

*This guest post is contributed by Mark Paul and Anastasia Wilson. Both are members of the class of 2011 at the University of Massachusetts-Amherst.*

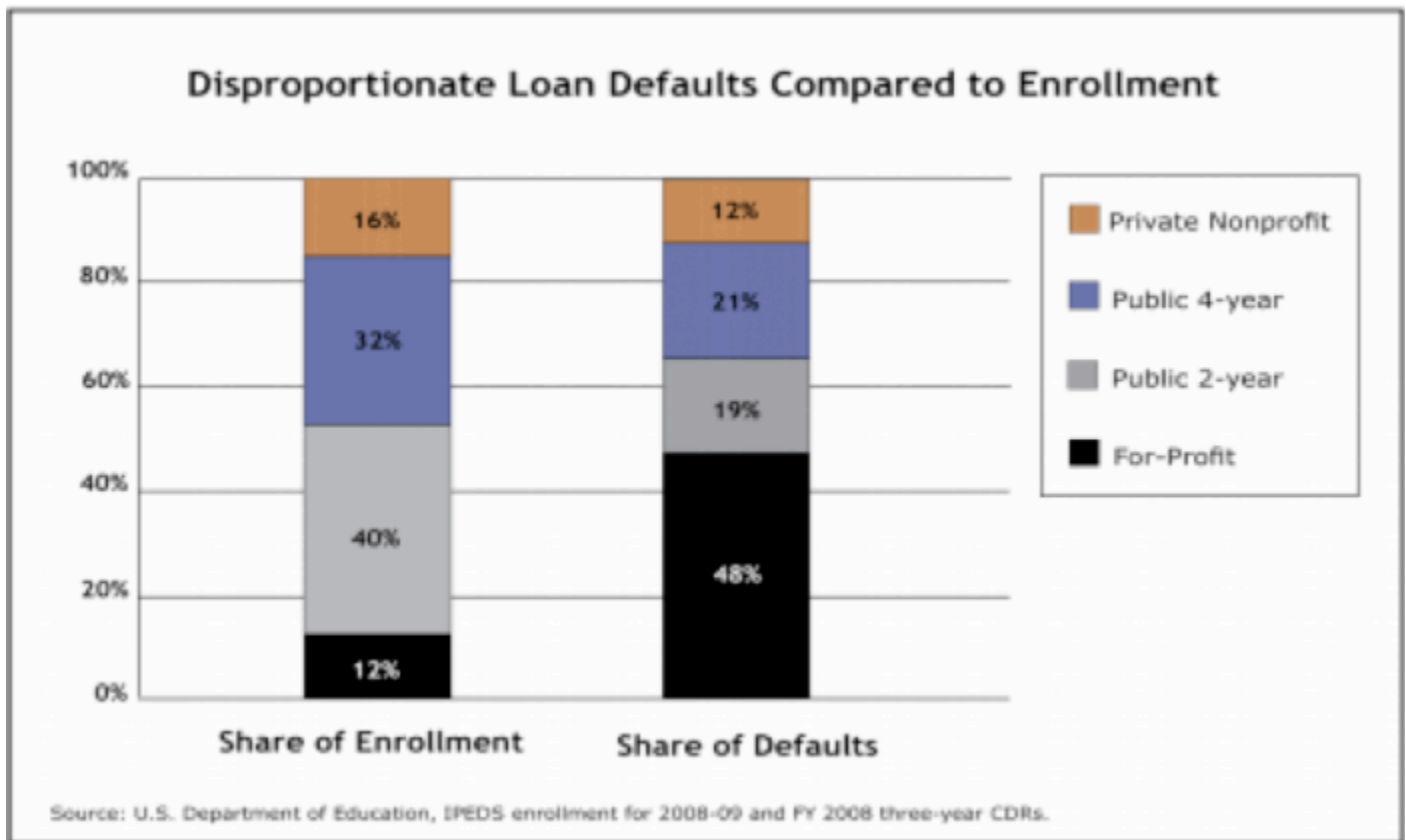
For-profit colleges are expanding enrollments at a rapid pace, but it is questionable whether these revenue-seeking universities give adequate consideration to students' welfare, retention/graduation rates, and overall economic well-being alongside their bottom line profits.

A new post by [Judith Scott-Clayton](#), a professor at Columbia Teachers College and new weekly contributor to the New York Times Economix blog, explores the merits of for-profit colleges, arguing that in many ways these schools are more efficient at seeking funding opportunities for students and adopting new teaching technologies. These schools procure more Federal dollars per student and employ more cost-saving technologies, in the classroom and online, than their non-profit public and private competitors.

