

By James Kwak

My [previous post](#) on Fannie/Freddie had two major parts. In the first part, I questioned whether the thirty-year fixed-rate mortgage would really go away (or become much more expensive) without Fannie/Freddie, as some people have argued. In the second part, I said, who cares?

The first part has gotten a fair amount of good criticism, for example from [Arnold Kling](#) and [John Hempton](#) (by email), and also in comments. My position, simplified, was that a thirty-year fixed-rate mortgage includes three kinds of risk: credit risk, interest rate risk, and prepayment risk. Credit risk can be diversified, interest rate risk can be hedged, and Fannie/Freddie didn't do anything about prepayment risk anyway. This is the kind of theoretical argument people make all the time, and the obvious question is whether the world actually works that way.

I think there are two important criticisms. One, which Kling makes, is that while there are thirty-year fixed-rate bonds (like Treasuries) floating around out there, there just aren't that many compared to the volume of U.S. thirty-year fixed-rate mortgages. So there might not be enough buyers, and without enough buyers the yields could go way up. One response is that the interest rate risk can be hedged, but that means you have to find a lot of people willing to take the other side of the interest rate swaps, and maybe that would be too hard. So the real question is how much demand there is for thirty-year fixed-rate assets.

The second criticism, which Kling and Hempton make, is that the big issue isn't the thirty-year maturity; the big issue is prepayment risk. A thirty-year fixed-rate mortgage gives the borrower the right to refinance and pay off the loan at any time, which means that even if you want a thirty-year asset, you can't count on it. When interest rates go down, you're likely to get your principal back, and then you'll have to reinvest it at lower rates. Now, the classical response is that this is just an embedded option (for the borrower), and you should be able to price the option into the mortgage. So the real question is how many people are willing to write those options, and maybe the markets just aren't deep enough.

I'm not completely convinced by this, though, because Fannie/Freddie didn't actually hold onto most of their mortgages. Instead, they created pools that issued mortgage-backed securities, and those things had both interest rate risk and prepayment risk (see pages 11-16 of this [prospectus](#) for a long list of prepayment risk factors). So people buying the MBS issued by Fannie/Freddie (\$5 trillion of them), it seems to me, were happily taking on both interest rate risk and prepayment risk. This seems obvious to me, so I'm almost certainly missing something.

For this reason, I'm still not entirely convinced that the private sector couldn't take this on. Sure,

interest rates would have to be higher because the private sector wouldn't have the Fannie/Freddie implicit government guarantee* (although, as one commenter pointed out, part of the private sector has something like it). And with higher interest rates, thirty-year fixed-rate mortgages might become less popular compared to adjustable-rate mortgages. But that's not the end of the world.

Relatedly, [John Hempton](#) has another proposal for Fannie/Freddie: simply raise the fee they charge for guaranteeing credit risk. At some point the private sector will step in and take on the job, and in the meantime the government will lose less money and distort the economy less.

* Without the implicit guarantee, the credit risk would be properly priced into the MBS issued by Fannie/Freddie, because Fannie/Freddie already charge a fee for guaranteeing the MBS.

The Ruinous Fiscal Impact Of Big Banks

The Baseline Scenario » 2011 » February 2/3/11 at 7:14 AM Simon Johnson

By Simon Johnson

The newly standard line from big global banks has two components – as seen clearly, for example, in the statements of [Jamie Dimon \(JP Morgan Chase\)](#) and [Bob Diamond \(Barclays in the UK\)](#) at Davos last weekend. First, if you regulate us, we'll move to other countries. And second, the public policy priority should not be banks, but rather the spending cuts needed to get budget deficits under control in the US, UK, and other industrialized countries.

This rhetoric is misleading at best. At worst it represents a blatant attempt to effectively shakedown the public purse.

On Tuesday morning, [in testimony to the Senate Budget Committee](#), I had an opportunity to confront this myth- making by the banks head-on and to suggest that the bankers' logic is completely backwards.

Start with the bankers' point about budget deficits and spending cuts. Public deficits and debt relative to GDP have ballooned in the past three years for one simple reason – the big banks at the heart of our financial system blew themselves up. On this point, the conclusions of the Financial Crisis Inquiry Commission, which appeared last week, [are very clear and utterly compelling](#).

No one forced the banks to take on so much risk. Top bankers lobbied long and hard for the rules that allowed them to behave recklessly. And these same people effectively captured the hearts, minds and some would say pocket books of the regulators (in the sense that a well-regarded regulator can and often does go work for a bank afterwards).

The mega-recession, which is starting to look more like a mini-depression in employment terms for the US (we lost 6 percent of employment and we are still down 5 percent from the pre-crisis peak), caused a big decline in tax revenues. Falling taxes under such circumstances is known technically as part of the “automatic stabilizers” for the economy, meaning in this context that they help offset the contractionary effect of the financial shock – without the government having to take any discretionary action.

Whatever you think about the effectiveness of the additional fiscal stimulus packages provided to the economy in early 2008 (under President Bush) or starting in early 2009 (under President Obama), just remember that the impact of these on the deficit was small relative to the decline in tax revenues.

The total fiscal impact of this regulatory capture cycle, as reflected for example on the Congressional Budget Office baseline debt forecast – comparing what this was pre-crisis and what this is now – is about a 40 percentage point increase in net federal government debt held by the private sector.

As we discussed at length during the Senate hearing, it is therefore not possible to seriously discuss bringing the budget deficit under control in the foreseeable future without measuring and confronting the risks still posed by our financial system.

Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program put it well in his [latest quarterly report](#), which appeared last week: “perhaps TARP’s most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are ‘too big to fail.’”

But next up for the US economic outlook is not necessarily another “too big to fail” boom-bust-bailout cycle; we may well move on to “too big to save”, which is what Ireland is now experiencing. When reckless banks get big enough, their self-destruction ruins the fiscal balance sheet of an entire country.

In this context, the idea that megabanks would move to other countries is simply ludicrous. These behemoths need a public balance sheet to back them up, otherwise they will not be able to borrow anywhere near their current amounts.

Whatever you think of places like Grand Cayman, the Bahamas, or San Marino as off-shore financial centers, there is no way that a JP Morgan Chase or a Barclays could consider moving there. The “national champions” of banking are actually very poorly-run casinos with completely messed-up incentives; they need a deep-pocketed and somewhat dumb sovereign to back them.

The latest credit rating methodology from Standard and Poor’s says essentially just this – henceforth, it will evaluate banks not just on their “stand alone” creditworthiness, but also in terms

of their ability to attract generous support from a creditworthy government in the event of a crisis.

New York-based banks might move to London, and vice versa. But the Bank of England is far ahead of the Federal Reserve in its thinking about how to rein in banks – see, for example, the [new paper by David Miles](#) (member of the Monetary Policy Committee in the UK) on the need for much more equity financing in banks than specified in the Basel III agreement.

Officials outside the US are increasingly beginning to understand the point being made by [Anat Admati and her colleagues](#) — bank capital is not expensive in any social sense (e.g., look at Switzerland, where [the biggest banks are now required to have about double the Basel III levels of equity funding](#)). We need our financial system, particularly our largest banks, to be financed much more with equity than is currently the case.

The [intellectual right in the United States understands all this](#) and, broadly speaking, agrees. Officials in other countries begin to see the light. Unfortunately, officials in the United States and [most of the political right](#) (i.e., those who seek public office) – as well as much of the political left – still appears greatly in thrall to the big banks.

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

Fordham Panel on Monday

The Baseline Scenario » 2011 » February 2/3/11 at 11:00 AM James Kwak

By James Kwak

The Fordham Law School is holding a [symposium on regulatory capture](#), with a vague emphasis on the financial sector, on Monday morning from 8 to noon, plus lunch if you want to stick around. Senator Sheldon Whitehouse (D-RI) will be talking — I've heard him, he knows his stuff — and the panelists will include [Lawrence Baxter](#), [Daniel Kaufman](#), [Steven Davidoff](#) and [Robert Weber](#). And me. I'll be talking (for ten minutes, plus discussion) about types of regulatory capture, in particular how regulatory capture can operate in the absence of corruption and dishonesty.

I believe according to the website it's free if you don't want lunch. And lawyers can even get CLE credit (you have to pay a bit more), even though I'm still in law school!

The Problems with Rivlin-Ryan

By James Kwak

[Uwe Reinhardt](#) has a post about the Rivlin-Ryan Medicare Plan, which would convert Medicare into a voucher program for people currently under 55 and also fix the growth rate of the value of the vouchers at GDP growth plus one percentage point. The issue Reinhardt focuses on, and which I also [blogged about](#) a while back, is that health care costs have been climbing considerably faster than that, so over time the value of the vouchers will fall relative to real health care costs.

But another problem is that, at least according to the [CBO's summary](#), the Rivlin-Ryan plan doesn't say anything about how elderly people will buy insurance. Today, the cost of Medicare is reduced by the program's bargaining power with providers. which means the total amount spent by Medicare is less than the total amount that would be spent by all Medicare beneficiaries if they had to buy insurance on the individual market. A voucher system would push them into the individual market, which means that the amount they would have to spend would go up dramatically.

Now, it's possible that the Rivlin-Ryan plan takes the Obama health care reform and its reforms to the individual market (including a prohibition on medical underwriting and the creation of exchanges for buying insurance) as a starting point. But that would be interesting, since Paul Ryan [voted](#) to repeal the Obama health care reform.

The Rivlin-Ryan proposal leaves the payroll tax unchanged, so it doesn't change the amount people are forced to spend on health insurance up front. If you don't like the idea of forced saving, Rivlin-Ryan doesn't do anything for you.

It does two main things. First, it reduces the dollar value of the benefits people get, which is unequivocally bad for beneficiaries. That is, for every dollar by which it reduces the deficit, it takes one dollar out of someone's pocket. In this sense, it's *exactly the same as a tax increase* – in this case, a tax increase levied on the elderly.

