolvencies grew and the FSLIC's resources became increasingly strained, Congress in early 1986 was asked to authorize the FSLIC to borrow $15 billion, to be paid back almost entirely from future insurance premiums. Congress dithered, however. The operators of insolvent thrifts, who feared (correctly) that more resources for the FSLIC would mean more rapid closure of their operations, encouraged this delay. Not until August 1987 did Congress pass the Competitive Equality Banking Act of 1987, and the act authorized the borrowing of only $10.8 billion. Other parts of the legislation indicated that Congress neither wanted nor expected rapid closures.

Nevertheless, the Bank Board in 1987 and 1988 began closing and disposing of large numbers of insolvent thrifts—some through liquidation, most by finding acquirers. In 1988 alone, it disposed of 205 insolvent thrifts. These disposals (along with 18 "stabilizations," in anticipation of future disposals) were estimated to cost the FSLIC almost $40 billion (on a present-discounted-value basis). Since this sum greatly exceeded the FSLIC's immediate cash resources, these transactions were accomplished largely through the issuance of notes and promises of future payment.

These disposals were usually described by the press and the electronic media as "bailouts." But the owners and managers of insolvent thrifts were being removed from these thrifts (and were often being sued or indicted). Though uninsured depositors were sometimes kept whole and sometimes forced to absorb losses, they were in all circumstances a tiny fraction (usually around 1 percent) of the deposits in insolvent thrifts and thus were an unimportant component of the overall costs. Virtually all costs were devoted to honoring the FSLIC's guarantee to insured depositors, either directly through a liquidation and payout to depositors or indirectly through an acquirer's taking on the FSLIC's liability to depositors. But the continued use of the term "bailout" carried the unfortunate connotation (that persists even today) of "unexpected windfall for thrift owners and managers" and did not further the public's understanding of these actions.

FIRREA

In early 1989 hundreds of insolvent thrifts were still operating, and further legislative action was necessary. In February the Bush administration proposed legislation, which was eventually passed in modified form by Congress in August.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 authorized an additional $50 billion of borrowing that Congress and the Bush administration hoped would be adequate to clean up the remaining insolvent thrifts. Treasury revenues were explicitly brought into the picture and are expected to cover about 75 percent of the overall costs of the cleanup; higher insurance premiums and other levies on healthy thrifts will cover the remainder. FIRREA abolished the Bank Board and the FSLIC and scattered the agency's powers to other entities across the federal government. More money was allocated for criminal prosecutions of errant thrift owners and managers. And Congress mandated that higher and risk-based net-worth standards be applied to thrifts. (It is worth noting that the Bank Board was already in the process of putting such standards into place through regulatory action.)

Unfortunately, along the way Congress insisted on legislating the details of thrift regulation (the Act runs to 393 printed pages!) that were best left to the Office of Thrift Supervision (which succeeded the Bank Board as the primary federal regulator of thrifts)—but Congress was apparently not in a mood to trust thrift regulators. FIRREA specified exactly how net worth should be calculated. It cut back on the range of allowable investments by even well-capitalized and well-run thrifts. And it required that thrifts increase their percentage of assets devoted to housing-related activities to 70 percent, up from the 60 percent level that had been mandated two years earlier.

The Necessary Reforms

Four changes to the regulation of all depository institutions—banks and credit unions as well as thrifts—must be made to offset the moral hazard implicit in deposit insurance: higher (and risk-sensitive) net-worth standards; better (market-value) accounting; risk-sensitive premiums; and stronger powers of early intervention by regulators. Unfortunately, FIRREA endorsed only the first and shunted the other three to an 18-month study by the Treasury.

The net worth of a depository is an important protection for the insurer of its deposits. Net worth is a direct buffer: The larger is net worth, the greater can be the fall in the value of the depository's assets before the insurer's obligation to depositors is activated. It is also an indirect buffer, since a larger net worth is likely to make owners more cautious and reduce their moral-hazard behavior. In many ways the net worth of a depository is similar to a deductible in a normal home or auto insurance policy, and it has similar effects in protecting the insurer. It is encouraging that Congress now seems to understand the importance of net worth, but more is needed.