However, the real question is not a matter of efficiency, but instead concerns students and the taxpayers funding Federal loans and grants consumed by for-profits. Are the relative merits of profit-oriented schools, including their comparative advantage in securing Federal funding, being used to improve the return on investment for students or for their shareholders? On the macro level, does the growth of for-profit higher education promote new risks in the economy, as drop-out and loan default rates continue to increase?

The relative efficiency or effectiveness of for-profit schools is not necessarily what has been driving record enrollment rates, which were [up 25%](#) just over the past year. The Great Recession has pushed many students and unemployed folk towards higher education, as better credentials often mean better job prospects. With the unemployment rate for those holding a bachelors degree at [4.2%](#), there are incentives to enroll. In fact, [applications](#) and [enrollments](#) for colleges are up across the board, perhaps meaning the overflow from more selective schools is being crowded into the fast-growing for-profit institutions.

Though increased enrollment appears to imply increased opportunity, many students are in higher risk of drop-out and loan default when choosing a for-profit college. The for-profit education sector is in large part to blame for the sharp rise in student loan defaults, accounting for almost half of total defaulters. In the graph below, the [Department of Education](#) has concluded that despite only having 12% of total enrollments, for-profit schools disproportionally account for 48% of total student debt defaults. Since for-profits are so effective in securing Federal loans and grants for their students, this means that the schools are in essence receiving an indirect subsidy from the government and taxpayers, while leaving students in the red.



While an increasing number of students enroll in for-profits and take on large amounts of student debt, they also increase their risk of drop-out. A report published last year by the [Education Trust](#) shows how devastating dropout rates are, with only 22% of students enrolled at for-profit four-year universities graduating within six years, as compared to 55% and 65% at public and private non-profit universities, respectively. Many students enrolling in these institutions are left without credentials and burdened with debt, yet the schools are able to retain their profits made from students' tuition.

The increased prevalence of for-profit universities, with their dangerous combination of drop-out and default, may be aggravating a [looming student debt crisis](#). Overall, the volume of loans in default grew to [\\$50.8 billion](#) in 2009, up 30% from the year before. As more students enroll in risky for-profit schools, these rates are likely to increase, perhaps leading to another consumer debt crisis similar to the foreclosure fiasco.

Although many are well aware of these alarming facts, our elected officials appear to continue favoring the implicit tax dollar handouts to for-profit colleges. The [spending bill](#) recently passed by House Republicans even blocks the Department of Education from enforcing a new rule that could limit for-profit schools' access to Federal money. While arguments can be made that profit-seeking schools give wider access to higher education, it seems that the profit motive and shareholder loyalty are overtaking concerns for the well-being of students and the economy at large. Instead of allowing Federal dollars to support for-profit education, the money ordinarily received by these schools should be used to increase the capacity of public higher education and provide ["finish line" grants](#) to those facing financial struggles in their final year of study.

As the Obama administration seeks to increase enrollment, graduation rates, and investment in higher education, policy makers need to consider redirecting their funding towards students and not into the pockets of shareholders by subsidizing private profits.

## Is The New York Fed Making A Serious Mistake On Bank Dividends?

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The Baseline Scenario » 2011 » March 3/3/11 at 4:05 AM Simon Johnson

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*By Simon Johnson*

An uncomfortable dissonance is beginning to develop within the Federal Reserve. On the one hand, senior current and former officials now generally agree with the propositions put forward by Professor Anat Admati and her distinguished colleagues – our leading banks need more capital, i.e., more equity financing relative to what they borrow.

The language these officials use is vaguer than would be ideal and they refuse to be drawn on the precise numbers they have in mind. The Swiss National Bank, holding out for 19 percent capital, and the Bank of England, pushing for at least 20 percent capital, seem to be further ahead and much more confident intellectually on this issue.

But an important split appears to be emerging within the Federal Reserve system, with the Board of Governors and most regional Feds tending to want higher capital levels from today's levels, while the New York Fed is – incredibly – pushing hard to enable big banks actually to reduce their capital ratios (in the first instance by allowing them to pay increased dividends).

The New York Fed will not go on the record in any detailed way and my attempts to engage constructively with them have proved futile, so it is hard to know if there is any analytical basis whatsoever for their position. They have certainly put up no meaningful counterarguments to the powerful points made by Anat Admati and her colleagues – both [in general](#) and [against allowing U.S. banks to increase their dividends](#) today (see also this [letter to the FT](#)).