Second, it gives people more choice over how they spend their benefits. It's theoretically possible that this could compensate for the fact that those benefits are now lower. It's theoretically possible for two reasons. One is that people can now buy the plan that they want, instead of the one-size-fits-all Medicare plan. But that's not much of an advantage here, since if you're sick you'll want to buy at least what Medicare provides already, and if you're healthy you can't buy a really cheap plan and cash in the unused part of your voucher. The other reason is that, theoretically, the operation of the free market could lead to general efficiencies in the system. In practice, however, we're talking about the market for health insurance, which is already terribly inefficient and, as Reinhardt shows anecdotally, has been completely unable to keep the cost of healthcare in check. So while government provision of services introduces inefficiencies, you have to compare those inefficiencies to the ones in the private sector — you can't hypothesize a private sector that always produces

optimal results.

Does Behavioral Economics Undermine the Welfare State?

The Baseline Scenario » 2011 » February 2/6/11 at 12:09 PM James Kwak

By James Kwak

That's the title of a post by [Mike Konczal](#), who answers it in the negative. The question comes from [Karl Smith](#) and is based on a paper by [Bryan Caplan and Scott Beaulier](#). The paper argues that welfare programs expand the set of choices available to people; while that is all good according to traditional economics, if we think that people are inclined to make bad choices ("behavioral economics"), then welfare programs give people more opportunity to make bad choices and hurt themselves. This is particularly a problem because, they claim, "there are good empirical reasons to think that behavioral economics better describes the poor than it does the rest of the population" (p. 4). In other words, if poor people are more irrational, then giving them more choices will hurt them more than other people.

Let's start with that last claim. What could it even mean that "[some academic subfield] better describes [one group of people] than it does the rest of the population"? It seems to me there's a category error here. Behavioral economics describes human beings, and the major population used in most experiments is undergraduates at prestigious universities. If the findings of the research are biased in any way, that's the bias.

But what Caplan and Beaulier really mean to say is this: "Existing literature provides good reasons to think that the deviations of the poor from the standard neoclassical model are especially pronounced. Their judgmental biases are more extreme, and their self-control problems more severe, than those of the rest of the population" (p. 12). So basically they boil down all of behavioral economics to the proposition that people behave irrationally (admittedly, this is what is most prominent in the popular literature), and then they say that the poor are more irrational than "normal" people. (The normative standpoint is theirs, not mine. Check out this clause: "deviant behavior is much more pronounced among the poor.")

OK, this is offensive. But still, is there something to it? Not much, I would say. This is their evidence:

- Poor people are more likely to exhibit heavy alcohol use.
- Poor people are more likely to be obese.
- Poor people are more like to smoke and use illegal drugs.
- Poor people are more likely to have sex earlier and have children while in their teens.

- Poor people are more likely to commit crimes.

Since all of these behaviors involve (they claim) an inability to make rational judgments about the tradeoffs between present benefits and future costs, this means that the poor are more prone to the judgment problems that are often cited in popular accounts of behavioral economics.

There is so much nonsense here it's hard to figure out where to start. First of all, some of the factual claims aren't even supported. For example, on obesity, they cite a study finding that obesity declines with educational level. Then they assert: "Given the strong correlation between education and income, there is little doubt that the poor have more trouble maintaining a healthy body weight." Yes, given the above, it is likely that there is a negative correlation between obesity and income; but it is also likely that *that negative correlation is explained by education, not by poverty*. Couldn't they have made the effort to find a study with the facts they need instead of just assuming?*

Second, and more importantly, if we assume for the purposes of argument that more poor people are obese, it's an enormous leap to say that this is because they make worse judgments. There are many other possible explanations. Here are a few, each of which I find more compelling than the behavioral one:

- It's more expensive to eat healthy food than unhealthy food.
- Many poor people work long hours or have limited child care options, which makes it harder to buy and cook healthy food from the grocery store.
- Poor people have worse health care than rich people.

You can add your own.

This criticism can be easily made of several of their points. Take crime, for example. The most obvious counterargument is that crime is more prevalent among the poor because they are poor. Caplan and Beaulier think they can deal with this by saying that few inmates received illegal income prior to being arrested. But this is only a small part of the puzzle. A major reason for high incarceration rates among the poor is recidivism, and a major reason for recidivism is the difficulty of finding employment and otherwise integrating into society when you have a criminal record. People without stable support networks are more likely to commit crimes and have less to lose, regardless of their ability to make judgments. The failure to control for anything at all should make their point invalid.

Along the way, they also cite Levitt and Dubner to support the proposition that since drug dealers don't make much money, "it is easy to see the appeal of crime to those who overestimate their chance of becoming a gang leader, or who simply have poor impulse control" (p. 14). But what Levitt and Dubner really say is this (*Freakonomics*, paperback edition, p. 102):

| "To the kids growing up in a housing project on Chicago's south side, crack dealing seemed

like a glamour profession. For many of them, the job of gang boss — highly visible and highly lucrative — was easily the best job they thought they had access to.”

So far, so good for Caplan and Beaulier. But they continue:

“Had they grown up under different circumstances, they might have thought about becoming economists or writers. But in the neighborhood where J.T.’s gang operated, the path to a decent legitimate job was practically invisible. Fifty-six percent of the neighborhood’s children lived below the poverty line . . . Seventy-eight percent came from single-parent homes. Fewer than 5 percent of the neighborhood’s adults had a college degree; barely one in three adult men worked at all. The neighborhood’s median income was about \$15,000 a year, well less than half the U.S. average. During the years that Venkatesh lived with J.T.’s gang, foot soldiers often asked his help in landing what they called “a good job”: working as a janitor at the University of Chicago.”

Levitt and Dubner’s real points are these: First, people turn to drug dealing because there are no good options. Second, drug dealers are just like people pursuing other glamour professions.

OK, enough for that point. What else? Well, there are measurement problems, although they probably aren’t that big. Poor people are more likely to use illegal drugs and commit crimes in part because society defines those drugs as illegal (as opposed to, say, prescription pain-killers) and enforces the laws more strictly against poor people. But that’s probably not a huge factor.

In any case, the idea that poor people are more likely to exhibit bounded rationality is a huge assertion backed up by not much of anything. This isn’t even a standard correlation-causation problem. This is a correlation where their preferred cause is well down the list of possible causes.

But . . . that still leaves the theoretical point. Is it possible that expanding people’s choice sets enables them to make bad decisions? Of course. Even if you’ve never read a behavioral economics paper in your life, just look at any chapter of *Predictably Irrational*. But does that justify this conclusion?

“Most obviously, if government assistance to the disadvantaged amplifies the ill effects of their judgmental biases and self-control problems, it strengthens the case for reducing the size of welfare benefits, limiting their duration, restricting eligibility, and even abolition.”

Let’s take that sentence one clause at a time. Does government assistance necessarily amplify judgmental biases? Not at all. As Konczal noted, there’s a lot of picking and choosing going on in this paper. Take retirement savings, for example. Mountains of research shows that people are very bad at savings and investment decisions, because of all the usual culprits: loss aversion, hyperbolic discounting, etc. So Social Security is a good thing: it forces people to save, and doesn’t let you invest it all in tech stocks, and forces you to wait until you’re in your sixties to get anything back.

(There's also a redistributive component, but even without that component it would still be a good thing for the above reasons.)

Then there's the topic du jour: the individual mandate. Because of optimism bias, some people will not buy health insurance even when they should, with negative consequences for them and for society as a whole.

At most, even if we accept the first clause of Caplan and Beaulier's sentence for purposes of argument, it should affect the way we deliver welfare benefits, not their existence or size (which should be determined on other grounds). If the problem is choice, then we should just reduce choice. For example, we could eliminate every single welfare program and replace all of them with (1) Medicare for everyone and (2) a flat \$10,000 (indexed) cash payment to every person in the country. (If you want to switch to a flat tax or a consumption tax to raise the necessary revenue, I'm willing to take that trade, as long as nothing eats into (1) or (2).) That way we would achieve the social goals of welfare with none of the choice problems Caplan and Beaulier complain about. Even leaving aside my fantasy, we should be happy about things like unemployment insurance and the EITC, which both give you an incentive to work.

Finally, on Konczal's broader question: Like any field, behavioral economics gives you lots of opportunity to pick and choose, and if you're willing to be superficial or unscrupulous, you can justify lots of policy positions with it. But on balance I think it cuts in favor of the welfare state. In its popular form, behavioral economics is all about judgment errors that hurt people's own self-interest, which provide support for the idea that government should attempt to correct for those errors. Forced saving is one example. Robust disclosures are another (although not one I'm particularly optimistic about). Now, there is a valid argument about how effectively government policy can correct for those errors, and at what cost, so maybe we should be humble about the ability of Cass Sunstein to come up with the right correction for every problem. But in principle that seems like the simplest inference to draw.

More fundamentally, behavioral economics throws into question all of the foundations of traditional microeconomics, on which the entire theory of the free market is based. One of the findings of the research is that not only do people not make decisions that are consistent with their preferences, but their preferences are arbitrary in the first place, even under conditions of perfect information. (See "Coherent Arbitrariness" by Ariely, Loewenstein, and Prelec, for example.) If people can be tricked into valuing something more highly because, say, the last two digits of their social security numbers are high, how much confidence should we have that market prices reflect absolute value to consumers?

* This may seem harsh, especially coming from a blogger. Frankly, I would be more sympathetic to Caplan and Beaulier if they had put their ideas in the form of a blog post instead of a "paper," with the level of carefulness the latter used to imply.

“To Blame Wall Street For the Financial Meltdown Is Absurd”

The Baseline Scenario » 2011 » February 2/7/11 at 9:24 AM Simon Johnson

By Simon Johnson

At the heart of the Treasury Department’s strategy for refloating our largest financial institutions is an important assumption – decision-makers at our largest institutions have “learnt their lesson” and will be more careful going forward.