Accounting is normally considered a "boring" topic. But, properly conceived, it is an information system. And, for depository regulation, it is *the* information system. Unfortunately, the existing accounting framework ("generally accepted accounting principles" or GAAP) is seriously defective. Net worth—this crucial protection for the insurer—is measured within an accounting system that mainly focuses on historical book value rather than on the current market values of assets and liabilities. But it is only net worth measured according to market values that provides the direct protection for the insurer, as well as shaping the incentives of owners. Market-value accounting must become a standard part of the depository regulatory process.

Deposit insurance premiums are currently levied on a flat-rate basis, with no adjustment for risk. (In 1989 they were 8.33 cents per $100 of deposits for banks and 20.83 cents per $100 of deposits for thrifts; FIRREA lays out a schedule of future changes that will eventually bring them into equality at 15 cents per $100 in 1998.) Flat-rate premiums clearly fail to provide any disincentive to risk-taking. The same principles that will be applied to determining risk-based net-worth standards could be applied to premiums as well. If nothing else, depositories that choose to operate with higher levels of net worth than the required minimum should be rewarded with a lower premium. Every auto insurance company in America offers its insureds a lower premium if they take out a larger deductible. The same principle should apply to deposit insurance.

Finally, the powers of the regulators to appoint a receiver—in essence, to revoke the future coverage of insurance by removing the owners—must be strengthened. Currently, insolvency is the strongest and clearest grounds for appointing a receiver. But waiting for insolvency—especially under the current accounting system—means waiting until the real costs to the insurer are likely to be significant. Instead, the regulators should have the powers to appoint a receiver when the measured net worth of a depository is low but not yet zero.

What about cutting back on the coverage of government-provided deposit insurance, or even eliminating it? The argument for doing so is that it would encourage greater market discipline. If depositors (or private insurers) were at greater risk, they would be less inclined to provide the funds for risk-taking by depository managers. To address this question, however, we must understand the reasons for deposit insurance. There are two primary reasons—to provide safety and security for unsophisticated savers and to dampen or eliminate runs on depositories. The former goal could probably still be achieved with reduced coverage; but the likelihood of bank runs would be increased by reduced coverage. There are many critics of deposit insurance who believe that bank runs would not have serious consequences. I am not among them and hence believe (unfashionably) that deposit insurance should be expanded to 100 percent coverage of all deposits. As for private deposit insurance, the need for government monitoring, regulating, and "reinsuring" the private insurers would still be present; so the fundamental problems of government regulation and insurance would not be avoided. It is worth noting that there were no private deposit insurers in existence before the onset of federal deposit insurance in 1933, despite (or, perhaps, because of?) numerous bank failures and losses by depositors.

In sum, I believe that depositors are the wrong parties to bring market discipline to depositories. A good argument can be made, however, for long-term subordinated debt holders as a useful monitoring and disciplining force. Primarily, though, we must learn the painful lessons of the regulatory failures of the past decade and act on them: We need higher (and risk-based) net-worth standards; they should be based on market-value accounting; they should be buttressed by risk-based insurance premiums; and the regulators should have the power to take control of an errant depository before insolvency.

Do We Still Need a Thrift Industry?

No essay on the S&L debacle can conclude without addressing this question. It is usually asked by those who implicitly assume that, at least in the past, the thrift industry was the primary or sole way of providing residential mortgage finance and that the industry somehow needed special protection or coddling. Regardless of the validity of these assumptions in the past, they clearly are not true today. No, we do not "need" a thrift industry. There are other ways of providing residential mortgage finance. Commercial banks are likely to become more involved in the future, and an active secondary mortgage market has increased the role of mortgage bankers. (I would answer the same way if a similar question were asked about the "need" for commercial banks.)

