

By Peter Boone and Simon Johnson

Is the global economic recovery still on track? The mainstream view is: yes, without a doubt. But increasingly, there are reasons to fear another financial disruption – particularly given the latest developments in Ireland.

The consensus among officials and most of the international banking community is that the global economy has stabilized and is now well down the road to recovery. The speed of this recovery is proving disappointing – as seen in the [revised second-quarter growth estimate](#) for gross domestic product in the United States, with annualized growth down to 1.6 percent. But, according to this view, easy monetary policy and still-loose fiscal policy around the world will keep sufficient momentum going.

Never mind that Japan, the United States and most of Europe are running unsustainable fiscal policies, while the [Federal Reserve](#) chairman [Ben Bernanke is fretting](#) over how to prevent deflation with a limited toolbox, and [Jean-Claude Trichet](#), president of the [European Central Bank](#), is calling for more fiscal tightening. To enjoy this rosy global picture, we are also told to ignore the plight of heavily indebted peripheral euro-zone nations still suffering from uncompetitive wages and prices, and concerns over default, that strangle their credit markets and growth.

An essential part of this relatively positive view is that the euro-zone economies have stopped the series of “financial runs” that, earlier this year, took intense market pressure from Greece to Portugal and Ireland and threatened to move on to Spain and potentially almost everywhere else (except, presumably, Germany). [A collapse was averted](#) in large part by the euro-zone countries agreeing to rescue each other – meaning that the Germans agreed to support Greece and other weaker countries – with some additional cash resources provided by the International Monetary Fund.

However, let’s be clear: [Europe’s headache remains large](#), and this should concern all of us – just look at Ireland to see how misunderstood and immediate the remaining dangers are. Ireland’s difficulties arose because of a massive property boom financed by cheap credit from Irish banks. Ireland’s three main banks built up loans and investments by 2008 that were three times the size of the national economy; these big banks (relative to the economy) pushed the frontier in terms of reckless lending. The banks got the upside, and then came the global crash in fall 2008: property prices fell more than 50 percent, construction and development stopped, and people stopped repaying loans. Today roughly one-third of the loans on the balance sheets of major banks are nonperforming or “under surveillance”; that’s an astonishing 100 percent of gross national product, in terms of potentially bad debts.

The government responded to this with what are currently regarded as “standard” policies in

Europe and America. It guaranteed all the liabilities of banks and [began injecting government funds](#) to keep these financial institutions afloat. It bought the most worthless assets from banks, paying them government bonds in return. Ministers have promised to recapitalize banks that need more capital. Despite or perhaps because of this therapy, financial markets [are beginning to see Ireland as Europe's next Greece](#). In the last few weeks the perceived probability of default by Ireland (as traded in credit-default swap markets) has shot up, so that markets now price a 25 percent risk that Ireland will default within five years.

Until very recently, Ireland was seen as Europe's poster child of prudent reforms. Mr. Trichet himself highlighted Ireland as an example that Greece and other financially stricken nations should follow. His message was simple: If only Greece, or Portugal or Spain would cut public wages, reduce the budget deficit and make structural reforms as Ireland has done, then growth could occur and default prevented.

However, it is now apparent that Ireland has not done enough to stem its march toward further crisis. The ultimate result of Ireland's bank bailout exercise is obvious: one way or another, the government will have converted the liabilities of private banks into debts of the sovereign (that is, Irish taxpayers), yet the nation probably cannot afford these debts. According to the [Royal Bank of Scotland](#), Irish banks have debt worth 26 billion euros, or one-fifth of Ireland's national income, coming due in the month of September alone. Ireland's third largest bank just announced it will likely need 25bn euros in total capital injections from the government (19% of Gross National Product, GNP), while Standard and Poor's argue this figure is too low. In total, the debts of Irish banks could easily result in a charge to government debt equal to one-third of G.N.P.

These debts need to be added to the fiscal deficit, which also remains dangerously out of control. This year the government will run a deficit of 15 percent of G.N.P., and with nominal G.N.P. falling, it could well remain that high next year, even if the government cuts spending by the 2 to 3 percent of G.N.P. currently envisaged.

The government is gambling that growth will recover to more than 4 percent a year starting in 2012, in order to make all this spending and debt affordable, and officials insist that growth is already under way. Ireland's gross domestic product did grow in the first quarter of 2010, but that was not the good news that many press and officials claimed.

This misunderstanding stems from Ireland's success as a tax haven. Many years ago Ireland cut corporate taxes to attract business. This created one of Europe's most impressive tax havens – it is possible to set up a corporation in Ireland, channel sales through that head office (with some highly complicated links to offshore tax havens in order not to pay Irish tax) and then pay a minuscule corporate profits tax. Ireland boasts a large industry of foreign “tax minimizers” that do this, but these tax minimizers hardly employ any people. Nearly one-quarter of Irish G.D.P. comes from the profits of these ghost corporations.

The likes of [Google](#), [Yahoo](#), [Forest Labs](#) and many others helped Ireland's exports grow in the first quarter, but the domestic economy when excluding their profits, as measured by G.N.P., actually contracted, and so did Ireland's tax revenues and employment. Today Irish unemployment is

estimated at 13.8 percent, up from 13.1 percent at the start of the year.

Ireland, simply put, appears insolvent under plausible scenarios with current policies. The idea that Ireland, Greece or Portugal can cut spending and grow out of overvalued exchange rates with still large budget deficits, while servicing all their debts and building more debt, is proving – not surprisingly – wrong. Such policies leave nations burdened with large debt overhangs that effectively tax businesses and borrowers – because interest rates must stay high to reflect risk.

Investors must wonder whether businesses and homeowners can afford these higher interest rates, so banks and investors cut credit lines and reduce lending. This strangles economies, even when the fiscal authorities take tough steps needed to cut deficits.

Ireland had more prudent choices. It could have cut the budget deficit while also acknowledging insolvency and requiring creditors to share some of the burdens. But a strong lobby of real estate developers, the investors who bought banks' bonds and politicians with links to the failed developments (and their bankers) prefer that taxpayers rather than creditors pay. The European Central Bank, the [European Union](#) and the International Monetary Fund share some responsibility; they advocate these unlikely programs in order that European and global banks, which provided the funds to the Irish banks, do not suffer losses from such bad lending decisions.

The Irish government plan is – with good reason – highly unpopular, but the coalition of interests in its favor seems strong enough to ensure that it will proceed, at least until it either succeeds and growth recovers, or ends in complete failure with default of banks or the nation itself.

Under the current program, we estimate each Irish family of four will be liable for 200,000 euros in public debt by 2015. There are only 73,000 children born into the country each year, and these children will be paying off debts for decades to come – as well as needing to accept much greater austerity than has already been implemented. There is no doubt that social welfare systems, health care and education spending will decline sharply.

Watch for renewed emigration from a famously footloose population. If current policies continue, the calamity of the Irish banking system will lead to a much deeper recession and the consequences will be felt for decades. Watch also for further global financial disruption as this kind of deal starts to unravel.

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A Bit About Me

By James Kwak

As [loyal readers know](#), I spent the summer working and mainly not-blogging. I'm back in school now, but this semester will be busier than previous ones. I'm taking two clinics, and I have to make up for phoning it in last fall when I was writing *13 Bankers*. (Simon and I wrote it in four months while I was in school and he was teaching three classes.) Also, I only have one more year of school left in my life, I'm paying more than \$45,000 for it, and I'd like to take it seriously.

So the blog is going to be a somewhat lower priority in the past.* I'm hoping to post a few times a week this semester, if I have enough original ideas. I hope you will keep reading; I assume most people get the blog via [email](#) or an [RSS reader](#), so frequency shouldn't be an issue for you.

It's possible that after school I will go back to more serious blogging; I do think it's a valuable and potentially powerful medium, and certainly a lot more gratifying than writing academic papers.