The latest string of pronouncements from the top of Wall Street suggests that this assumption is badly flawed.

[In a column now running on Bloomberg](#), I review the recent statements of Robert Benmosche (AIG) and Bob Diamond (Barclays). Their views are not encouraging. They want to run bigger, more global and extremely complex financial institutions. They also appear to favor a great deal of leverage (high debt relative to equity) wherever possible.

Steve Eckhaus – a top Wall Street compensation lawyer (he will get you your bonus) – articulated the underlying view with great clarity to Saturday’s Wall Street Journal, “To blame Wall Street for the financial meltdown is absurd.” (p.B13 of Feb.5-6 print edition).

The absurdity here is that we have created Too Big To Fail banks (and insurance companies) and that we are allowing them to become Too Big To Save – while our political elite blithely looks the other way.

Direct link to Bloomberg column: <http://www.bloomberg.com/news/2011-02-07/wall-street-knows-meltdown-was-just-bad-dream-commentary-by-simon-johnson.html>

Is Happiness Conservative?

The Baseline Scenario » 2011 » February 2/8/11 at 11:07 PM James Kwak

By James Kwak

A few days ago I wrote [a post](#) addressing [Mike Konczal’s question](#) of whether behavioral economics, as a whole, weakens the case for the welfare state or, more generally, for activist liberal policies. I said the answer was “no.” But I think positive psychology—otherwise known as happiness research—presents a more difficult question.

I've only consumed popular versions of happiness research, such as [*The Happiness Hypothesis*](#), by Jonathan Haidt, but basically the story is something like this. For much of its history, psychology had a pathological bent: it was concerned with figuring out why people had psychological problems and how to cure those problems. (Whether it had any success whatsoever is a question for another day and another blog.) A few decades ago, however, some psychologists decided they would try to figure out what makes people happy, and they started a wave of happiness studies that continues today. In many of these studies, people are pinged at random times and asked to rate how happy they are at that moment. Then treatments are introduced so you can measure the difference in happiness between the treatment and control groups. For example, if people find a quarter in a pay phone,* afterward they will report they are happier than people who didn't find the quarter; not only does this effect persist for a surprisingly long time (into the next day, I think), but also affects people's reported happiness about unrelated parts of their life, like their family life.

Happiness research is vaguely related to behavioral economics research in that both show that people can be easily tricked, but it has a different emphasis. Happiness research is in a sense less threatening to traditional microeconomics, because it is about figuring out how to measure utility. In economics, money has always been just a proxy for utility. The idea is that people maximize utility under constraints; since we can't measure utility, we assume that they maximize money under constraints.

Well, we still can't measure utility directly, but we know some things that make people happy: Short commutes. Predictability. Control over the environment (random noises are bad). Eating, but only until satiation. Sex, but only until satiation. Money—but only to a point; once your basic needs are met and you don't face constant insecurity, more money no longer buys you more happiness. Participation in social groups. Marriage, usually. (Children, not so much.) Being appreciated by your boss. Generosity toward other people—even if the generosity is not observed by anyone. Work that is challenging but not overwhelmingly so. Physical contact with other people. And finding quarters in pay phones.** (This is a partial list based on my current recollections of things I read at various points in the past, so it may not be perfectly accurate. But you get the idea.)

Now, understanding these things can be very important for your personal well-being. For example, it implies that you should choose a short commute over a higher-paying job (for some range of commuting and salary differentials).

But what does this mean for public policy? It still means we should be ensuring a minimum standard of welfare for everyone, since uncertainty about obtaining the basic necessities of life is a major source of unhappiness.

But you can also draw some conservative implications from the research. For one thing, a central principle of the research is adaptation: people tend to adapt to the situation they're in. Once you have the basic necessities, if your income goes up, you quickly adapt to it, so the added income doesn't make you happier. If you make a big purchase, most of your happiness is consumed in

anticipating it; by the time you actually get it, you've already adapted to having it. In other words, most economic changes in your life aren't going to have much lasting impact on your happiness—not as much as, say, going to church every week. And the implication of adaptation is that you should try to be satisfied with what you have, because having more of it isn't going to make you any happier.

Another possible implication is that, if we want to promote happiness, government should encourage the formation and strengthening of community organizations. While this may not necessarily sound conservative today, the conception of society as composed of tightly knit local groups was historically a conservative one, while the progressive movement (formerly known as the workers' movement) was framed much more in classically economic terms: getting people more money for fewer hours of work. And today, the strongest community organizations are churches. Again, churches are not inherently liberal or conservative, but the idea that people should seek fulfillment in their church community rather than by improving their economic station has a conservative tinge to it.

As you can tell, this isn't a black-and-white issue, and breaks differently in different contexts. But I personally have had some second thoughts when reconciling my belief in the importance of happiness with my general support for traditionally progressive policies. And I think the general question is certainly worth thinking about: If we believe in maximizing happiness as we understand it today, what kind of public policies does that entail?

* Pay phones, for the kids out there, were fixed-line telephones that were installed in public places (train stations, street corners, etc.). To use such a phone, you had to put money in it, hence the name. They have mainly been rendered obsolete by the rise of mobile phones.

** There is one huge caveat to this list. These are factors that contribute to happiness in the moment, which is what is primarily measured by studies that ask people how happy they are right now (and measure the effect of treatments administered in the last few hours or days). Daniel Kahneman has a brilliant [TED Talk](#) making the point that there are two different kinds of happiness: happiness in the moment and satisfaction with your remembered life.

Paul Ryan Criticizes Bernanke for Failing to Contain Tooth Fairy

The Baseline Scenario » 2011 » February 2/9/11 at 1:18 PM James Kwak

By James Kwak

In a [Congressional hearing today](#), Representative Paul Ryan (R-WI), chair of the House Budget Committee, strongly criticized Federal Reserve Chair Ben Bernanke for failing to contain the severe inflation threat posed by the Tooth Fairy.

Ryan pointed to numerous studies showing that, despite ongoing economic sluggishness, the Tooth Fairy is paying much more for children's baby teeth than in past years. In neighborhoods such as Winnetka, Cleveland Park, the Upper East Side, and Palo Alto, children can receive more than \$20 per tooth — a dramatic increase from the 25-50 cents that the Tooth Fairy paid only a decade or two ago. In the Hamptons, summertime prices for teeth can easily exceed \$100, according to a survey commissioned by the American Enterprise Institute.* Because the Tooth Fairy is able to create money magically, her purchases of unused teeth (with no apparent economic value**) increase the money supply, fueling inflation. Without explicitly accusing Bernanke of participation in the Tooth Fairy's scheme, Ryan implied that the Tooth Fairy's higher payouts may be part of the Federal Reserve's quantitative easing scheme.

Ryan pointed to Tooth Fairy-driven inflation as part of “a sharp rise in a variety of key global commodity and basic material prices” that, he said, threaten to produce higher overall inflation and reduce the value of the dollar. “The inflation dynamic can be quick to materialize and painful to eradicate once it takes hold,” said Ryan, calling on Bernanke to end the quantitative easing program and raise interest rates in order to counteract the expansionary policies of the Tooth Fairy.

Bernanke responded, “On the inflation front, we have recently seen increases in some highly visible prices, notably for children's teeth. . . . Nonetheless, overall inflation is still quite low and longer-term inflation expectations have remained stable.” He pointed out that all measures of domestic inflation — the prices that real Americans pay for the real stuff that they actually buy — are at historic lows: core inflation of 0.7 percent in 2010, the price index for personal consumption expenditures at 1.2 percent, and average hourly earnings at 1.7 percent. He also pointed out that inflation in emerging markets is higher because those economies are growing faster and that commodity prices are always volatile. But Ryan insisted that the Fed take aggressive action against the Tooth Fairy because an unemployment level of 9 percent would fail to contain the inflationary spiral that would inevitably result from this particularly sinister form of monetary expansion, taking place quietly, in the dark, in our children's own bedrooms.

“There is nothing more insidious that a country can do to its citizens than debase its currency,” he said, apparently forgetting for a moment that he has [proposed replacing Medicare](#) with a voucher system whose benefits are explicitly designed to grow slower than the rate of health care cost inflation.*** Ryan also apparently believes that a more valuable currency is always better than a less valuable currency, which is crazier than a kid believing in the Tooth Fairy. After all, if you're six years old and the tooth under your pillow gets replaced by money and a note from the Tooth Fairy, then that's physical evidence in favor of her existence. Paul Ryan seems to believe that China (like Korea, Taiwan, Germany, and France before it) is hurting its economy by keeping the value of its currency low in order to promote exports and create jobs. This fetishization of the dollar's exchange rate is even crazier than the typical fetish, which at least attaches to some object. Paul Ryan's fetish

attaches to an abstract ratio and elevates it to moralistic terms.

* In inner-city Detroit, however, survey respondents gave answers such as, “No Tooth Fairy comes around here. Haven’t you seen nobody has a job anymore?” The AEI report concluded that the Tooth Fairy must value teeth from the Upper East Side more than teeth from Detroit.

** See the introduction to a [This American Life episode](#) for some children’s theories about what the Tooth Fairy does with all those teeth.

*** The growth rate of benefits is capped at GDP plus one percentage point. Historically health care costs have grown significantly faster. More to the point, the whole point of the Ryan-Rivlin plan is to force Medicare to grow more slowly than health care costs overall; if health care cost growth is GDP plus one percentage point or less, then converting Medicare to a voucher system provides no fiscal benefits.

What Did Bank CEOs Know And When Did They Know It?

The Baseline Scenario » 2011 » February 2/10/11 at 4:30 AM Simon Johnson

By Simon Johnson

One view of executives at our largest banks in the run-up to the crisis of 2008 is that they were hapless fools. Not aware of how financial innovation had created toxic products and made the system fundamentally unstable, they blithely piled on more debt and inadvertently took on greater risks.