It is, however, the wrong question to ask. Instead, is there a group of institutions who primarily take in deposits and make mortgages (and perhaps offer a few complementary financial services) and who can efficiently compete in the financial marketplace by specializing in these services? I believe that the answer is yes, although their numbers are fewer than the current population of thrifts, and mergers and consolidation are inevitable. Do these efficient producers need to be coddled and protected? No, of course not. Should they be forced to diversify, so as to look more like commercial banks? Conversely, should those who can diversify efficiently and prudently be prevented from doing so? No; and no. And we should not, through discriminatory taxation or regulation, eliminate these efficient producers from the marketplace.

An analogy with general retailing is useful. We see specialty shoe stores, and we see diversified department stores that include a shoe department. Both can survive in the marketplace. Should we force shoe stores to become department stores or (at the other extreme) force them to remain specialized? Clearly not.

With proper regulatory reform, both specialty depositories and diversified depositories ought to be able to survive in the marketplace. And, in any event, within the boundaries of sensible safety regulation, their survival should be decided by the market and not by excessively rigid regulation.

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The Deposit Insurance Reform Bandwagon

The depth of the financial hole created by insolvent savings and loans over the past decade has shocked many observers, particularly as it has become apparent that taxpayers will be required to fill most of the cavity. But problems among U.S. financial institutions are not confined to the nation's thrifts. The banking industry has also experienced record failure rates during the 1980s, FDIC reserves are at historic lows, and growing credit problems in several sectors of the economy raise questions about the future stability of many remaining banks.

In response to increased instability among both S&Ls and banks, the Minneapolis Federal Reserve Bank's lead article in its *1988 Annual Report* was entitled, "A Case for Reforming Federal Deposit Insurance." Furthermore, W. Lee Hoskins, president of the Cleveland Federal Reserve Bank, argued in a May 1989 speech entitled "Rethinking the Regulatory Response to Risk-Taking in Banking" that a crucial element in that response must be reform of the federal deposit insurance system. Nor are these the only Federal Reserve Banks where the staffs are joining a growing chorus advocating fundamental reform of the federal deposit insurance system as a necessary step to stabilizing conditions among U.S. financial institutions.

Recent articles from the Dallas, Richmond, San Francisco, and Atlanta Federal Reserve Banks, to name a few examples, make it clear that there is widespread agreement that flaws in the federal deposit insurance system are at the core of the savings and loan industry crisis and go far in explaining the increased instability among banks. Flat-rate deposit insurance premiums that do not reflect portfolio risk and expanding deposit insurance coverage converge to create a moral-hazard problem. None of the parties most directly involved—depositors, stockholders, or managers—bears any of the direct costs of increased risk-taking among depository institutions.

Consequently, the present deposit insurance regime encourages bank managers and stockholders to pursue riskier investments than they otherwise would. If these investments are successful, stockholders reap the increased profits. Meanwhile, federally insured depositors neither remove their funds nor demand more interest on their deposits as a rule; after all, their risk exposure remains basically unchanged. Nor do the federal guarantors impose any financial penalty for greater risk-taking.

In addition to its impact on private actors, federal deposit insurance also affects the decisions of public servants. As Lee Hoskins notes in the reprint of his May 1989 speech, federal deposit insurance allows, even encourages, federal authorities to delay the closure of insolvent institutions. But once a bank or S&L has exhausted its capital, it raises deposits (that is, it borrows money from depositors) solely on the credit of the federal government, and hence the taxpayers.

Thus, an important theme running through recent Federal Reserve Bank articles is the need for stricter supervision. Note that the emphasis is on supervision, not regulation. That is, the authors of recent articles argue that banking authorities should emphasize compliance with capital standards and should be committed to prompt closure of insolvent insured institutions. This emphasis on capital and closure is in contrast to the more traditional regulatory approach to controlling risk by defining acceptable banking activities.

Reflecting this emphasis on supervision, Anatoli Kuprianov and David Mengle (Richmond Fed) conclude, for example, "Regulators should have the means to deal promptly and firmly with insolvencies before they threaten the soundness of the deposit insurance funds, [and] no institution should be considered too big to fail." Michael Keeley (San Francisco Fed) goes further to note, "It is essential that bank and thrift regulators credibly commit themselves to strictly follow a policy that alters the risk-taking behavior of bank and thrift managers. Regulatory reform cannot succeed if bank and thrift executives know that they can pursue high-risk strategies and then invoke special exceptions or expect forbearance. In fact, it was just such forbearance that got us into the [S&L] mess we are in today."