The key point is this. Given that the final capital requirements under Basel III remain to be set by the Fed – and top officials say they are still working on this – what's the big rush to pay dividends? Retaining earnings (i.e., not paying dividends) is the easiest way to build capital (i.e., shareholder equity) in the banks. There is strong logic behind not paying dividends until capital is at or above the level needed for the future.

Without any substance on their side, the New York Fed is increasingly creating the perception that it is just doing what its key stakeholders – the big Wall Street banks – want.

Bankers traditionally dominate the board of directors for regional Feds. We can argue about whether this is a problem for most of those organizations, but for the New York Fed the predominance of big Wall Street institutions has become a major source of controversy.

At the bottom of the NY Fed's current board membership webpage, you can review who belonged to the board [every year from 2000 to 2008](#). Note the presence of influential bankers in the past such as Dick Fuld (Lehman), Stephen Friedman (ex-Goldman), and Sandy Weil (Citigroup). Their firm hand helped guide the New York Fed into the crisis of 2007-08.

The Dodd-Frank legislation reduced the power of big banks slightly in this context, so that the president of the New York Fed is [no longer picked by Wall Street's board](#) representatives (unlike Tim Geithner, the previous head and current Treasury Secretary, and Bill Dudley, the current head and former Goldman Sachs executive.) But the [current New York Fed board still includes Jamie Dimon](#), head of JP Morgan Chase, and an out-spoken voice for allowing banks to operate with less capital (by paying out dividends).

In fact, Dimon has [a theory of "excess capital" in banks](#) that is beyond bizarre – arguing banks (or perhaps any firms) with strong equity financing will do “dumb things”. This is completely at odds with reality in the US economy where many fast-growing and ultimately successful companies are financed entirely with equity.

If the New York Fed's top thinkers have convincing reasons for not wanting to increase capital in our largest banks, e.g., because they agree with Dimon, they should come out and discuss this in public (and providing some evidence would be nice). Hiding quietly behind official walls is, at this stage, beyond irresponsible.

If the New York Fed were really pushing for higher dividends at this time, for example by constructing a stress tests to justify this action, it would be setting us up to mismanage credit – allowing the megabanks to misallocate resources during the good times and crash just as badly when the next downturn comes. The top leadership of the New York Fed has a responsibility to engage constructively and openly in the technical debate.

Some Federal Reserve officials act as if they have a constitutional right to run an independent central bank. Fortunately or unfortunately, this is not the case. Congress created the Fed and Congress can amend how the Fed operates.

The legitimacy of the Federal Reserve System rests on its technical competence, its ability to remain above the political fray, and the extent to which it can avoid being captured by special interests.

There is a very real danger that the New York Fed now will fatally undermine the fragile credibility of the rest of the Federal Reserve System.

*An edited and expanded 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.*

*By Simon Johnson. Testimony submitted to the Congressional Oversight Panel, "[Hearing on the TARP's Impact on Financial Stability](#)," Friday, March 4, 2011.*

### **I. Summary**

- 1) The financial crisis is not over, in the sense that its impact persists and even continues to spread. Employment remains more than 5 percent below its pre-crisis peak, millions of homeowners are still underwater on their mortgages, and the negative fiscal consequences – at national, state, and local level – remain profound.
- 2) To the extent that a full evaluation is possible today, the financial crisis produced a pattern of rapid economic decline and slow employment recovery quite unlike any post-war recession – it looks much more like a mini-depression of the kind the US economy used to experience in the 19<sup>th</sup> century. In addition, the fiscal costs of the disaster in our banking system so far amount to roughly a 40 percentage point increase in net federal government debt held by the private sector, i.e., roughly a doubling of outstanding debt.
- 3) In this context, TARP played a significant role preventing the mini-depression from becoming a full-blown Great Depression, primarily by providing capital to financial institutions that were close to insolvency or otherwise under market pressure.
- 4) But part of the cost is to distort further incentives at the heart of Wall Street. Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program put it well in his [latest quarterly report](#), which appeared in late January, emphasizing: "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.'"
- 5) Adjustments to our regulatory framework, including the Dodd-Frank financial reform legislation, have not fixed the core problems that brought us to the brink of complete catastrophe in fall 2008. Powerful people at the heart of our financial system still have the incentive and ability to take on large amounts of reckless risk – through borrowing large amounts relative to their equity. When things go well, a few CEOs and a small number of others get huge upside.
- 6) When things go badly, society, ordinary citizens, and taxpayers get the downside. This is a classic recipe for financial instability.
- 7) Our six largest bank holding companies currently have assets valued at just over 63 percent of GDP (end of Q4, 2010). This is up from around 55% of GDP before the crisis (e.g., 2006) and no more than 17% of GDP in 1995.
- 8) With assets ranging from around \$800 billion to nearly \$2.5 trillion, these bank holding

companies are perceived by the market as “too big to fail,” meaning that they are implicitly backed by the full faith and credit of the US government. They can borrow more cheaply than their competitors and hence become larger.