The alternative view is that these people were more knaves than fools. They understood to a large degree what they and their firms were doing, and they kept at it up to the last minute – and in some cases beyond – because of the incentives they faced.

New evidence in favor of the second interpretation has just become available, thanks to the efforts of Sanjai Bhagat and Brian Bolton. These researchers [went carefully through the compensation structure of executives at the top 14 US financial institutions during 2000-2008](#).

The key finding is that CEOs were “30 times more likely to be involved in a sell trade compared to an open market buy trade” of their own bank’s stock and “The dollar value of sales of stock by bank CEOs of their own bank’s stock is about 100 times the dollar value of open market buys” (p.4).

If the CEOs had really believed in what their banks were doing, they would have wanted to hold this

stock – or even buy more. Disproportionately more sales than purchases strongly suggests that the CEOs felt their stock was more likely overvalued than undervalued.

The problem runs deeper, as Professors Bhagat and Bolton explain. Given the compensation structure of CEOs – particularly the fact that they can sell stock with very little restriction – they have an incentive to take on excessive levels of risk. When the outcomes are good, as they may be for a while in an up market, the CEO can turn his or her stock into cash. When the outcomes are bad, the CEO doesn't care so much because he (or she) already has cash – and some form of government bailout or other support may be forthcoming.

Bhagat and Bolton argue that if this incentive problem is important, we should see CEOs make a great deal of money while long-term buy-and-hold shareholders lose money.

Table 4 in their paper shows the amounts of money involved, and they are simply staggering. Collectively the people who headed these 14 institutions pocketed – in hard cash terms – over \$2.6 billion during 2000-08. It's true that the paper value of their wealth dropped in 2008, although this was an unrealized paper loss. But even including that notional loss, the CEOs netted an impressive \$650 million.

In contrast, long-term shareholders in these 14 banks did very badly, particularly in 2008 (see Figure 1 in the paper). Bhagat and Bolton show that shareholders in the biggest banks – where CEOs got their hands on more cash – did significantly worse than investors in smaller banks. Interestingly, CEOs in the smallest banks in their sample did not sell much stock relative to their purchases of their own bank's stock. The big bank-small bank contrast is quite striking.

This points the authors towards moderate but appealing changes in executive compensation practices.

“Executive incentive compensation should only consist of restricted stock and restricted stock options – restricted in the sense that the executive cannot sell the shares or exercise the options for two to four years after their last day in office” (p.37).

The authors are very much on the same page as Professors [Admati, Demarzo, Hellwig, and Pfleiderer](#) (and many others in the finance profession), with regard to our need to increase the equity financing of all banks.

“As a bank's equity value approaches zero (as they did for some banks in 2008), equity based incentive programs lose their effectiveness in motivating managers to enhance shareholder value. Hence, for equity based incentive structures to be effective, banks should be financed with considerable more equity than they are being financed currently.”

This recommendation should be taken on board by all shareholders and their representatives. But who designed and negotiated the compensation packages at issue here, and who is in charge

going forward?

The executives in question hire people like Steven Eckhaus, a top Wall Street compensation lawyer, who puts up a spirited defense of current practices and insisted the Wall Street Journal just last weekend that “to blame Wall Street for the financial meltdown is absurd” ([p.B13 of Feb.5-6 print edition](#)).

There is no sign that financial sector executives making decisions at our largest banks – and supposedly acting in the interests of shareholders – are at all interested in being compensated in a more responsible fashion that would better protect shareholder value. They want to get the cash out at every opportunity. Boards of directors comply; the breakdown in corporate governance in this respect is complete.

The only fools here are the shareholders – and the rest of society that buys into such a foolhardy scheme.

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.

Richard Posner Is My New Hero

The Baseline Scenario » 2011 » February

2/11/11 at 6:30 AM

James Kwak

By James Kwak

Yes, I have said some critical things about Posner in the past, usually about his penchant for abstract theoretical arguments that presume perfectly functioning markets. But I'm happy to say we can make common cause on an issue of much greater importance: the *Bluebook*.

The *Bluebook* is the 511-page “uniform system of citation” that is prescribed by — well, actually, by the editors of the main student law reviews at Columbia, Harvard, Penn, and Yale — and enforced by the student editors of law reviews (almost) everywhere. But it is not enforced by the courts, whose citation systems vary from jurisdiction to jurisdiction and are not effectively enforced by anyone, anyway. Posner calls it “a monstrous growth, remote from the functional need for legal citation forms, that serves obscure needs of the legal culture and its student subculture.”[1]

There are many charges one can level at the *Bluebook*, and Posner touches on some of them, but he only scratches the surface. (Which he acknowledges, having written an earlier critique of the *Bluebook* twenty-five years ago.[2]) Lawyers and law students will be familiar with everything below,

and can surely add their own criticisms.

The first, and most obvious, is that it's full of silliness. A few examples:

- Books are cited in large and small capitals (which I can't reproduce here, so I'll just do all caps): SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 188 (2010). (That's page 188, by the way, with no comma.) Journal articles, however, are cited with the author in plain text, the article title in italics and the journal title in large and small capitals: Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 457 (2004). (That means the article begins on page 451, and the citation is to page 457, after the comma.) Administrative documents like SEC releases are done in ordinary type, but regular reports of those same agencies should be in large and small capitals. Huh? (In most citation systems, article titles are in quotes, both book and journal titles are in italics, and you never use large and small capitals.)
- In abbreviations where each element is a single letter, you do not put spaces between the letters; but if one element has more than one letter, you do put spaces around it. So: S.D.N.Y. (Southern District of New York); but D. Mass. (District of Massachusetts) *But*, if one of the abbreviations "refers to the name of an institutional entity," it gets padding to separate it from other elements, as in N.Y.U. L. REV. *But but*, if the element is the abbreviation of an ordinal number, don't pad it, as in F.3d (third series of F., whatever that is).

I could go on and on, but I would just lose readers, and really this isn't that important, except for the thousands of hours of lost productivity the rules create.

More importantly, the *Bluebook* reinforces class distinctions. By making legal citations impossible for lay people to read, it serves the same function as the Vulgate Bible did. The most obvious example, which Posner ridicules, is the practice of abbreviating source titles to the point of indecipherability. Here's Posner:

"An example that I have picked literally at random is 'C.Ag.' What does 'C.Ag.' stand for? Why, of course, the *Código de Águas* of Brazil. Now suppose one had occasion to cite the *Código de Águas*. Why would one want to abbreviate it? The abbreviation would be meaningless to someone who was not a Brazilian lawyer, and perhaps to Brazilian lawyers as well (but do they abbreviate *Código de Águas* "C.Ag"?)."[3]

Posner continues:

"Consider 'Temp. Envtl. L. & Tech. J.,' 'ILSA J. Int'l & Comp. L.,' 'Emp. Rts. & Emp. Pol'y J.,' and 'AIPLA Q.J.' These are names of journals. Now try figuring out 'B.T.A.M. (P-H),' 'A. Ct. Crim. App.,' 'A.F. Ct. Crim. App.,' 'C.G. Ct. Crim. App.,' 'N-M Ct. Crim. App.,' 'Ne. Reg'l Parole Comm'n,' and 'Cent. Ill. Pub. Serv. Co.'"

"What is the point? It's as if there were a heavy tax on letters, making it costly to write out

When I make this point, I say that the core principle of the *Bluebook* seems to date from a time when carbon paper was expensive, or perhaps when type was set by hand. The real cost today, when marginal bits are free, is that another academic, say a sociologist, might not be able to even figure out what journal to go to to follow a citation, defeating the most important function of citations.

Posner lays into the abbreviations, but he supports the most general secret code in the *Bluebook*: putting the volume number before the title. So, in “372 U.S. 335, 344 (1963),” that’s Volume 372 of the U.S. Reports (Supreme Court cases); 335 is the page the opinion starts on; and 344 is the page that is cited. Well, you might say, that’s just for cases and law reviews; it’s been done with cases for so long that it probably can’t be changed. But what is this? 3 THE LETTERS OF VIRGINIA WOOLF, 1923-1928, at 224. That’s page 224 of the third volume of Virginia Woolf’s collected letters, which covers the years 1923 to 1928, of course.

In sum, vast swathes of the *Bluebook* serve the purpose of shutting out lay readers — even those just one wing over in the ivory tower — which undermines a major purpose of citations.

Besides formatting citations in gibberish, the *Bluebook* makes readers’ lives harder in another way: by fetishizing the printed page. The general rule is that if something was published in print and on the Internet, you should cite to the printed version. So if an article appeared in the *The Scranton Times Tribune* and on its website, thetimes-tribune.com, you are *not allowed* to just cite the web version with a URL. Instead, some poor law review editor has to track down a physical copy of the newspaper, or a microfiche, find the page number, and put that page number in the citation. (I know one of those editors; otherwise I would never have known about this rule.) Now, which is better for the reader: the page number or the URL? You decide.

Well, one defense of the *Bluebook* is that it is comprehensive and uniform: it tells you exactly how to cite everything. But it doesn’t even do that well. For example, if a periodical has consecutive pagination within each volume (that is, the first page number of issue $n+1$ is one greater than the last page number of issue n , except that you start over at 1 once a year), you do it this way: 120 YALE L.J. 850 (2011), with no reference to the issue within the volume (Rule 16.3)[5]. If it doesn’t have consecutive pagination, you do it this way: FEDERAL RESERVE BULLETIN, February 2009, at A16-17 (Rule 16.4). But the *Bluebook* doesn’t say what to do if the periodical has issue numbers but no dates within a year, like [this](#). [6]

Or how about this. On page 188 of *13 Bankers*, we cited a statement that Michael Lewis made in a lecture to the Hudson Union Society, which I transcribed from a FORA.tv video, which was embedded in a Huffington Post news story. How do you cite that?