Thanks again for reading.

* In my defense, most of the high-volume economics bloggers are either tenured professors (Cowen, Thoma, DeLong, Krugman) or people whose job is to blog (Salmon, Klein). (Yves Smith is an exception; how she finds the time I don't know.)

Why the Education Gap?

The Baseline Scenario » 2010 » September 9/6/10 at 7:30 AM James Kwak

By James Kwak

Probably the most important and intractable economic problem we face is not restarting the economy after the financial crisis, but the decades-old problem of stagnant wages for the lower and middle classes and the consequent massive increase in income inequality. This is something that Raghuram Rajan brings up in the first chapter of *Fault Lines*, and, like many people, he points the finger at education. Citing (like everyone else) Claudia Goldin and Lawrence Katz, he writes (pp. 22-23),

“As agriculture gave way to manufacturing in the mid-1800s, the elementary school movement in the United States created the most highly educated population in the world. . . . The high school movement took off in the early part of the twentieth century and provided the flexible, trained workers who would staff America’s factories and offices. . . .

“Recent technological advances now require many workers to have a college degree to carry out their tasks. But the supply of college-educated workers has not kept pace with demand—indeed, the fraction of high school graduates in every age cohort has stopped rising, having

fallen slightly since the 1970s."

There are certainly many problems with our educational system. Rajan lays some out, and Arianna Huffington has a longer discussion in *Third World America* (pp. 113-21). The list includes huge disparities in early childhood preparation; expensive college tuition and insufficient financial aid; the property tax funding system for K-12 education, which means that rich towns (usually) spend more on their schools; unions that make it impossible to get rid of bad teachers; the fact that we don't even know what exactly makes a good teacher; and, though not that big a factor, the fact that some parts of the country insist on teaching children that human beings aren't subject to the laws of evolution.

I don't claim to know how to fix our educational system. But I have an idea about why it hasn't been fixed, which I'm sure someone can write up as a cute two-period economic model. Assume that society is divided into the capitalists and everyone else, and the capitalists make investment decisions for society as a whole. Until 1980, if the capitalists wanted to make more money, they needed to invest in technology, which meant they needed an increasingly educated workforce, and therefore they were willing to invest some of their profits (via taxes and public schools) in education. And, according to Goldin and Katz, from 1930 to 1980 the average educational level of Americans increased by 4.7 years.

But since 1980, and especially since 1990, the world has become more open. If the American capitalists want to make more money, they still have to invest in new technology, and they still need an increasingly educated workforce. But now, because of globalization, they can get that workforce anywhere in the world. You can think of this as arbitrage: China doesn't have that many college graduates as a proportion of its population, but they come cheaper than American college grads. Or you can think of it as free riding: if China (or Korea, or India, or Brazil, or anywhere else) is willing for whatever reason to invest in increasing the number of domestic college graduates, the American capitalists can simply expand their operations over there and save themselves the trouble and expense of investing in the American educational system. (And for China, the returns on investment in education might be higher than the returns for America, because the marginal productivity of new investments in education is probably higher.) And as a result, average educational attainment only went up by 0.8 years from 1980 to 2005.

Put another way, if you own Accenture—the largest consulting firm in the world—and you can hire all the talented, educated people you need in India, what incentive would you have to invest your profits in the American educational system? Why not just move to Bermuda and leave America's problems behind?*

I have long had this instinct that it is the interests of big corporations that determine government policy in the United States. This instinct is certainly wrong in detail (how do seven years of war in Iraq serve American business?) but, I think, possibly right on a high level. Applied here, it means that if our large corporations needed better domestic education in order to make more money, then one way or another it would happen, just like it happened for the first two centuries of our history. But since they don't need it anymore—at least as long as they can free ride off of other countries' investments in education—it won't.

* Actually, I checked Wikipedia and apparently Accenture moved its residence from Bermuda to Ireland.

Yet More Unending Telecom Hell

The Baseline Scenario » 2010 » September 9/7/10 at 7:30 AM James Kwak

By James Kwak

When [last we left our hero](#), he had just (with some difficulty) placed an order with Comcast because of Verizon's many system and customer service failures. A friend of mine said that he couldn't want to see the post I would write about Comcast, which he had found to be terrible as well. This post is probably coming sooner than even he expected.

So . . . a week after placing that order, I showed up at the installation time, and no one came. I asked my wife to call Comcast, and they told her that our order had almost vanished; after much digging they found some record of it (this is a new service order, so if they had our name and address at all, it could only have come from my order), but no further information. Again, just like with Verizon, the phone people said they have no visibility into the online system (is it really possible that the phone and online front ends go into two completely separate back-end systems? yes), and also said cheerfully that many online orders go into unfulfilled limbo.

So I placed a phone order this time. I was already so dispirited that I didn't even bother explaining to the rep the specific products that I wanted, and just took the package he was trying to sell me. (I have a year to downgrade it before the price jumps.)

This time someone did show up to do the installation—but only for TV and Internet. Apparently the phone component had been canceled on their end (something the technician had no record of—all he can see is the job orders that come through to his phone) because no one had done a third-party verification to port the phone number from Verizon. Why hadn't anyone done it? Because the sales rep I talked to on the phone forgot to do it. Now how could his computer system possibly let him book an order without completing a mandatory step? Because the software that these big, big companies use to run their operations—even the really important software, like the stuff they rely on to bring in revenues—doesn't work.

(By the way, this supports the incompetence theory rather than the calculated indifference theory. Companies may underinvest in customer service systems because they just don't care about customer service, especially in the telecom duopoly. But if their new customer acquisition systems don't work, that must be pure incompetence.)

Now, there is still a little blame to pin on Verizon here. Comcast claims that if there is no third-party

verification, their system should have made automated phone calls to tell me there was a problem. But in the interim, the phone service (Verizon) mysteriously stopped working, even though Verizon is still billing me for it. All Verizon had to do was do nothing and the phone would have kept on working, yet they couldn't even do that.

Anyway, with luck this ordeal will be over within a week. For those looking for an economics lesson, it's the same as last time, so I'll just quote from my earlier post:

“Oligopolies are bad for customers. Switching from Verizon to Comcast wasn’t nearly as joyous as [dumping Bank of America](#) for a local community bank was, because I’m just trading one member of the duopoly for the other. In theory, duopolies are supposed to be somewhat better than monopolies. (Draw the demand and supply curves and you could figure it out, although it’s been over a decade since I did.) But in practice they’re usually not, because it doesn’t take a lot of signaling for two companies to agree to charge the monopoly price. The same goes for customer service; they can both suck, but as long as neither is significantly worse than the other, there’s no reason for either to change, since their churn rates are more or less the same.

“Since the 1980s, we’ve had cable TV, cell phones, the Internet, satellite . . . and no significant increase in telecom competition. What’s wrong with this picture?”

PS After [Sunday’s post](#) about cutting back on blogging to take school a little more seriously, I got a lot of well-wishing emails as if I were quitting blogging. While I appreciate all of the warm thoughts, this is probably a smaller change than many people think. Even last year before my summer internship I was probably posting only about five-six times per week, and this semester I’m shooting for about three times per week. So I probably didn’t even need to write Sunday’s post. But I wanted to give some explanation for anyone who might have been hoping for a return to last year’s frequency.

Good Economics

The Baseline Scenario » 2010 » September 9/7/10 at 4:33 PM James Kwak

By James Kwak

On my way to and from New Haven, I listen to podcasts, including a lot of TED Talks. Today I listened to a [talk by Esther Duflo](#), the recent winner of the Clark Medal (top economist under forty), from earlier this year. The topic was using randomized experiments to test alternative social policies and determine what measures of fighting poverty are more effective than others. It was probably the best and most inspiring economics talk I’ve heard in a long time.