This is not to suggest that any single plan for reform emerges from reading the Federal Reserve Bank literature. Some of the articles offer an overview of the pros and cons of current proposals. Others, like the one by Larry Wall (Atlanta Fed), offer specific reform proposals of their own.

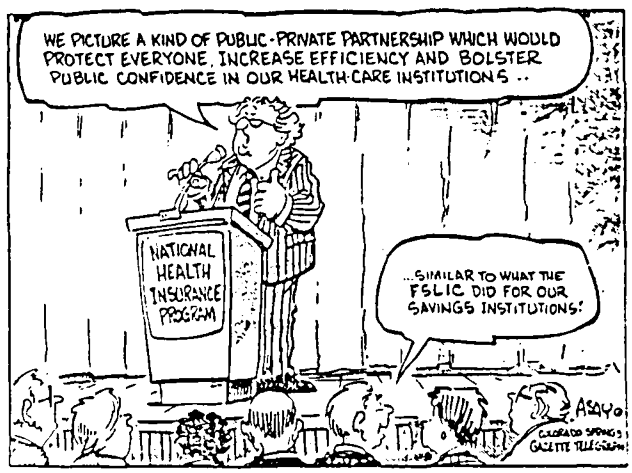
But once again, certain themes are echoed more often than others. Most of the authors advocate some increase in market discipline as an aid to enforcing capital standards and ensuring prompt closure. For example, Kuprianov and Mengle argue, "To make banking safer, it must be made less safe for bank creditors." John Boyd and Arthur Rolnick (Minneapolis Fed) conclude, "Deposit insurance should be reformed to better reflect private insurance principles and to encourage market discipline. This implies more direct market involvement in bearing bank risk. Through higher deductibles (capital requirements) and coinsurance, shareholders and depositors will have an increased stake in the soundness of their banks." And Lee Hoskins notes, "The deposit-insurance system must be reformed so that the market plays a greater role in assessing and pricing bank risk."

Not all the authors fully agree, however. Some express concerns about possible negative effects of increased market discipline, and Richard Randall (Boston Fed) maintains that market discipline would be ineffective in gauging bank risk.

Despite this lack of consensus on a single reform plan, recent articles from the Federal Reserve Banks recognize that an expanding federal safety net has increasingly shifted the responsibility for monitoring the performance of depository institutions from depositors and stockholders to federal regulatory authorities. It is also generally accepted that this regulatory/supervisory task has become more difficult—as well as increasingly important—in a world with rapidly changing and increasingly interdependent financial markets. Thus, all the authors surveyed recognize the need to reassess the U.S. system of bank oversight and insurance.

Of course, the Federal Reserve Banks did not just discover the problems created by deposit insurance. Articles by Mark Flannery (Philadelphia Fed), John Kareken (Minneapolis Fed), and Eugenie Short and Gerald O'Driscoll (Dallas Fed) in 1982 and 1983 sounded early warnings about the dangers of deregulating banks and thrift institutions without first dealing with the adverse incentives created by the federal deposit insurance system. (It was the 1980 Depository Institutions Deregulation and Monetary Control Act that decontrolled interest rates on deposits while raising de jure insurance coverage from $40,000 to $100,000. And it was in 1982 that the Garn–St Germain Act gave S&Ls broader asset powers.) But the tenor of the recent articles is different from earlier papers. The articles from the early 1980s talked about deposit insurance reform in terms of the ongoing debates over deregulation. That is, the line of reasoning was, if bank deregulation is desirable, then deposit insurance reform is also necessary. The more recent studies discuss the need for deposit insurance reform, period.