So what is the justification of this nonsense? Standardization, supposedly. Precision. One person at

Yale said I was all wrong because I didn't realize that legal scholarship required a higher degree of precision than other disciplines, pointing out that legal citations are generally to specific pages. Well, I wrote a dissertation back in the 1990s that had 834 footnotes, the vast majority to specific pages, which I indicated with a nice, helpful letter "p".

Furthermore, if standardization is so important, why doesn't the the legal system as a whole collapse? Different jurisdictions use different rules. Some differences are silly. For example, in the *Bluebook* you have to underline the period at the end of "Id."; in Massachusetts courts you have to *not* underline it ("Id."). Even more crazy, however, in law review format, the *Bluebook* says you have to italicize the period at the end of "*Id.*" Here it is without italics: "*Id.*" Me neither. (I do have a friend who can see the difference, at least in Microsoft Word; another friend suggests looking at documents in New Baskerville, where periods are square.)

Some differences are more significant. For example, in the *Bluebook* you are supposed to use national reporters for state cases, so *Kerrigan v. Commissioner of Public Health* would be 957 A.2d 407 (that's volume 957 of the second series of Atlantic reports, page 407). But in all the states I've done work in you are supposed to cite to state reporters, so the same case would be 289 Conn. 135. Yet, despite this chaos, the world doesn't end. (And, as Posner points out, the federal courts have no uniform system of citation, the Seventh Circuit, on which he sits, has no citation system,[7] and he created his own two-page system for his clerks to use.[8])

But more importantly, somewhere the baby got tossed with the bathwater. The most important purpose of citations is to tell readers what your sources are and allow them to go and look at your sources if they like. In law, I am confident that we spend more time on our citations than anyone else, yet our citations are harder to follow than anyone else's. We are sinking untold hours into citation formatting that, taken as a whole, is worse than useless — it destroys value by reducing the informational content of the footnotes.

Posner concludes with an argument that the *Bluebook* exists because lawyers want to demonstrate that they have rigorous methods; but because their core method, legal reasoning, "is uncomfortably close to careful reading, to rhetoric, and to common sense," the profession has instead sought rigor in citation formatting.[9]

Here I think Posner is being too elegant. I think the answer is simpler. Lawyers are a cult, citations are our rites, and the *Bluebook* is, not our Bible, but our prayer manual. It is a tradition in the true sense of that word: something we do because we have done it for as long as we can remember, and not for any other reason (even though people come up with justifications for it all the time). And traditions perpetuate themselves. I use the *Bluebook* format (as well as I can, that is) when I want to communicate with other people in the cult because, once the rites exist, it's individually rational for me to follow them. It's individually rational for law reviews to follow them as well. And so the system perpetuates itself year after year.

[1] Richard A. Posner, *The Bluebook Blues*, 120 YALE L.J. 850, 851 (2011). This is a *Bluebook*

citation, and a relatively simple one, except that I can't do "Yale" in large and small capitals as required. What does it mean? Even if you can figure out that "YALE L.J." means "Yale Law Journal," what do you think 120, 850, and 851 mean? Since this is a blog, though, I will kindly provide you a [hyperlink to the article](#).

[2] Richard A. Posner, *Goodbye to the Bluebook*, 53 U. CHI. L. REV. 1343 (1986).

[3] Posner, *supra* note 1, at 853.

[4] *Id.* Can you see that the period after "Id" is italicized? Well, it is, because the *Bluebook* says it must be so.

[5] I only have the Eighteenth Edition, so it may be in a different place in the Nineteenth Edition.

[6] I expect some law review editor out there will say that there is a rule in there, somewhere, for this situation. But I'm not the slowest person in law school out there, and I pored over the rules for a while before giving up, and as we say in software, at some point it's the system's fault, not the user's.

[7] Posner, *supra* note 1, at 859 ("My court does not have a citation form book, and the publishers of judicial opinions do not impose a citation style on our opinions. That means that the court reports published by West do not have a uniform citation style—and no one notices or objects.").

[8] *Id.* at 858. Although I think Posner is being too cute by referring to his two-page guide, because it is really just a list of changes from the *Bluebook* standard: either his own personal rules or issues where he is more flexible.

[9] *Id.* at 860-61.

\$1.30 > \$1.00

The Baseline Scenario » 2011 » February 2/11/11 at 2:41 PM James Kwak

By James Kwak

[Bruce Bartlett](#) (hat tip [Catherine Rampell](#)) reproduces a table from a paper by Suzanne Mettler showing that most people don't realize that they are beneficiaries of government social programs. For example, 60 percent of people who take the mortgage interest deduction say they "have not used a government social program." Now, while the mortgage interest deduction is a subsidy designed to enable people buy houses, you could get into an argument about whether it's really a

“social program.” But these are the analogous figures for some more classic welfare programs:

- Social Security retirement and survivors’ benefits: 44%
- Unemployment insurance: 43%
- Medicare: 40%
- Social Security Disability Insurance: 29%
- Medicaid: 28%
- Food stamps: 25%

Obvious it’s easy for people to support lower taxes and lower government spending when they don’t realize they are beneficiaries of that spending. (And the numbers on a per-program basis would certainly be higher. For example, it’s likely that of people who take the mortgage interest deduction, many more than 60 percent don’t think that it’s a government social program; the number is only 60 percent because some of those people realize that other things they receive, like Medicare, are government social programs.)

But there’s another number in Bartlett’s post that I think is more interesting. That’s an estimate by the [Tax Foundation](#) that, in 2004, the average middle-quintile household received \$16,781 in benefits from the federal government. That same study says that, on average, middle-quintile households get back \$1.30 in transfer payments and other government spending for every \$1 that they pay in taxes. I didn’t review the study in detail, but this is just common sense, anyway. When you have a progressive tax system and an income distribution with a much longer tail at the high end, you would expect people in the middle to be net beneficiaries of government.

I don’t really think that the point of democracy is for people to simply vote their self-interest. That could lead to all sorts of things, like the tyranny of the majority that Tocqueville warned about. But right now, it would be a distinct improvement if people would vote their self-interest.

Bad Data

The Baseline Scenario » 2011 » February 2/13/11 at 7:38 PM James Kwak

By James Kwak

To make a vast generalization, we live in a society where quantitative data are becoming more and more important. Some of this is because of the vast increase in the availability of data, which is itself largely due to computers. Some is because of the vast increase in the capacity to process data, which is also largely due to computers. Think about Hans Rosling’s [TED Talks](#), or the rise of sabermetrics (the “Moneyball” phenomenon) not only in baseball but in many other sports, or the importance of standardized testing scores in K-12 education, or Karl Rove’s usage of data mining

to identify likely supporters, or the [FiveThirtyEight](#) revolution in electoral forecasting, or the quantification of the financial markets, or zillions of other examples. I believe one of my professors has written [a book](#) about this phenomenon.

But this comes with a problem. The problem is that we do not currently collect and scrub good enough data to support this recent fascination with numbers, and on top of that our brains are not wired to understand data. And if you have a lot riding on bad data that is poorly understood, then people will distort the data or find other ways to game the system to their advantage.

Readers of this blog will all be familiar with the phenomenon of rating subprime mortgage-backed securities and their structured offspring using data exclusively from a period of rising house prices — because those were the only data that were available. But the same issue crops up in many different stories covering different aspects of society.

CompStat, an approach to policing that focuses on tracking detailed crime metrics, was widely credited with helping New York and other cities reduce crime in the 1990s. Last year, [This American Life](#) ran a story, based on a police officer's secret recordings, detailing how in at least one precinct officers were pressured to boost their numbers through dubious arrests and citations. They also found another precinct where serious crimes were reported as less serious crimes in order to make their numbers look better than they really were.

In a recent New York Times story, [David Segal](#) describes how law schools massage their metrics to score higher in the US News and World Report rankings. Segal focuses on the tricks that some schools seem to use to boost the number of graduates employed nine months after graduation; for example, some schools apparently hire their own graduates to temporary positions that happen to span the date on which employment rates are measured. The rankings are based on statistics that are defined by the American Bar Association but are self-reported by the schools and not audited by anyone.

The big, well-known example of how the importance of data breeds data manipulation is standardized testing. In the early days of the standardized testing boom, the key statistic was the percentage of students at or above grade level, defined as the fiftieth percentile on some standardized test. (For those wondering if this is circular, the scaled score required to be at the fiftieth percentile is set *before* the test based on the attributes of the questions included in the test; it is not set *after* the test based on students' actual performances.) So one obvious tactic would be to focus on students in roughly the thirtieth to sixtieth percentiles while ignoring the others. Another, more problematic tactic would be to classify as many low-performing students as possible into special education so that they would not be in the denominator. (Then there is blatant cheating, like giving your students more time to take the test or simply correcting their answers afterward — *Freakonomics* has a chapter on this — since few if any school districts have the capacity or the motivation to oversee the tests rigorously.) Even leaving aside data manipulation issues, there is also the basic problem that test difficulty varies from year to year. The test in year $N + 1$ is calibrated to be the same difficulty as the test in year N , but this is all based on statistics, and there

is this thing called random variation to deal with.

And I recently read Natalie Obiko Pearson's story in [Bloomberg](#) on the problems with greenhouse gas emissions data. Most of the numbers we read are self-reported by countries and the companies in those countries, and even if they are honest (a big if) they are "bottom up" estimates — based on how much fossil fuel is being consumed. But when scientists actually measure changes in greenhouse gases in the atmosphere, they get different results than predicted by the bottom-up estimates. And in all the examples cited in Bloomberg, actual atmospheric measurements are higher than bottom-up estimates. This could be because the article didn't mention atmospheric measurements that were lower than predicted by official data. But it could also be because both the companies burning the fossil fuels and the countries aggregating the data have the same incentive to underreport: companies because it means they don't have to buy as many carbon permits and countries because it means they can claim to be under their Kyoto Protocol targets.