Upcoming Appearances

The Baseline Scenario » 2010 » September 9/8/10 at 7:30 AM James Kwak

By James Kwak

I know you can see Simon somewhere virtually every week (OK, that's a big exaggeration, but you know what I mean), but I wanted to let you know about a couple of talks I'll be giving. I'll be the featured speaker at the [NS Capital Fall Financial Symposium](#) in Stamford, Connecticut, on October 7 (free, but pre-registration required).

On September 15, I'll be the keynote speaker at the [Washington Credit Union League Convention](#) in Seattle, but for that one I believe you need to register for the conference.

See you.

Update: I forgot to add that I'm also talking on a financial reform panel at Yale Law School on September 28 at 6 pm.

What a Little Bit of Economics Does to You

The Baseline Scenario » 2010 » September 9/8/10 at 10:04 AM James Kwak

By James Kwak

For a class, I read an old (1986) paper by [Kahneman, Knetsch, and Thaler](#) on fairness. It's based on surveys posing various hypothetical situations where businesses can take some action. For example, most people thought that it was OK for a grocer to pass on a wholesale price increase to consumers (Question 7) but not to raise prices because there is a general shortage and the grocer has the only shipment of a certain item (Question 12). In short, people have an intrinsic sense of fairness the authors summarize this way: "The cardinal rule of fairness is surely that one person should not achieve a gain by simply imposing an equivalent loss on another."

Today in class, the professor posed the first question from the paper:

"A hardware store has been selling snow shovels for \$15. The morning after a large snowstorm, the store raises the price to \$20."

In 1986, 82 percent of respondents thought this was unfair. In class, it was about 50-50.

As the professor said, this is probably because there are a lot of business school students in this class. Business school students are classic Econ 101 robots. They know enough to know that if

there is a demand shift, not only is it OK to raise prices, but you *should* raise prices in order to clear the market. In this case, supply is fixed in the short term, so raising the price won't increase supply; the Econ 101 argument is that raising the price allocates the shovels to people who will derive more utility from them (because they will pay more), thereby increasing social welfare.

But this rests on a huge assumption: that willingness to pay is the same as utility. Unfortunately, however, this assumption fails in the real world; poor people simply can't pay as much for snow shovels as rich people, and as a result a price increase will allocate shovels to rich people, not to those who need them the most.* But people who believe Econ 101 only remember the demand and supply curves they saw on the first day of class, so they think firms should raise prices.

I suspect that belief in Econ 101 is not only stronger among business school students (and the businessmen they become) than among ordinary people, but is also stronger today than it was in 1986. The free market ideology teaches not only that businesses can maximize profits by any legal means, but that they have a moral imperative to maximize profits by any legal means, including generating profits by imposing equivalent losses on their counterparties. (Essentially all proprietary trading fulfills this condition.) And three decades of this ideology have probably changed people's responses to these types of questions.

More fundamentally, the 1986 paper shows that Econ 101 is diametrically opposed to human beings' intuitive sense of fairness. Yet public policy largely follows the dictates of Econ 101. Is that a good thing?

* I'm not saying that there is a perfect way to allocate the shovels, just that using price isn't perfect, and does have inequality effects.

What Is President Obama's Fiscal Message?

The Baseline Scenario » 2010 » September 9/9/10 at 6:07 AM Simon Johnson

By Simon Johnson

President Obama is finally attempting to cut through some of the disinformation and confusion that surrounds US fiscal policy in general and taxes in particular. His suggestion this week is: let's (effectively) raise taxes on relatively high income people – by letting the Bush tax cuts expire for those people – while introducing temporary tax breaks that will more directly stimulate business investment and presumably hiring.

Any way you cut it, the numbers involved are not big enough to impact unemployment significantly by November, but these ideas – and the Republican rival suggestions currently on the table – are more about symbols, messages, and midterm votes than about accelerating the economic recovery. Seen in those terms, the president is still missing a key argument in both economic and

political terms.

The president's point is simple. If you are arguing to keep the Bush tax breaks for upper income groups in order to support the economy, his proposal represents a direct and reasonable challenge – there are better ways to “use” (i.e., for the government to forgo) tax revenue to help reduce unemployment.

The bigger issue, of course, is the budget deficit and the president feels the need to tread gingerly because the 2010 deficit will come in around \$1.3 trillion, according to the Congressional Budget Office, i.e., almost 10 percent of our gross domestic product and over the last two years we have run the highest deficits since World War II.

[Everyone agrees that we need to worry about this deficit](#). The US Treasury can borrow at record low interest rates, but we should not presume this will be the case for the indefinite future. In particular, irrespective of what happens in the United States, our interest rates are determined in part by what developments in the rest of the world – if some subset of Europe, for example, becomes more creditworthy over the next 12-24 months, this will tend to reduce the relative appeal of US government debt to investors (both US and non-US) and likely push up our long-term interest rates – deterring private sector investment and making it more expensive to finance the budget deficit.

Cutting our budget deficit in the short-term would tend to slow the economy and both sides of the aisle are currently treading carefully in this regard. But agreeing to cut the deficit in the future would be helpful and should stimulate the economy – because it would lower long-term interest rates by reducing uncertainty about the trajectory of fiscal policy. This dimension is completely missing from our current political dynamic and from the sensible debate.

The president should be pushing harder for agreement on medium-term deficit reduction, including by putting forward ideas for comprehensive tax reform. The US system has become complex and quite opaque – people have a hard time figuring out what taxes they are pay and what they get in return. Tax systems elsewhere in the industrialized world are just as (or more) progressive while also being more efficient, i.e., cause less distortion in terms of reducing the incentive to work and to invest per dollar of revenue collected.

In the context of redesigning the tax system to promote employment and responsible savings, it is entirely appropriate to look for ways to shift the burden of taxation back to relatively high income individuals. This group has had a great run over the past 30 years – while the consequences for most Americans, as seen for example in real median wages (flat), the stability of employment (look around you), or the vulnerability to financial crisis (2008-09 was a wake-up call), have been much less favorable.

The president's latest proposals are tinkering at the margins and will likely only have a limited impact. But if the president moves the broader debate towards considering fair, reasonable, and efficient ways to tax higher income individuals, this is a step in the right direction.

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Republican Nightmare: Putting Elizabeth Warren to Work Now

The Baseline Scenario » 2010 » September 9/10/10 at 5:13 AM Simon Johnson

By Simon Johnson

President Obama is finally looking for bold, creative, and clever ways to change the way the US economy operates – preferably with measures that will take effect by the November midterms and change the tone of the broader political debate. His tax proposals this week have some symbolic value, but in the broader sense all of these fiscal suggestions are tinkering at the margins.

What could he possibly do that would grab people's attention, mobilize his political base, and put his opponents on the defensive? There is an easy answer: Appoint Elizabeth Warren to start running the Consumer Financial Protection Bureau (CFPB) immediately.

And the brilliant part of this idea – as explained by [Shahien Nasiripour at the Huffington Post](#) (see also [David Dayen's Thursday coverage](#)) – is that the Dodd-Frank financial reform legislation allows the person charged with setting up this new agency to be an outright appointment, rather than a nomination subject to Senate confirmation.

Elizabeth Warren's credentials are impeccable – she came up with the original idea for the CFPB, she pushed effectively for it to become legislation, and she has proved most effective in her oversight role as chair of the Congressional Oversight Panel (COP) for the Troubled Asset Relief Program. And [her manifesto](#) for the CFPB is sensible and actually pro-business – although she naturally opposes [the specific ways in which big banks mistreat people](#).

No doubt Republicans in the Senate would try to derail her nomination to head the CFPB as they have done with numerous other nominations over the past year and a half. Their motivation would not be her views or expertise – she has earned serious Republican respect as a result of her COP role – just part of their electoral strategy to block the president's agenda and to undermine an agency they have consistently opposed.