Though official Washington seems to be carefully ignoring the contribution made by federal deposit insurance to the thrift crisis, the Federal Reserve Bank representatives are not. And many of them end with a warning. James Thomson (Cleveland Fed) remarks, "Conspicuously absent from [the S&L bailout legislation] are fundamental reforms to the federal deposit-insurance system that would help prevent another such crisis." Lee Hoskins warns, "Without reform, the consequences of excessive risk-taking will remain with the taxpayer." And Genie Short and Jeffrey Gunther (Dallas Fed) con-



clude, "Piecemeal efforts of introducing financial reforms, coupled with policy efforts that focus on the symptoms of the financial problems rather than on their underlying causes, have contributed to, rather than diminished, unstable financial conditions in this country. In particular, legislative changes which have reduced constraints that were imposed to prevent federally insured financial institutions from incurring excessive risk, without introducing changes to the nation's system of financial safety nets, have contributed to current financial difficulties."

Meaningful reform of the deposit insurance system will not be easy. Depositors, bank managers and stockholders, and government officials are all dependent on the subsidies and protections provided by federal deposit guarantees. But it is increasingly apparent that, as with other types of dependencies, this one weakens the banking system rather than stabilizing it. Matters are further complicated by the numerous competing proposals and theories about what steps to take when. But what is clear is that the federal deposit insurance system is seriously flawed, it contributed to the existence and size of the savings and loan fiasco, and it is undermining the stability of the banking system. For the sake of taxpayers and to protect our financial sector, and hence the economy, it is time Congress and the president admit the problem and begin to work toward a solution.

C.E.

Getting Tough on White-Collar Criminals

Since its inception in 1984, the U.S. Sentencing Commission has been grappling with the task of reducing the variance in criminal penalties for similar federal crimes. But in attempting to reduce this disparity in sentencing, the commission dramatically increased penalties for many white-collar crimes. Although to many observers the Reagan administration appeared to be soft on white-collar criminals, the majority of President Reagan's appointments to the Sentencing Commission have consistently taken a harsh stance toward businessmen accused of breaking the law. In fact, the Sentencing Commission has reversed fifty or more years of past practice where white-collar crimes ranging from antitrust violations to insider trading to tax evasion usually did not result in imprisonment. The Sentencing Commission has dramatically expanded the use of prison terms and has simultaneously increased the size of criminal fines used to punish white-collar criminals.

In its expanded use of prison sentences, the Sentencing Commission has ignored the body of economic research on crime and punishment. There are substantial costs associated with imprisonment, for society as well as for the individuals jailed. In determining when prison sentences are appropriate, then, policymakers should consider, among other things, the foregone legitimate earnings of those imprisoned as well as the costs to society of providing prisons. As a result of these societal costs, economists have traditionally argued that, in cases where the criminal poses no further threat to society and when he has sufficient assets, fines are preferable to imprisonment since they involve lower total social costs. Thus, in *Economic Analysis of the Law*, published in 1986, Judge Richard Posner concluded that "white-collar crimes . . . probably could be punished exclusively by fines."

The Sentencing Commission's position has been, by contrast, that without imprisonment, criminals do not face any real burden from conviction. Members of the commission have argued that white-collar criminals should go to prison for at least as long as criminals convicted of other classes of crime that involve similar dollar amounts, but in fact the sentencing guidelines developed by the commission have been especially harsh on white-collar criminals.

For example, under commission guidelines, inside traders face a longer prison sentence than those taking the same amount of money through larceny. Of the twenty cases of insider trading both brought and completed during 1988, only three resulted in imprisonment (two sentences of four months each and one of three years). If these violations had been committed after the Sentencing Commission's guidelines took effect in November 1987, criminal convictions would have resulted in imprisonment in every case. Those convicted of having earned only $10,001 through insider trading would have faced eight to fourteen months in prison. (All but three of the cases involved amounts greater than this.) Combined with other commission-sponsored changes involving probation, this would have represented real time served, and higher insider trading profits would have resulted in even longer sentences. In comparison, a common thief stealing $10,001 would face only a four-month to ten-month sentence. The typical thief would have to steal more than $40,000 before he would face a prison sentence of eight to fourteen months. Crimes of embezzlement, property destruction, and receipt of stolen property that involve similar dollar amounts are now also punished less severely through imprisonment than insider trading.