Greenhouse gases are a good example of how we think data will help save us — if we can track how much carbon dioxide each company is producing, we can make it pay for that carbon — but we may just not have good enough data. In general, I think the current trend toward using more and more data is a good thing. I mean, what's the alternative: gut intuition? But this only increases the importance of having good data to begin with. And when some parties benefit from bad data, this can be a big challenge with no easy solution.

Misleading "Research" From The Chamber Of Commerce

The Baseline Scenario » 2011 » February 2/14/11 at 1:49 PM Simon Johnson

By Simon Johnson

On behalf of key financial sector players, Keybridge Research has [just published a report](#) that claims the Dodd-Frank reforms for over the counter derivatives market "could cost 130,000" jobs. My MIT colleague, John Parsons, deftly [takes this apart on his blog today](#) — pointing out that the technical basis of this report is very weak (or nonexistent).

John is an expert on these issues and spends a great of time with nonfinancial companies that use derivatives in a sensible and responsible manner. His critique should carry weight — including with the relevant congressional hearings scheduled for this week.

But I would go further.

This is the "end-users coalition" at work again — a notorious lobby group for the derivatives industry

that had great negative impact on the reform process in the past 18 months. And it is backed in this instance, apparently, by the full might of the Chamber of Commerce and its “Center for Capital Markets.”

The Keybridge document itself is pure lobbying masquerading as research. We know that financial sector players like to have as little capital at possible in all aspects of their business – a reckless degree of leverage is how they boost their return on equity (as [Anat Admati is explaining to anyone who will listen](#)). The Keybridge survey seems to have been structured to elicit responses that are pro-leverage.

The central issue here is system stability. Dodd-Frank is not perfect but that legislation – and Gary Gensler at the CFTC – have been arguing for sensible leverage-reducing restrictions.

If Congress now presses the regulators to defer to the industry lobby, that would be reckless and foolish. To do so on the basis of Keybridge’s “research” would be completely misleading.

This is not any kind of research. This is people who want to overleverage and risk the system – because, once again, they will get the upside and taxpayers/all citizens get the downside.

Derivatives Industry Report Collapses

The Baseline Scenario » 2011 » February 2/15/11 at 4:59 AM Simon Johnson

By Simon Johnson

The credibility of a major report commissioned by the “Derivative End Users Coalition” – run by big banks against implementing the Dodd-Frank reforms – just collapsed.

As [Andrew Ross Sorkin reports](#) in the New York Times, the report has no meaningful substance – it is destroyed by the critique of Joe Stiglitz – and the consulting company (Keybridge Research) behind the report sought misleading credibility through falsely claiming affiliations with substantive academics.

At the end of Sorkin’s article is a remarkable admission by Mr. Wescott, the **president** of Keybridge, conceding these facts.

“When I told Mr. Wescott of Keybridge about Mr. Stiglitz’s comments, he replied that ‘the client had asked us’ to put the report together. ‘It was a hypothetical study.’”

Mr. Wescott admits that it is a bogus study (“hypothetical”) that was “asked” for - and in exchange

for a fee they delivered what was asked for, i.e., a report that has no basis in fact or credibility. (See also [my points about the report's lack of substance](#) from yesterday.)

This is lobbying for favor on the basis of misrepresenting what is in the public's interest.

Nowhere in this Keybridge "study" or the Chamber's press release or in any materials put out by the Coalition of Derivative End Users was any of this disclosed.

The industry is making completely baseless claims – and must resort to this kind of hollow chicanery. This report is revealed as nothing other than a deliberate attempt to mislead the public and to fool people on Capitol Hill.

No No No! It's Already Priced In!

The Baseline Scenario » 2011 » February 2/16/11 at 11:55 AM James Kwak

By James Kwak

That was undoubtedly the response of theoretical law and economics devotees to the premature retirement of [Kansas City Royals pitcher Gil Meche](#) a few weeks ago, which we discussed in one of my classes last week. Meche signed a five-year, \$55 million, guaranteed contract before the 2007 season, which would have paid him \$12 million in 2011 simply for showing up, despite a broken-down shoulder that made him an ineffective pitcher. Yet Meche decided to retire, giving up the \$12 million. Meche said this:

“Once I started to realize I wasn’t earning my money, I felt bad. I was making a crazy amount of money for not even pitching. Honestly, I didn’t feel like I deserved it. I didn’t want to have those feelings again.”

One of the topics of the class was non-economic preferences, particularly preferences for fairness, which have been a staple of psychology and behavioral economics over the past decade. Classical theory says that Meche should have kept the \$12 million for two reasons. The obvious reason is that \$12 million is more than zero, and almost certainly more than the disutility of having to show up to work for another eight months. (Although maybe his marginal utility of money is very low at this point, after four years of his big contract.)

The slightly less obvious reason, which is drilled into law students' heads in the first semester, is that the risk of career-debilitating injury is already priced into the contract. On this theory, parties are free to bargain for whatever contract terms they wish. In Major League Baseball, the standard for free agent contracts is that they are guaranteed, meaning that they cannot be terminated due to

injury (and, I believe, only for cause, where cause includes things like going to jail or getting injured in specifically prohibited activities like dirt-bike racing). So, the argument goes, baseball players chose to bargain for contract guarantees, and in return they are getting less of something else that they want — presumably less money. Put another way, the risk of injury is already priced into the contract. If a player goes through his contract without injury, and remains productive, the team is not going to pay him more money simply because of that. (The player will get more money eventually, either by renegotiating partway through or by getting a bigger contract at the end of the current one, but presumably that's priced in as well.)

This all may be right. More importantly, it provides a powerful justification for taking the money. It's hard to stand up and say, "I'm taking the \$12 million because it's in my contract, and I want it, and it's legally mine." It's a lot easier to say, "Teams and players are free to contract however they want, and I accepted less money each year because I got a guarantee, so the \$12 million is not only legally but morally mine — it's just like the payout on an insurance contract, where the reductions in my salary each year were the premiums and the \$12 million is the payout."

So maybe Meche should have taken the money. But at the same time, theoretical law and economics doesn't dictate our societal norms, at least not yet. As he said, "It's just me getting back to a point in my life where I'm comfortable. Making that amount of money from a team that's already given me over \$40 million for my life and for my kids, it just wasn't the right thing to do." It sounds like he just decided he was happier without the \$12 million than he would have been with it.

Card dealers, on the other hand, would have kept the money, as discussed in a paper by [John List](#). The main point of List's paper is that people may show preferences for fairness in lab experiments, but those same people — in this case, card dealers — will revert to pure economic self-interest in real-world transactions. By contrast, other studies have shown evidence of real-world preferences for fairness, for example in George Akerlof's study of [cash posters](#). I find it not particularly surprising that card dealers do not show preferences for fairness in the real world. Their business is predicated on making money through zero-sum transactions: paying less than something is worth and selling it for more than it is worth. Kind of like Wall Street traders.

Branching Out

The Baseline Scenario » 2011 » February 2/17/11 at 2:36 PM James Kwak

By James Kwak

Tomorrow I'll be writing the February 18 post for [the3six5](#), a collective diary written by 365 different people, mostly creative/artistic/media types (which I am not, in case you hadn't noticed). The post should be a diary entry for that day — so, not an analysis of the Treasury's proposal for Fannie and

Freddie, for example. But if you have any suggestions feel free to let me know.

Is Economics the Problem?

The Baseline Scenario » 2011 » February 2/18/11 at 8:00 AM James Kwak

By James Kwak

For a class, I recently read "[The Psychological Consequences of Money](#)," a 2006 article in *Science* by Kathleen Vohs, Nicole Mead, and Miranda Goode. It describes nine experiments testing how reminding people of money leads them to behave differently — in ways that we should not be proud of. You may have heard of these experiments.

In Experiment 5, participants first played Monopoly, after which the game was cleared except for a large or a small amount of play money; then they were asked to imagine a future with abundant finances or with strained finances (there was also a control group); then someone walked into the room and dropped a box full of pencils. People who saw more money and imagined having a lot of money picked up fewer pencils. In Experiment 7, participants saw a screensaver with currency symbols floating underwater or fish swimming underwater; then they were asked to move two chairs together for a conversation with another person. People who saw the currency symbols placed the chairs further apart than people who saw fish.

The conclusion is that simply thinking about money — even unconsciously — makes people more self-sufficient, more socially insensitive, and less cooperative.

Now, this caught my attention because (a) I often think about money, and large sums of money (it's kind of unavoidable when you write about the financial crisis or the national debt) and (b) I tend toward being self-sufficient and not especially given to cooperation. I'm the kind of person who, in school, prefers to do assignments by myself, not so I can stand out, but simply because I find it more efficient to avoid interaction costs. I try to overcome this by being generally helpful to others, but if there's something I have to do, I often prefer to do it alone.

It also struck a chord with something I've written about before: my suspicion that studying a [little bit of economics](#) makes you more self-interested and less interested in fairness. Robert Frank, Thomas Gilovich, and Dennis Regan wrote [two papers](#) on this back in the 1990s that most of the professional economists out there already know. In one of their experiments, they asked undergraduates at the beginning and end of the semester several questions such as whether or not they would return \$100 lost by a stranger at the end of the semester. They found that the proportion of students who gave more dishonest answers at the end of the semester than at the beginning was highest for students who took introductory micro from the mainstream economist,

lower for students who took introductory micro from the developmental economist, and lowest for students who took introductory astronomy.

If there's an effect here, I don't think the mechanism is that economics makes you a bad person. Instead, it changes your expectations about what the rest of the world is like. If you are an altruistic person and someone teaches you that (a) most people are self-interested and (b) the world would be better if everyone behaved in a self-interested way, that is likely to make you behave in a less altruistic way.