The Treasury Secretary is explicitly authorized by an Act of Congress to pick an interim head for the new agency – with a view to getting it up and running immediately (in fact, what has he been waiting for?) Presumably the Senate (and the House) passed this specific measure expressly to expedite the CFPB's work.

Professor Warren has strong political support and would get the new agency off to a great start. She would represent the Obama administration's serious attempt to rein in financial misbehavior –

at the same time as keeping the economic recovery on track. Anyone who thinks she would be bad for American families has not been paying close attention. And best of all, she is very good at explaining what she is doing and why that makes sense.

The president needs clearer messages and stronger substance – and he needs them fast. He should move at once to appoint Elizabeth Warren.

The Importance of the 1970s

The Baseline Scenario » 2010 » September 9/13/10 at 7:30 AM James Kwak

By James Kwak

It isn't often that I read two books in a row that both cite Alexis de Tocqueville, probably my favorite Social Studies 10 author (although he was far from my favorite at the time). In *Third World America*, Arianna Huffington cited Tocqueville's observation that democracy should promote the interests of "the greatest possible number"; as [I pointed out](#), this is clearly no longer true in America (if it ever was). In [Winner-Take-All Politics](#),* Jacob Hacker and Paul Pierson explain why.

In [13 Bankers](#), Simon and I argue that the key forces behind the transformation of the financial sector and the resulting financial crisis were political, not simply economic. To this argument, at least two good questions spring to mind: Why finance? And why then? Hacker and Pierson have good answers to both of these questions. Their answer to the latter question is better than (though not inconsistent with) the answer we gave in our book.

To the former question, their argument is simple: business interests in all sectors organized a takeover of political power that pushed organized labor and other groups protecting middle-class interests to the sidelines and made possible decades of policies that have enriched the super-rich at the expense of everyone else, including the merely affluent. Finance was simply the biggest and most profitable of these sectors—and, we would emphasize, the one best able to hold the government hostage in a financial and economic crisis.

The answer to the second question is a bit more involved but particularly important. Many people, including Simon and me, have observed that American politics and the American economy reached some kind of turning point around 1980, which conveniently marks the election of Ronald Reagan. (We also pointed to other factors such as the deregulation of stock brokerage commissions in 1975 and the high inflation of the 1970s.) Other analysts have put the turning point back in 1968, when Richard Nixon became President on the back of a wave of white, middle-class resentment against the 1960s. Hacker and Pierson, however, point the finger at the 1970s. As they describe in Chapter 4, the Nixon presidency saw the high-water mark of the regulatory state; the demise of traditional liberalism occurred during the Carter administration, despite Democratic control of Washington, when highly organized business interests were able to torpedo the Democratic agenda and begin

the era of cutting taxes for the rich that apparently has not yet ended today.

Why then? Not, as popular commentary would have it, because public opinion shifted. Hacker and Pierson cite studies showing that public opinion on issues such as inequality has not shifted over the past thirty years; most people still think society is too unequal and that taxes should be used to reduce inequality. What has shifted is that Congressmen are now much more receptive to the opinions of the rich, and there is actually a negative correlation between their positions and the preferences of their poor constituents (p. 111). Citing Martin Gilens, they write, “When well-off people strongly supported a policy change, it had almost three times the chance of becoming law as when they strongly opposed it. When median-income people strongly supported a policy change, it had hardly any greater chance of becoming law than when they strongly opposed it” (p. 112). In other words, it isn’t public opinion, or the median voter, that matters; it’s what the rich want.

That shift occurred in the 1970s because businesses and the super-rich began a process of political organization in the early 1970s that enabled them to pool their wealth and contacts to achieve dominant political influence (described in Chapter 5). To take one of the many statistics they provide, the number of companies with registered lobbyists in Washington grew from 175 in 1971 to nearly 2,500 in 1982 (p. 118). Money pouring into lobbying firms, political campaigns, and ideological think tanks created the organizational muscle that gave the Republicans a formidable institutional advantage by the 1980s. The Democrats have only reduced that advantage in the past two decades by becoming more like Republicans—more business-friendly, more anti-tax, and more dependent on money from the super-rich. And that dependency has severely limited both their ability and their desire to fight back on behalf of the middle class (let alone the poor), which has few defenders in Washington.

At a high level, the lesson of *Winner-Take-All Politics* is similar to that of *13 Bankers*: when looking at economic phenomena, be they the financial crisis or the vast increase in inequality of the past thirty years, it’s politics that matters, not just abstract economic forces. One of the singular victories of the rich has been convincing the rest of us that their disproportionate success has been due to abstract economic forces beyond anyone’s control (technology, globalization, etc.), not old-fashioned power politics. Hopefully the financial crisis and the recession that has ended only on paper (if that) will provide the opportunity to teach people that there is no such thing as abstract economic forces; instead, there are different groups using the political system to fight for larger shares of society’s wealth. And one group has been winning for over thirty years.

* I got a free advance copy. The book goes on sale tomorrow.

[**Brady Bonds For The Eurozone, Starting With Ireland**](#)

[The Baseline Scenario](#) » 2010 » September 9/15/10 at 8:40 AM Simon Johnson

By Peter Boone and Simon Johnson. This post comprises the opening paragraphs of a longer article available for free and without advertising [at Project Syndicate](#).

Today's conventional view of the eurozone is that the crisis is over – the intense, often existential concern earlier this year about the common currency's future has been assuaged, and everything now is back under control.

This is completely at odds with the facts. European bond markets are again delivering a chilling message to global policymakers. With bonds of “peripheral” eurozone nations continuing to fall in value, the risk of Irish, Greek, and Portuguese sovereign defaults is higher than ever.

This comes despite the combined bailout package that the European Union, International Monetary Fund, and European Central Bank created for Greece in May, and despite the ECB's continuing program of buying peripheral EU countries' bonds. Heading into its annual meetings in a few weeks (followed by the G-20 summit in Seoul in November), the IMF is bowing to pressure to drop ever-larger sums into the EU with ever-fewer conditions.

Indeed, official rhetoric has turned once again to trying to persuade markets to ignore reality. Patrick Honohan, the governor of Ireland's central bank, has labeled the interest rates on Irish government bonds “ridiculous” (meaning ridiculously high), and IMF researchers argue that default in Ireland and Greece is “unnecessary, undesirable, and unlikely.”

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Basel III: The Fatal Flaw

The Baseline Scenario » 2010 » September 9/16/10 at 6:15 AM Simon Johnson

By Simon Johnson

The international discussion among government officials regarding bank reform is, at an informal level, going better than you might think. Top people in the “official sector” are increasingly willing to confront the banking lobby and even refute its more egregious claims, particularly the completely erroneous notion that making banks safer – by requiring them to hold more capital – would actually hurt the broader economy and undermine growth.

Unfortunately, the structured intergovernmental process that actually changes the rules around banks – known as Basel III (or “Basel 3”) – was rushed to an unsatisfactory conclusion last

weekend. The US and other countries with major financial centers will need to add substantial additional capital requirements at national levels if these new rules are to be at all effective.

The heart of the substantive discussion regards whether tightening “capital requirements” – the buffers against losses that banks are required to hold – will have a negative impact on the economy. The banks insist that requiring them to hold more capital would slow lending and therefore slow the real economy. The global banks’ Institute for International Finance [issued a paper in June](#) that insisted on this point, but there is really no substance to their claims.

The most readable counter arguments come from a paper by Sam Hanson, Anil Kashyap, and Jeremy Stein (reviewed here recently). The fact that three leading academics would take on the banks’ arguments is not news, but in recent months it has become clear that – behind the scenes and off-the-record – a growing number of important officials agree broadly with this view. The Bank for International Settlements itself has produced two serious assessments which, if you look at them carefully (and this is not light reading) argue strongly that [longer-term growth would benefit from higher capital requirements](#) because we would experience fewer mega-crises, and that [the transition to such arrangements would be much smoother](#) than the industry claims.