Assuming that the commission's goal was to set the expected penalty equal to the social cost of the crime, the recent changes might have been justified if the harm created by insider trading was greater than the harm in cases of larceny or if the probability of being convicted for insider trading was lower than the chances of getting caught for theft. But the commission considered neither aspect in setting the penalties. In fact, a study conducted while I was at the Sentencing Commission found evidence consistent with setting the prison terms for insider trading lower than those for larceny.

Not only do inside traders face civil fines and larger criminal fines than individuals convicted of these other crimes, but inside traders also suffer greater reductions in their legitimate earnings once they return to the labor force. From June 1984 to July 1987, legitimate income for inside traders declined on average by over $53,000 between the twelve months before their conviction and the last twelve months of their probation or parole. In contrast, the average bank robber convicted for the first time suffered only a $2,100 reduction in legitimate earnings after his conviction. In general, those with the largest preconviction earnings suffered the largest percentage drop in postconviction earnings as a result of their crimes' being discovered. Even being charged with a white-collar crime appears to reduce the legitimate income of the accused by over 40 percent.

A troublesome feature of the insider trading cases is that the exact nature of the crime has never been clearly defined. The Securities and Exchange Commission has failed to offer any explicit demarcation of illegitimate trading behavior because it fears that a clear definition would limit its options in future enforcement cases. In a similar vein, though the Sentencing Commission's guidelines state that the penalty for insider trading is a function of the dollar amount of profits involved, the guidelines fail to define how those profits should be measured. Again, the SEC is left to define insider trading after the fact. Unfortunately, the enforcement attitude that "we will know it when we see it" seems destined to continue.

The Sentencing Commission has taken a tough stance not only in the arena of insider trading. Recent changes in the antitrust penalties for horizontal restraints of trade have also been strikingly harsh. Under preguideline practices, approximately 39 percent of all individuals convicted of antitrust violations from 1984 to 1986 were imprisoned (usually for only a couple of months), and criminal fines averaged $27,000. The guidelines issued by the commission in 1987 have changed this. Current penalties range from imprisonment of two to eight months when the total affected gross sales for the firm are less than $1 million to imprisonment of ten to fourteen months if affected sales exceed $50 million. Individual fines in cases of antitrust violations are now set at 4 to 10 percent of the volume of affected commerce, and the commission's guidelines strongly imply that fines should usually be set at the upper level. Until Congress grants the Department of Justice's recent request to increase the maximum statutory fine for individuals, the Sentencing Commission expects that most criminal fines in antitrust cases will equal the $250,000 maximum allowable fine.

In the case of antitrust violations, the managers commit the crimes because they increase the firms' expected profits. Thus, a fine that eliminates the return to the firm violating the law would also eliminate the manager's incentive. Imprisonment for managers, on the other hand, will cause firms to shift away from hiring the best managers to hiring managers who have a comparative advantage at spending time in prison.

In sum, in its zeal to ensure that white-collar criminals do not go unpunished, the Sentencing Commission may have gone overboard. In attempting to equate insider trading and antitrust violations with theft and to impose similar jail sentences on the guilty parties, the commission failed to give adequate weight to the social costs of imprisoning white-collar criminals. Why should taxpayers pay for the room, board, and medical care of these individuals when they have sufficient assets to pay fines equalling the social costs of their illegal actions? Furthermore, standard penalties for white-collar criminals now exceed typical penalties for other types of criminals whose misdeeds involve similar dollar amounts. White-collar criminals are subject to longer average prison sentences and substantially higher fines than larcenists, for example. In addition, the market imposes its own penalties on those guilty of ignoring the law, and the evidence indicates that white-collar criminals lose much more than larcenists in terms of earning potential, in both dollar terms and as a percentage of their former incomes, when their crimes are uncovered.

Imposing harsh penalties on white-collar criminals may make some participants in the legal system feel that they are getting tough on crime, but such penalties are economically very inefficient. In the end such tactics do not really increase the evenhandedness with which the federal criminal code is applied, and the result is more likely to be a reduction of managerial talent in the sectors of the economy where such talent is most needed.

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