But back to the original study: Money in general and large amounts of money in particular have become more accepted parts of general American culture than they were when I was a child. It seems quite plausible that this is also changing the way that Americans behave and making the ideology of individual autonomy even stronger than it already was. Which I don't think is such a good thing.

February 18, 2011

The Baseline Scenario » 2011 » February 2/19/11 at 11:27 AM James Kwak

By James Kwak

Thank you for all the suggestions about my post on [the3six5](#). I decided to write about my favorite topic: my daughter. But at the suggestion of several people, here's another one (also limited to 365 words and in diary style).

Today I spent another two hours in the car, mostly on Interstate 91.

The section between Amherst and Hartford is the stretch of highway I know best in all the world. For six years I went to the Hartford airport every week or two for business. For three years I've been driving to New Haven for school. And I recently accepted a job in Hartford.

The thing that makes it at all tolerable is the radio — more specifically, the podcasts I play from my phone. My favorite, loyal readers know, is This American Life, followed by RadioLab, Planet Money, Fresh Air, and TED Talks. (When I'm too tired for anything even remotely intellectual, I listen to [embarrassing music](#) on Pandora.)

Most of those shows come from NPR or its affiliates. The [spending cuts](#) just passed by House Republicans eliminate funding for the Corporation for Public Broadcasting, which according

to [Wikipedia](#) provides about 17 percent of all funding for public broadcasting stations.

One might ask: public radio is nice, but can we afford it? The obvious response is that the CPB budget, like all the spending cuts, is peanuts: a few hundred million dollars, when Republicans and Democrats just agreed to cut taxes by \$900 billion over two years.

More substantively, though, the question is whether public broadcasting provides something that the free market can't. If you take free markets and incentives seriously, you have to recognize that (a) interest groups will try to buy the media and (b) the media will be bought. We could argue about whether media organizations can make more money by preserving their reputations for integrity, but recent experience dictates the opposite: just look at Fox News and [whatever outlet conservatives like to complain about]. The point of public broadcasting is to support media outlets that are more resistant to being bought, and to provide that support through a bipartisan process. It may not work perfectly, but it's not a service that the free market would provide. Without public broadcasting, we'll be a little bit closer to the world of *Citizens United*, where everything is for sale. And that will make our current political problems that much harder to solve.

Update: Various podcasts recommended by various people, in comments or in emails to me:

- Bob Edwards
- Martini Shot
- The Breakdown (by The Nation)
- KCRW's Left, Right & Center
- The New Yorker: The Political Scene
- In Our Time (BBC)
- Thinking Allowed (BBC)

Conventional Meaninglessness

The Baseline Scenario » 2011 » February 2/22/11 at 10:14 PM James Kwak

By James Kwak

David Brooks may be a wonderful person, but I don't like his columns (and I didn't like *Bobos in Paradise*, either). It's hard to put my finger on why, but he helped me out with [yesterday's column](#). For one thing, he has this annoying habit of trying to claim the reasonable center, often by making false equivalences between the two things he is trying to sound more reasonable than. So, for example:

| "No place is hotter than Wisconsin. The leaders there have done everything possible to

maximize conflict. Gov. Scott Walker, a Republican, demanded cuts only from people in the other party. The public sector unions and their allies immediately flew into a rage, comparing Walker to Hitler, Mussolini and Mubarak.”

Comparing the other side to Hitler is bad.* Pushing for legislation that hurts the other side is something else. In the abstract, that legislation may be justified; Walker did just win an election, after all. But it's a completely different category from making stupid signs to hold at rallies, and it's a classic David Brooks false equivalence.

But that's just a minor peeve. It's when Brooks adopts his pseudo-reasoned “everybody knows” tone that I get really mad.

“Everybody now seems to agree that Governor Walker was right to ask state workers to pay more for their benefits. Even if he gets everything he asks for, Wisconsin state workers would still be contributing less to their benefits than the average state worker nationwide and would be contributing far, far less than private sector workers.”

Brooks is trying to make you believe that “everyone agrees” that state workers should pay more because they don't contribute enough toward their benefits. This is an important predicate if you want to make the case for slashing public sector benefits. But first of all, by “everyone,” Brooks seems to mean “whoever writes talking points for [Paul Ryan](#),” who said, “State workers who have extremely generous benefits packages, [Walker's] asking that they contribute 12 percent to their health care packages. It's not a lot, it's about half of what private-sector employees pay, and he's getting riots.”

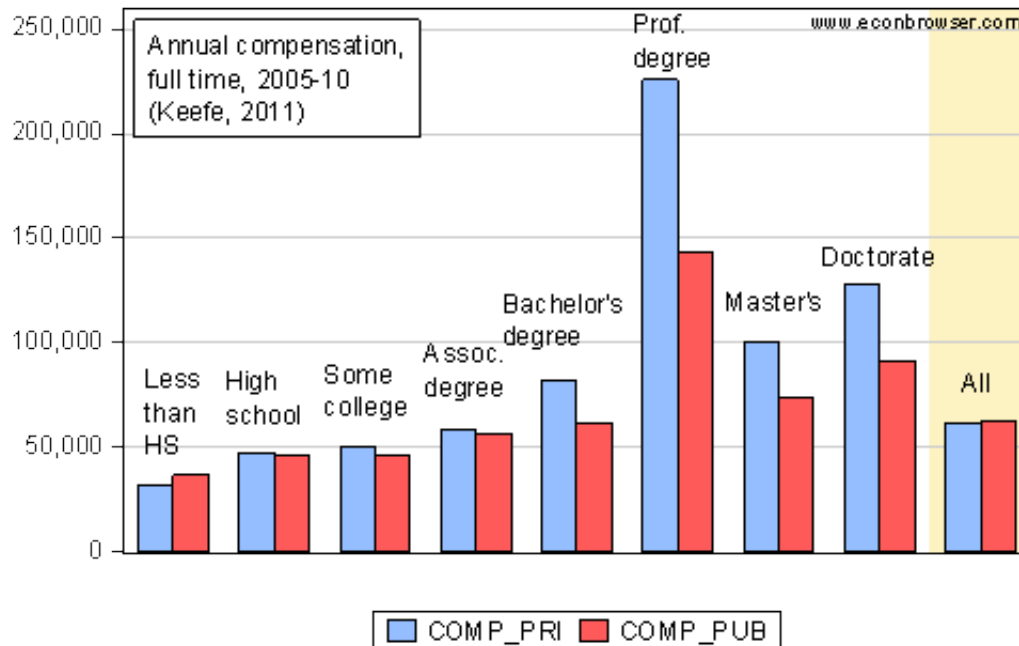
More importantly, though, I have no idea what Brooks's (or Ryan's) claim — that public sector workers pay less for their benefits than private sector workers — could even mean.

How much do you “contribute” to your benefits? Let's say you work in the public sector and have a \$60,000 base salary. You also have a health care plan that is worth \$12,000, of which you contribute \$3,000, so you end up with a post-benefit salary of \$57,000 and a health care plan worth \$12,000 for a total value of \$69,000. Compare that to your sister in the private sector who has an \$80,000 base salary but has to pay half the cost of her equivalent health plan. So she has a post-benefit salary of \$74,000 plus a \$12,000 health care plan for a total value of \$86,000. You “contribute less to your benefits,” but your sister is much better off.

The idea that you can compare the amount that people contribute toward their benefits is based on the assumption that first everyone in the world bargains for salary and *then* everyone in the world bargains separately for benefits. That's nonsense. Insofar as there is any bargaining, there's only one bargaining phase, in which you bargain for both and all you care about is the total value. The amount you nominally “contribute” to your benefits is meaningless, because you also pay for benefits by accepting a lower salary. A lot of the pain over restructuring retirement benefits for unionized manufacturing workers was because their unions had specifically negotiated for those

benefits *instead of* wage increases decades before — and management went along because it wanted to push those costs far into the future.**

So the only meaningful thing to look at when comparing public and private sector workers is total compensation. By educational level, this is what that comparison looks like:



The chart is from [Menzie Chinn](#), based on data from a briefing paper by [Jeffrey Keefe](#).*** At every level except “less than high school,” private sector workers make more than public sector workers. Furthermore, if you control for full-time status, education, years of economic experience, gender, race, citizenship, and organizational size, it turns out that public sector workers make about 5 percent less per hour than private sector workers.

Now, they may be getting something in exchange for taking less money: more job security, less stress, whatever. So I’m not claiming here that they are underpaid. I’m just saying that claims based on the amount that people “contribute” toward their benefits are meaningless. I’m not surprised that politicians like Paul Ryan make those claims. I’m not particularly surprised that David Brooks repeats them, either. I just wish he would stop.

Update: I agree that trying to measure whether public sector workers are overpaid or underpaid is difficult. You can always say that Keefe should have added more controls and would have gotten a different result. But the main nonsense I wanted to focus on is this idea that your nominal contribution to your benefits is a meaningful number at all.

* “‘Scott Walker’ Hitler” returns 400,000 results; “‘Barack Obama’ Hitler” returns 20.3 million results.

** This was before ERISA, which introduced more stringent rules for funding pension plans.

*** In case you're wondering how public sector workers in aggregate can make more than private sector workers, even though private sector workers make more in every educational category except "less than high school," it's because public sector workers in aggregate are more educated than private sector workers.

Does The U.S. Really Have A Fiscal Crisis?

The Baseline Scenario » 2011 » February 2/24/11 at 8:09 AM Simon Johnson

By Simon Johnson

The United States faces some serious medium-term fiscal issues, but by any standard measure it does not face an immediate fiscal crisis. Overindebted countries typically have a hard time financing themselves when the world becomes riskier – yet turmoil in the Middle East is pushing down the interest rates on US government debt. We are still seen as a safe haven.

Yet leading commentators and politicians today repeat the line “we’re broke” and argue there is no alternative other than immediate spending cuts at the national and state level.