Running parallel with this nascent intellectual renaissance among officials, there has been pressure on the Basel Committee on Banking Supervision – comprising 27 countries with substantial financial sectors – to produce an agreement on capital requirements ahead of the Seoul G20 summit in November. The rush to reach agreement in this time frame undermined those arguing for a broader rethink – as the consensus among officials only shifts slowly. The result – the framework agreement announced this weekend – increases capital requirements only modestly and phases those increases in only gradually.

The key conceptual breakdown is this: While pushing back against the banks’ claims that higher capital requirements would be harmful, the officials have still allowed the banks to frame the discussion – implicitly conceding that moving to higher requirements quickly could reduce lending and damage growth.

But again the best thinking from independent analysts demonstrates that this view is completely at odds with the reality. David Scharfstein and Jeremy Stein, [summarizing experience on this issue](#), point out that there is a world of difference between requiring banks to reach a certain capital-asset ratio (which they are likely to do by shrinking assets, i.e., making fewer loans among other things) and requiring them to raise specific dollar amounts of capital.

You can say what you want about the bank stress tests implemented in the US in spring 2009 (e.g., that they were not tough enough, in terms of considering potential future losses – and therefore how much capital the banks needed), but in terms forcing banks to raise specific dollar amounts of capital subsequently, this is the approach to follow.

Banks do not like to raise capital; they will generally only do it when forced. The fair way to do this is through tough and transparent stress tests; these should be repeated in the US and on a comparable basis in other financial center countries every year. Agreeing to move in this direction

should be a major goal of the G20, but alas it is currently nowhere near being on the agenda.

The Hanson-Kashyap-Stein view, which is completely mainstream financial economics ([not any kind of radical or political view](#)) is that banks should be required to hold enough capital at the peak of the cycle so that when they suffer losses (and, 2007-2010, US banks lost about 7 percent of their “risk-weighted” assets, which is the denominator here), they still have enough capital so that the markets do not think they will fail – and therefore there is no need to dump assets in a desperate bid to survive. (It’s the forced asset sales of this nature that turn financial distress at particular institutions into broader asset price declines and that can trigger panics.)

The logic here points towards at least 15 percent Tier 1 capital being required in good times; the most forward looking officials in G20 countries start to mention aiming for closer to 20 percent (Tier 1 is a good headline measure of loss-absorbing capital, i.e., what stands between the bank and insolvency; [the discussion sometimes slips into other related measures](#)). This is what would really help make banks much safer (i.e., thus making banks’ stock a much less risky investment and reducing the required rate of return for all involved).

Treasury Secretary Tim Geithner is fond of saying that the appropriate response to the crisis – and the way to prevent any kind of recurrence – is with “capital, capital, capital.” The Dodd-Frank financial reform act did not raise capital requirements – as Treasury insisted on deferring to the Basel III process. Basel III, we learned this weekend, is on course to raise capital requirements – but to a level below what US banks have held on average in recent decades (for Tier 1 capital, Basel III posits 8.5 percent at the end of the day; US banks fluctuate roughly around 10 percent).

The best – and perhaps only remaining chance – is for the US to insist on stronger capital requirements for domestic financial institutions, as permitted or even encouraged in Basel III under the heading of “countercyclical buffer”. And systemically important financial institutions, for which the Basel process appears to have completely dropped the ball, should be subject to even higher requirements. This should be coordinated with the UK (where there is already thinking in the right direction), Switzerland (again, forward thinking officials hold sway), and anyone else who can be brought on board.

An edited version of this post appeared this morning on the [NYT.com's Economix blog](#); it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

[Elizabeth Warren: The Right Appointment At The Right Time](#)

The Baseline Scenario » 2010 » September 9/16/10 at 8:56 PM Simon Johnson

By Simon Johnson

The case for appointing Elizabeth Warren to set up the new Consumer Financial Protection Bureau (CFPB) was, at [the end of the day, overwhelming](#). She had the original idea, she helped build political support, and her own credentials have been only strengthened by her work as head of the Congressional Oversight Panel for TARP. On Friday, [the president will reportedly appoint](#) Professor Warren as an assistant to the president and special adviser to the Treasury Secretary, with the task of setting up and initially running the CFPB.

Some of Ms. Warren's supporters think this move is something of a half-measure – they would have preferred a conventional nomination, with all the fanfare of a classic confirmation battle in the Senate. There is something to be said for that, but the interim appointment route is by far the best way forward for three reasons.

First, this form of appointment puts Elizabeth Warren to work right away – on the issues of consumer protection that are first order both for ordinary families and for the macroeconomy. You really cannot build a sustainable economic recovery on the back of exploitative or abusive behavior by the financial sector. These issues are urgent and need resolution as soon as possible.

Second, the president finally has an adviser who understands the financial sector and who has healthy skepticism about its intentions and actions. As we documented at length in [13 Bankers](#), too many top policy people – both in this administration and all its recent predecessors – have been overly inclined to accommodate the interests of finance, particularly the big banks. In this regard, putting Ms. Warren directly into the White House with the highest possible level of access is exactly the right thing to do – much better, for example, than making her purely a Treasury appointment.

Third, this step does not avoid a debate in the Senate – it merely postpones it to a more advantageous moment. Presuming that Ms. Warren is nominated as for a five year term as head of the CFPB, she would go before the Senate Banking Committee with a real track record of achievement as interim head. The debate would not be about what the agency could do, but rather what it has already done – and what it is set up to do next. These are exactly the right terms on which to bring out into the open all those who think that the financial sector only ever behaves well – or that enforcing sensible rules on lenders would somehow bring the economy to its knees.

Barney Frank has the right overall assessment, [telling the New York Times](#):

"I congratulate the administration on its creativity. There's no possibility she would take something like this unless she was fully empowered to do the job."

After The Recession: What Next For the Fed?

The Baseline Scenario » 2010 » September 9/23/10 at 6:15 AM Simon Johnson

By Simon Johnson

The [Federal Reserve](#) was created in 1913 to help limit the impact of financial panics. It took a while for the Fed to achieve that goal, but after World War II – with a great deal of help from other parts of the federal government – the Fed hit its stride. Today the Fed has not only lost that touch but, given the way our political and financial system currently operates, its own policies exacerbate the cycle of overexuberance and incautious lending that will bring on the next major crisis (and presumably another severe [recession](#)).

Sudden loss of confidence in the financial system was not uncommon toward the end of the 19th century, and while the private sector was able to stave off complete disaster largely by itself, the tide turned in 1907. In that instance [J.P. Morgan](#) could stand firm only because, behind the scenes, his team received a large loan from the [United States Treasury](#) (on this formative episode, see [The Panic of 1907: Lessons Learned From the Market's Perfect Storm](#) by Robert F. Bruner and Sean D. Carr). Leaders of the banking system realized they needed help moving forward, and there was general agreement that the widespread collapse of financial intermediaries was not in the broader social interest. The question of the day naturally became: How much government oversight would bankers have to accept in return for the creation of a modern central bank?

The skeptics from the left – but also from the nonfinancial private sector (including those speaking on behalf of small business people) – pointed out that the presence of a “lender of last resort” (of the kind already operational in Western Europe), would be likely encourage less care on the part of major financial institutions and the people who lent to them. The issue we now call “moral hazard” was front and center in the political discourse at the very founding of the Federal Reserve (although with different terminology).

Nevertheless, the original deal turned out to involve only a very light supervisory touch. In part this was about the individuals involved – the [New York Fed](#) was run by [Benjamin Strong](#), a close associate of Morgan, until 1928. In part it was about the choice of organizational structure and internal rules – so the Federal Reserve Board in Washington had little de facto power relative to the New York Fed. But mostly the structural weakness was that the central bank was not designed to keep up with the pace of financial innovation.

This innovation had an important feature then, just as it does now. While some new products were sensible, many seemingly good ideas turned out to be ways to disguise the true nature of risks being taken. (In the early 1930s, “what did they know?” and “when did they know it?” were big questions for leaders of the financial sector regarding the true risks involved; see Michael Perino’s [The Hellhound of Wall Street: How Ferdinand Pecora’s Investigation of the Great Crash Forever Changed American Finance](#), to be published in October.)

If banks had remained as they were in 1913, the Fed might have had a fighting chance. But banks changed dramatically after the tight World War I controls were removed and entered rapidly into the business of selling and trading securities. The result was the financial shenanigans of the 1920s – with big banks front and center. The victims in that instance were middle-class investors lured with the promise of easy money – the parallels with the subprime craze are all too apparent. But the

banks also damaged themselves thoroughly – as with subprime lending, because much of the ultimate risk ended up on banks' balance sheets, presumably much more than the top bankers intended.

As a result of that experience and the ensuing financial disaster, during the 1930s the Fed received more regulatory powers, became a tougher-minded supervisor and was supplemented by a range of powerful agencies – including the [Securities and Exchange Commission](#). The tougher rules included the [Glass-Steagall Act](#) of 1933, which separated commercial banking from the world of investment (and speculation). Yet none of this was anti-business: the Federal Reserve plus tough regulation oversaw the post-World War II boom in which the United States managed to combine the kind of investing and risk-taking that supports nonfinancial innovation – pushing forward the technological frontier while maintaining high real-wage growth – all the while avoiding significant financial crises.

But effective oversight and constraint on financial-sector innovation was dismantled, starting in the 1980s and culminating when Congress in 1999 tore down (what little was left of) the Glass-Steagall wall with the [Gramm-Leach-Bliley Act](#). And it was not reimposed or updated by the [Dodd-Frank financial regulations](#) of 2010. The Federal Reserve is again set to support a financial system within which “innovation” is not effectively constrained (at least this is my reading of Perry Mehrling’s [The New Lombard Street: How the Fed Became the Dealer of Last Resort](#), forthcoming in January). As a result we face again the prospect of a 1920s-type roller-coaster.

Regulation remains largely ineffective (in fact, the industry has managed to demonize the word), the big banks are too important to fail, and interest rates are low across the yield curve. The Fed provides downside protection and there is no effective limit on the amount or nature of risks that the private financial sector can take. This is a recipe not for stagnation but rather for a metaboom in which we will receive warnings, including painful recessions – but consistently ignore them.

The 1920s opened with an 18-month recession, an [eerie parallel to the 2007-9 experience](#). It ended with the Great Crash of 1929.

An edited version of this post appears this morning on the [NYT.com Economix blog](#); it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

[Foreclosure Wave Hits Cash Buyers, Too](#)

The Baseline Scenario » 2010 » September 9/23/10 at 9:56 AM James Kwak

By James Kwak

Since most of you probably read Calculated Risk, you’ve probably seen the Sun Sentinel story of the man in Florida who paid cash for a house—and still lost it in a foreclosure. Not only that, but he

bought the house in a short sale in December 2009, the foreclosure sale happened in July 2010, and only then did he learn about the foreclosure proceeding.

Even after that,

“Grodensky said he spent months trying to figure out what happened, but said his questions to Bank of America and to the law firm Florida Default Law Group that handled the foreclosure have not been answered. Florida Default Law Group could not be reached for comment, despite several attempts by phone and e-mail. . . .

“It wasn’t until last week, when Grodensky brought his problem to the attention of the Sun Sentinel, that it began to be resolved.”

Bank of America now says it will correct the error “at its own expense.” How gracious of them.

If the legal system simply allows Bank of America to correct errors, at cost and with ordinary damages, after they happen, this type of abuse will only get worse. There’s obviously no incentive for banks not to make mistakes, and as a result they will behave as aggressively as possible at every opportunity possible. Yes, this was probably incompetence, not malice, on the part of the bank. But if you don’t force companies to pay for the consequences of their incompetence, they will remain willfully incompetent, and the end result will be the same.

[Can Someone Explain Facebook Credits to Me?](#)

The Baseline Scenario » 2010 » September 9/23/10 at 1:30 PM James Kwak

By James Kwak

The recent [New York Times story](#) on Facebook Credits was just one of a slew of articles that have been coming out recently on this topic. (Hint: When that happens, it’s usually because the company in question is putting on a PR campaign, which means they are pushing stories to the media in an attempt to build buzz.) According to the generally positive reporting, Credits are “a virtual currency system that some day could turn into a multibillion-dollar business.”

As far as I can make out,* Credits are points that you can buy with real money and that are stored with your Facebook account data on the mother ship in Palo Alto (just like your bank keeps track of the Dollars you have on account there). You can use Credits to pay for a variety of stuff in Facebook apps, and Facebook takes a cut (currently thirty percent) of the value of any transaction using Credits. The story is that in the long run, you may be able to use Credits to buy anything, not just stuff on Facebook, positioning Facebook as a potential leader in electronic payments.

To me, this sounds like an ultimately futile attempt to keep marketing spin one step ahead of the

real world. Unless I'm missing something basic, Credits should be crushed by another competitor—Dollars. The value of Credits, supposedly, is that you don't have to enter your credit card number every time you want to buy something. This is true because you are logged into Facebook, which keeps track of your balance and deducts from it as necessary. But that has nothing to do with Credits themselves; Facebook could just as easily have used Dollars instead of Credits and gotten the same result (you use your credit card to put money in your Dollars account, and then when you buy things, Dollars come out of your Dollars account).

So why use Credits instead of Dollars? I can think of three reasons: (1) people are more likely to buy things with Credits than with Dollars, even if the real financial impact is the same, because Credits feel more fun, and Dollars remind them of their rent payments; (2) if Facebook tried to take a 30 percent cut out of Dollar payments, no one would go along; and (3) Credits sound much more exciting if you're trying to build media hype and drive up the value of your company (something I'm very familiar with from the Internet bubble). Note that all of these are actually bad.

Facebook's key asset is the fact that hundreds of millions of people are logged into it at any moment, so if there were a "Pay with Facebook" button on retailers' web sites, you could use that instead of reentering your data. There are not many companies that could compete on this level, but there are certainly a few, Google being the first that jumps to mind. If Google were to offer a competing service—and I think it does—but one that uses Dollars instead of Credits, it's hard to see why any retailer would take Facebook over Google. Facebook may have more logged-in users at any given moment, but it has some serious disadvantages: notably, that huge cut Facebook takes out of every transaction, and the fact that Credits are prepaid, so you can't use them for large impulse buys unless you keep your Credits account stocked with thousands of dollars . . . which is just crazy, even in today's low-interest rate environment.

Yes, Facebook might win this battle, if they bring their fees down to credit card levels, because of that huge user base. But that would be a bad thing, and not just for the reasons I mentioned below. Facebook not only has terrible privacy policies, it also just sucks at implementing security. Do we really want Mark Zuckerberg—a smart guy who is in way, way, way over his head—to own all the financial payment data in the universe? I don't.

So, it seems to me I must be missing some brilliant thing about Credits that will enable them to triumph over Dollars. Can someone tell me what it is?

* I have not used Credits because, well, I basically don't use Facebook. I also admit to having a general bias against everything Facebook, because I think it's a technologically incompetent, slightly abusive company.