Which view is correct? And what does this tell us about where our political system is heading?

Our main fiscal issues are three (see my [testimony to the Senate Budget Committee earlier this month](#)). The most immediate problem is that our largest banks and closely related parts of the financial system blew themselves up in 2007-08. The ensuing recession and associated loss of tax revenue will end up pushing up our government debt, as a percent of GDP, [by around 40 percent](#). Very little of this debt increase was due to the fiscal stimulus; mostly it was caused by lower tax revenue, because of the slump in output and employment.

The financial system poses a major risk to our fiscal outlook over the next few years. Unless you think that the Dodd-Frank reform bill really ended “too big to fail” and the associated excessive risk-taking culture, you should worry a great deal about the boom-bust-bailout-fiscal damage scenario that the Bank of England now refers to routinely as the “doom loop”.

Of the national level politicians now pushing for spending cuts, [almost none showed up to fight to contain the fiscal risks posed by our largest banks](#). The Brown-Kaufman amendment to Dodd-Frank – which would have placed a limit on the size and debt (relative to equity) was supported by 33 Senators, only a handful of whom were Republican.

But, then again, the Obama administration also fought hard against Brown-Kaufman. Treasury Secretary Tim Geithner argues that the TARP bank bailouts will end up costing the tax payer very

little. He is forgetting the broader fiscal damage done by the collapse of the real economy and the loss of 8 million jobs.

Second, we need to control healthcare spending as a percent of GDP. The issue is most definitely not about cutting the current level of such spending or immediately reducing the benefits in Medicare (although if you have ideas for that, send them along). But in the projections, by 2030 or 2040, the growth of healthcare spending ruins us all – whether or not we get the government to pay for it.

During the healthcare debate of 2009-10 there was very little attempt to explain this issue and discuss the options. The administration made a half-hearted move in this direction but backed away as soon as leading Republicans began to claim there were “death panel” proposals on the table.

Third, our [tax system is completely antiquated](#). For the same level of tax revenue relative to GDP, we could greatly reduce the distortions (e.g., disincentives to work) just by modernizing. The right and the left agree we should tax consumption more and income less, but neither is willing to make any kind of meaningful move towards a value added tax (VAT).

The right seems afraid that this tax will be too effective and power an expansion of government. The left thinks a VAT is necessarily regressive (imposing more burden on poorer people), despite all the evidence that the impact of VAT depends on how it is designed – because you can choose what gets zero taxes (e.g., baby clothes) and high taxes (e.g., yachts).

The only room for bipartisan consensus here seems to be what we got in December 2010 – a big tax cut. Cutting taxes is nice, but only if it is consistent with keeping the budget on a sustainable path.

How does the Republican initiative to cut spending fit in with these budget issues? Not very much is the generous answer. Their proposed cuts at the federal level are for discretionary nonmilitary spending, but this is small as a percent of the budget (and therefore of the economy).

But the problem here is bipartisan – [as it was with the tax cut last year](#). None of the leadership on either side is willing to talk openly about how our biggest banks caused great fiscal damage. No one is willing to explain why our healthcare costs continue to rise. And no top politicians currently champion real tax reform.

The Republicans have seized a moment. To them, this is not really about fiscal responsibility; this is about an opportunity to shrink the size of government.

But the Democrats have played perfectly into their hands. The heart of their mistake was the president’s refusal to explain clearly how the financial system produced a recession that has pushed up our national debt.

Both sides of our political elite have contributed to the sense of fiscal crisis. And as we continue down this path – dangerous big banks, out of control health care spending, significant tax cuts, small changes in nonmilitary discretionary spending, and irresponsible rhetoric on both sides – we are well on our way to a real crisis.

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.

Geithner's Gamble

The Baseline Scenario » 2011 » February 2/25/11 at 9:13 PM Simon Johnson

By Simon Johnson. This post comprises the first few paragraphs of a column now running at Project Syndicate: <http://www.project-syndicate.org/commentary/johnson17/English>

In a recent [interview](#), United States Treasury Secretary Tim Geithner laid out his view of the nature of world economic growth and the role of the US financial sector. It is a deeply disturbing vision, one that amounts to a huge, uninformed gamble with the future of the American economy – and that suggests that Geithner remains the senior public official worldwide who is most in thrall to the self-serving ideology of big banks.

Geithner argues that the world will now experience a major “financial deepening,” owing to growing demand in emerging markets for financial products and services. He is thinking, of course, of “middle-income” countries like India, China, and Brazil. And he is right to emphasize that all have made terrific progress and now offer great opportunities for the rising middle class, which wants to accumulate savings, borrow more easily (for productive investment, home purchases, education, etc), and, more generally, smooth out consumption.

But then Geithner takes a leap. He wants US banks to take the lead in these countries’ financial development....([column continues at Project Syndicate](#).)

Disinformation About The Consumer Financial Protection Bureau

The Baseline Scenario » 2011 » February 2/28/11 at 8:33 AM Simon Johnson

By Simon Johnson

In Washington, before lobbyists try hard to destroy something, they first spread a great deal of disinformation about it. Thus the “End Users’ Coalition” (a front for the derivatives dealers) [promotes its lobbying points as fake research](#). And “fiscal conservatives” [attempt to distract from the fact](#) that our largest banks brought us to the brink of budget disaster – this is their preparation for demolishing all vestiges of financial reform.

On a closely related front, there is now a concerted effort to undermine the newly formed Consumer Financial Protection Bureau (CFPB), mostly by spreading disinformation about its supposed lack of accountability.

This disinformation approach contains the standard elements of exaggeration, misdirection, and distraction (all quotes are [via Fred Barnes](#)):

1. Slogans: “If you like TSA at the airport, you’ll love these guys” (Congressman Spencer Bachus).
2. This is a major step towards dictatorship. “Its powers are very, very vast.... Who in the world would consider it appropriate to have one person appointed—one person!—to set the rules for the entire financial industry. It’s a tremendous overreach. It’s incredible to think about” (Senator Bob Corker)
3. And it would be a one-person dictatorship. “”It would be dangerous to the American economy if Elizabeth Warren were put in that job by a recess appointment, thwarting the will of Congress.... [She would be] accountable to no one” (Senator Richard Shelby)

Naturally, none of this is remotely close to the facts – an important principle of disinformation is that it should create an alternative reality which, through repetition by apparently disparate and supposedly credible people, becomes regarded as containing an element of truth.

Elizabeth Warren, the interim head of the new agency, has in fact consulted widely with members of Congress (from both sides), as well as with the industry. There is a great deal of accountability, down to the level of explaining exactly how the agency will be structured and the principles that will guide its operation.

She has also shared with members of Congress the details of key personnel appointments, as well as the responsibilities that various people will have. Legislators have every right to ask tough questions about the details – and this is exactly what they have been doing.

The oversight mechanisms at work here are exactly the same as for existing regulators – the CFPB is largely a consolidation and streamlining of their powers. Of course, we might worry that legislative oversight of regulators in the past helped bring us to the brink of financial and fiscal disaster, but that is another matter (e.g., see *Inside Job*, which just won the Oscar for Best Documentary.)

A particular bone of contention is the role of Elizabeth Warren herself. She is currently Assistant to

the President (i.e., a White House role), as well as a Special Advisor to the Secretary of the CFPB. She is not Director of the CFPB – nor is she currently the nominee for that position.

Some members of Congress are clearly positioning themselves for a bruising confirmation hearing – and sending signals that they will fight hard against any potential appointment of Professor Warren, presumably mostly on procedural grounds.

But everything about her current role, the timing of when and how the agency is established, and the confirmation hearings is exactly as laid down by the Dodd-Frank Act.

And remember that Ms. Warren was, until recently, head of the Congressional Oversight Panel for TARP – in other words, she had a prominent role overseeing part of the executive branch. She understands the need to be scrupulous and careful about process in the current situation. Her appointment calendar is posted on-line. By my count, she has met with more than 50 members of Congress in one-on-one meetings since September.

Elizabeth Warren stands for transparency. After decades of abuse, consumers of financial products deserve prices that are clearly stated up front, risks that are plainly visible, and absolutely nothing buried in the fine print. This kind of transparency allows people to comparison shop in an effective way; it will also spur market competition and encourage the kind of innovation that really benefits consumers. It's time to end the deception that comes packaged with complicated agreements wrapped around hidden fees and all kinds of nasty surprises.

And please remind all members of Congress, regarding their oversight role during 2000-08, that despite everything Countrywide did, including the horrible way it treated consumers and the many apparent deceptions in its practices, Angelo Mozilo walked away a rich man. According to the research of Professors Sanjai Bhagat and Brian Bolton, as CEO between 2000 and 2008, Mr. Mozilo received over \$90 million in salary and bonus and sold Countrywide stock worth over \$500 million. ([You must read the Bhagat and Bolton paper.](#))

Let's have the substantive discussion, in the open — before Congress and elsewhere. Which way do we go next: Elizabeth Warren's way, with transparency for all; or Angelo Mozilo's way, with vast fortunes for a very few people and great misery for many?

This is not about being pro- or anti-market. This is about what kind of market you want: transparent or opaque; honest or based on deceit.

But rather than discussing the merits of the debate – and the real issues at stake – instead we are treating to phony procedural complaints and fake claims regarding how the Constitution is supposedly being undermined.

“No smoke without fire” is the principle that reasonable people often apply to stories they hear. If enough people are talking about an issue in a particular way, there must be some legitimate

grounds for concern.

But, as any former official can tell you, while this presumption may be reliable in everyday life, it plays into the hands of politicians who wish to mislead you.

All the smoke around the CFPB is designed purely for mirrors; there is no merit to any of the accusations. This is the first stage in a careful and orchestrated campaign to undermine and eventually destroy the agency, with the ultimate goal of allowing some irresponsible elements in the financial industry to go back to the disgusting ways of 2000-08.