Bad Arguments Against Tax "Increases"

By James Kwak

Last week, a professor making more than \$250,000 per year (with his wife's income) put up a blog post (since taken down) criticizing President Obama for wanting to "raise" his taxes.* The post basically said, after all of their basic expenses, "we are just getting by despite seeming to be rich." If his taxes go up, he says he will have to cut back on spending, which will depress the economy, or perhaps even sell his house or cars, which will depress those asset markets. The problem, he argues, is that the tax "increases" won't affect the true super-rich, because they use tax dodges to avoid paying taxes; instead, they will just hurt the economy.

This post has been the target of some howitzers on the Internet, mainly focused on the professor's income and expenses, but I wanted to raise a few more general policy points.

First, it's just not true that the rich will reduce their spending dollar-for-dollar as their taxes go up. The reason that tax cuts are a lousy form of stimulus applies in reverse: just as extra cash leads to more saving, less cash leads to less saving. And this is especially true for the rich, who have more slack in their budgets. There might be individual rich households that will reduce their spending dollar-for-dollar, but in aggregate it just won't happen.

Second, there certainly are hard-working, young, dual-income, multiple-child, productive families who have high expenses. It is true that there is no single thing as "the rich." Different people making \$250,000 consume different amounts, and it's not just a function of personal virtue; it's also a function of where you live (some of those high salaries come in places with high costs of living) and where you are in your career lifecycle. But the obvious implication of that banal observation is that we should tax wealth, not income, or wealth in addition to income. If the people arguing against "raising" taxes on the rich were arguing for a wealth tax, or at least for a meaningful estate tax, then I would have more sympathy for them. (Or, say, a consumption tax with an exclusion for the first \$40,000 of consumption.)*

Third, the "Cayman Islands" argument (that the really rich don't pay taxes) is mainly false and, to the extent it is true, again yields a different policy conclusion. [Warren Buffett](#), for example, pays an average tax rate of 18%, so the claim that "the super rich don't pay taxes" is just not true. Now, that is a lower tax rate than many middle-class households, but the reasons for that are well known. Again, we tax income, not wealth; we tax capital gains and dividends at much lower rates than salary (again, thanks to George W. Bush), and the rich get a larger proportion of their income from investments; and the taxes that affect most working people are actually *regressive*, because of the cap on the payroll tax. So I would have more sympathy for the Cayman Islands argument if its author were also arguing for lifting the cap on the payroll tax and eliminating the tax breaks for capital gains and dividends.

Fourth, if it is true that the rich are feeling squeezed, this actually undermines the main argument against tax "increases"—that higher marginal rates will cause people to work less hard. If households making over \$250,000 per year really have no fat in their budgets, then "raising" marginal tax rates will not affect their propensity to work, which is what you want from an

economic standpoint.

Fifth, the professor makes the tired old argument that his spending (which goes to local “entrepreneurs”) is better than government spending (“handouts”). In general, I agree that it is better to make our production decisions based on consumers’ preferences rather than congressional votes. But the entrepreneurs-vs.-handouts is a red herring. In the long term, the choice is between consumption by the rich and health care for the elderly (Medicare). You can call this redistribution.^{***} But given that old people generally need more health care than young people, given that old people generally make less money than young people, and given that health care costs continue to grow faster than inflation, the question is whether we’re willing to let people suffer in their old age simply because they couldn’t save enough money in their lifetimes to pay for their medical emergencies in retirement. (And there will also be people who make lots of money, save lots of it, and still go broke in old age because they lose the medical lottery.) There are people who are willing to come out and say that. But most people opposing tax “increases” are not. Instead, they prefer to malign government spending in general.

In the long term, we have a big fiscal problem. Yes, “raising” taxes will have some impact on the economy. But we have to do something. Since partisan gridlock rules out any significant reform of the tax system (and even rules out sensible compromises like delaying the tax “increases” until the economy recovers), the only available lever to increase government revenue is letting Bush tax cuts expire. It’s a blunt tool, but in the current political climate it’s the only one we’ve got.

* Of course, as we all know, it’s President Bush who is raising his taxes; what’s happening is the Bush tax cuts had sunset provisions so that they could make the true fiscal costs of the tax cuts seem artificially small, and those sunset provisions are about to kick in.

** The other implication is that if you’re young and have a high salary but high expenses, you should just borrow more money; you’re really just borrowing from your future self, because someday the house will be paid off, the kids will be done with college, and you’ll be making even more money since you’ll have more seniority and experience.

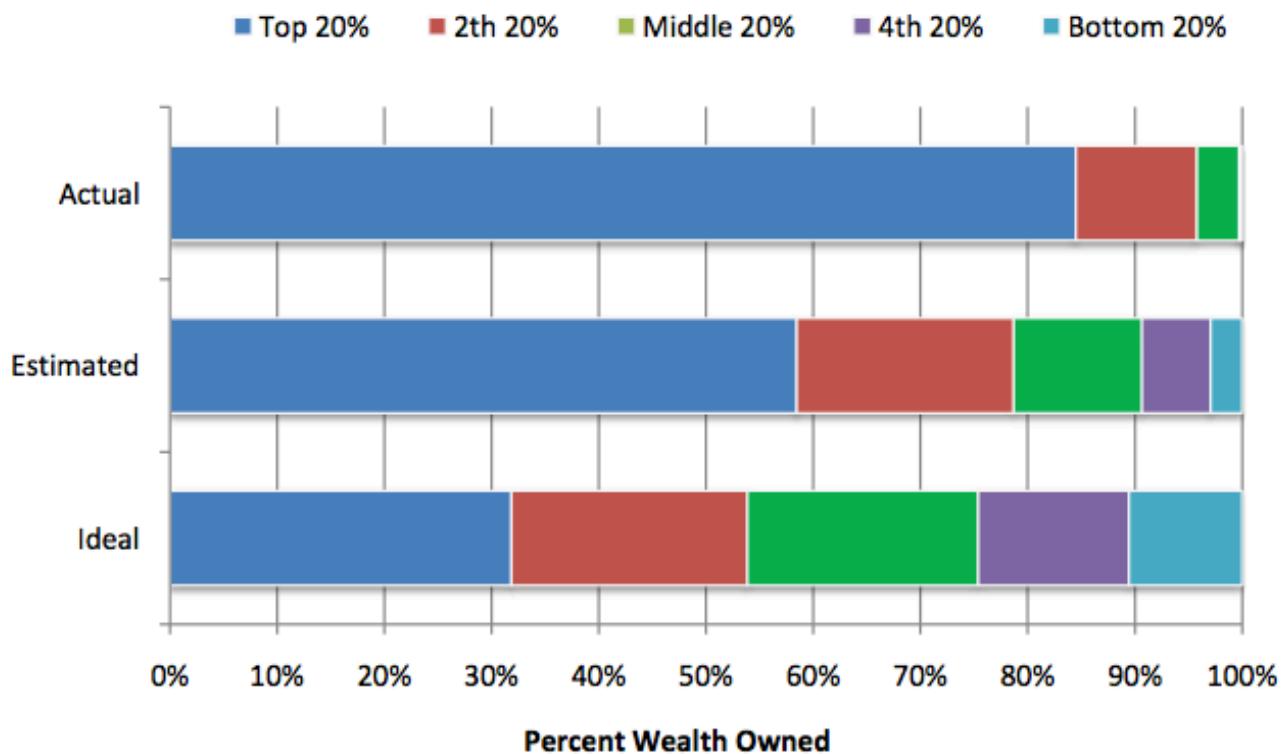
*** Most people think that a progressive tax system is redistributive. I’m not sure. The issue is who you think benefits more from government spending—the rich or the poor. The conventional answer is that the poor do, because they get “handouts.” But imagine a world without government. Who would lose more? Assuredly the rich, who would no longer have the armed forces, the police, and the courts (and the FDIC) to protect their property. I guess you could have a private security market, but how could you maintain, say, a financial system where most of your wealth is bits on a computer somewhere without a government to back it up?

Americans Want to Live in Sweden

By James Kwak

The chart below is from a [short paper by Michael Norton and Dan Ariely](#) (author of *Predictably Irrational*) (hat tip [Huffington Post](#)). The top line is the actual U.S. wealth distribution. The second is what Americans think the wealth distribution is. The bottom line is what Americans think the wealth distribution should be.

Figure 2. The actual United States wealth distribution plotted against the estimated and ideal distributions across all respondents.



Yes, in the real world, the wealth held by the bottom two quintiles together simply vanishes on a chart like this.

It's based on a survey done in 2005—before the financial crisis, and just about at the peak of housing boom-induced euphoria. The results are consistent across income groups, gender, and political affiliation. There are small differences, but they are swamped by the basic results.

There are two other great charts (including the U.S.-Sweden comparison), but in the interests of respecting fair use I'll send you [over there](#).

This is one of the themes brought up in *Winner-Take-All Politics* by Jacob Hacker and Paul Pierson. Americans really think that society should be considerably more equal than it is, and that attitude has not shifted appreciably during the past thirty years. Yet our political system produces

policies that make America more and more unequal, predominantly by cutting taxes for the very rich. Hacker and Pierson's point is that there has *not* been an ideological shift toward conservative positions in the country at large (at least not on this issue). Instead, it's the game of politics that has changed, so policy has become more disassociated from the preferences of the people.

President Obama Can Bounce Back

The Baseline Scenario » 2010 » September 9/29/10 at 8:49 AM **Simon Johnson**

By Simon Johnson

Conventional wisdom is now that the parlous state of the economy will seriously damage President Obama's reelection chances in 2012. Perhaps, but this view misses what we should expect in terms of global financial dynamics – and how this is likely to affect the US economy over the next two years.

Details are in [my Bloomberg column this morning](#).

TARP Is Gone – But May Soon Be Back

The Baseline Scenario » 2010 » September 9/30/10 at 6:15 AM **Simon Johnson**

The [Troubled Asset Relief Program](#), or TARP, is over – more specifically, its legal authority expires on Sunday, so it cannot be used for new “bailout” activities (although legacy programs, with money already disbursed, could last 5 to 10 years.)

The first draft of its history, looking back over the past two years, may be this: TARP was an essential piece of a necessary evil – that is, it saved the American financial system from collapse – but it was implemented in a way that was excessively favorable to the very bankers who had presided over the collapse. And this sets up exactly the wrong incentives as we head into the next credit cycle.

People who are opposed to bailouts of any kind like to argue that TARP was not really necessary. Banks could have been allowed to fail and the economic fallout around the world would not have been so dramatic.

This was, of course, the view taken by policymakers in 1929-31, after the Great Crash. Top people at the [Federal Reserve](#) and [Treasury](#) argued that the United States had experienced a financial mania (true), that a fall in asset prices was long overdue (quite likely, at least for stocks), and that the right approach was to stand back and – in the unforgettable words of Treasury Secretary

[Andrew Mellon](#) — let the private sector “liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.” (The exact wording of Mellon’s quote is according to President Hoover’s account, but this was Mellon’s general view; see p.445 of *Mellon: An American Life*, by David Cannadine).

The result was [the Great Depression](#). No responsible policymaker would want to run that risk again.

Supporting banks by injecting capital is best practice for preventing financial and economic collapse around the world. It was, by the way, not the idea of then-Treasury Secretary Henry Paulson – he wanted to have the government buy up “toxic assets,” an idea that never really got off the ground (too complex, too easy to abuse and inherently nontransparent in deeply scary ways).

It was Representative [Barney Frank](#), the Massachusetts Democrat, who insisted that the Treasury receive the power to provide capital. Within a week of the legislation’s approval, this was the main option on the table and has remained front and center of what the government did in fall 2008 and January 2009, and what it could promise (or threaten, depending on your perspective) to do after the [stress tests](#) of spring 2009.

But three serious mistakes were made in the implementation of TARP.

First, there was no need to be so excessively generous to the financial executives (and their boards) at the institutions that had to be saved. In part this generosity was due to insufficient safeguards in the legislation (a point [Ken Feinberg](#) makes persuasively with regard to compensation), but mostly this was a choice insisted upon by key people in [President Obama’s](#) economic team.

The bankers were not even embarrassed by what happened – this was extraordinary, probably unprecedented and completely at odds with what the very same administration officials had advocated when their advice (and money from the United States and the International Monetary Fund) was needed by other countries (we cover this in detail in Chapter 2 of [13 Bankers](#)). The historical record on this point is not in question.)

Second and closely related, the Obama administration missed the opportunity to change the structure and the incentives of Wall Street when it had the chance, at the very beginning of 2009. The Treasury line, then and now, was that the “essential functions” of the financial system had to be preserved, and this meant no one could be “punished.”

This is again a complete divergence from best practice, for example as recommended by the I.M.F. (with United States backing) in many situations over the last 50 years. The issue is not punishment or retribution; it is responsibility – and it provides incentives to be careful in the future. (Again, for more technical details, see [13 Bankers](#).)

Failing to seize an opportunity for reform is not sophisticated or the work of adults (as some members of the Obama administration self-servingly assert); it was simply a political mistake – and

terrible economics. The idea that some banks were too big to fail arguably played a role in the run up to 2007-8; we can have that debate. But the notion that our biggest six banks are untouchable today is uncontroversial.

Their creditors know this, so these banks can borrow more cheaply than their smaller competitors, they can become larger relative to the economy, and if you doubt the risks that this poses, just look at the situation today in Ireland.

Third, by the time the administration put forward its financial reform ideas, the big banks were back on their feet – and ready to throw huge numbers of lobbyists and unlimited cash into the fight to preserve their right to take inordinate risk and to mismanage their way into disaster.

The administration's proposals were weak to start with and were diluted by the House of Representatives (with a very few holding actions, most notably by [Representative Paul Kanjorski](#)). Surprisingly, and against great odds, the legislation was not gutted in the Senate – due primarily to the efforts of [Paul Volcker](#) (from the outside) and Senators [Kaufman, Levin, Brown, and Merkley](#), the reforms became a little bit stronger. But the [Dodd-Frank Act](#), while including some sensible consumer-protection measures, essentially [does very little to reduce system risk](#) as we move into a new credit cycle. In particular, there is nothing that ensures our biggest banks will be safe enough or small enough or simple enough so that in the future they cannot demand bailouts – the bailout potential exists as long as the government reasonably fears global financial panic if such banks are allowed to default on their debts

Where do we stand today, with the Financial Stability Oversight Council meeting for the first time tomorrow? In a devastating speech last week, Mr. Volcker [hit all the nails on the head](#) – our financial system is badly broken. This will lead another runaway mania and another awful collapse.

Read the [farewell speech](#) this week from Senator [Ted Kaufman](#) of Delaware to the Senate. Drawing the right lessons from the crisis and looking forward, with particular concern for the way "[high-frequency trading](#)" adds an extra level of opaqueness and risk to the system, he makes an impassioned plea for what is, in effect, a more pro-business approach (indeed, it's in the interest of almost everyone engaged in the financial system).

"We cannot afford regulatory capture, nor can we afford consensus regulation, not in any government agency," he said, especially the [Securities and Exchange Commission](#), "which oversees such a systemic, and fundamental, aspect of our entire economy."

He continued:

"[I]f we fail, if we do not act boldly, if the status quo prevails, I genuinely fear we will be passing on to my grandchildren a substantially diminished America – one where saving and investing for retirement is no longer widely practiced by a generation of Americans and where companies no longer spring forth from the well of capital flows that our markets used to provide."

TARP is gone, but we must not forget its lessons.

An edited version of this post appeared this morning on the [NYT.com's Economix blog](#); it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.