9) In public statements, top executives in these very large banks discuss their plans for further global expansion – presumably increasing their assets further while continuing to be highly leveraged.

10) There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially raising capital requirements would not be costly from a social point of view (e.g., see [the work of Anat Admati of Stanford University and her colleagues](#)).

11) But the financial sector’s view has prevailed – they argue that raising capital requirements will slow economic growth. This argument is supported by some misleading so-called “research” provided by the Institute for International Finance (a lobby group). The publicly-available analytical work of the official sector on this issue (from the Bank for International Settlements and the New York Fed) is very weak – if this is the basis for policymaking decisions, there is serious trouble ahead.

12) Even more disappointing is the failure of the official sector to engage with its expert critics on the issue of capital requirements. This certainly conveys the impression that the regulatory capture of the past 30 years (as documented, for example, in [13 Bankers](#)) continues today – and may even have become more entrenched.

13) There is an insularity and arrogance to policymakers around capital requirements that is distinctly reminiscent of the Treasury-Fed-Wall Street consensus regarding derivatives in the late 1990s – i.e., officials are so convinced by the arguments of big banks that they dismiss out of hand any attempt to even open a serious debate.

14) Next time, when our largest banks get into trouble, they may be beyond “too big to fail”. As seen recently in Ireland, banks that are very big relative to an economy can become “too big to save” – meaning that while senior creditors may still receive full protection (so far in the Irish case), the fiscal costs overwhelm the government and push it to the brink of default.

15) The fiscal damage to the United States in that scenario would be immense, including through the effect of much higher long term real interest rates. It remains to be seen if the dollar could continue to be the world’s major reserve currency under such circumstances. The loss to our prestige, national security, and ability to influence the world in any positive way would presumably be commensurate.

16) In 2007-08, our largest banks – with the structures they had lobbied for and built – brought us to the verge of disaster. TARP and other government actions helped avert the worst possible outcome, but only by providing unlimited and unconditional implicit guarantees to the core of our financial system. This can only lead to further instability in what the Bank of England refers to as a “[doom loop](#)”.

## II. TARP Compared

1) In the immediate policy response to any major financial crisis – involving a generalized loss of confidence in major lending institutions – there are three main goals:

1. To stabilize the core banking system,
2. To prevent the overall level of spending (aggregate demand) from collapsing,
3. To lay the groundwork for a sustainable recovery.

2) IMF programs are routinely designed with these criteria in mind and are evaluated on the basis of: the depth of the recession and speed of the recovery, relative to the initial shock; the side-effects of the macroeconomic policy response, including inflation; and whether the underlying problems that created the vulnerability to panic are addressed over a 12-24 month horizon.

3) This same analytical framework can be applied to the United States since the inception of the Troubled Asset Relief Program (TARP). While there were unique features to the US experience (as is the case in all countries), the broad pattern of financial and economic collapse, followed by a struggle to recover, is quite familiar.

4) The overall US policy response did well in terms of preventing spending from collapsing. Monetary policy responded quickly and appropriately. After some initial and unfortunate hesitation on the fiscal front, the stimulus of 2009 helped to keep domestic spending relatively buoyant, despite the contraction in credit and large increase in unemployment. It was also consistent with parallel countercyclical fiscal moves in other countries. This was in the face of a massive global financial shock – arguably the largest the world has ever seen – and the consequences, in terms of persistently high unemployment, remain severe. But it could have been much worse.

5) There is no question that passing the TARP was the right thing to do. In some countries, the government has the authority to provide fiscal resources directly to the banking system on a huge scale, but in the United States this requires congressional approval. In other countries, foreign loans can be used to bridge any shortfall in domestic financing for the banking system, but the U.S. is too large to ever contemplate borrowing from the IMF or anyone else.

6) Best practice, vis-à-vis saving the banking system in the face of a generalized panic involves three closely connected pieces (see chapter 2 of [13 Bankers](#) and the references provided there):

1. Preventing banks from collapsing in an uncontrolled manner. This often involves at least temporary blanket guarantees for bank liabilities, backed by credible fiscal resources. The government's balance sheet stands behind the financial system. In the canonical emerging market crises of the 1990s – Korea, Indonesia, and Thailand – where the panic was centered on the private sector and its financing arrangements, this commitment of government resources was necessary (but not sufficient) to stop the panic and begin a recovery.
2. Taking over and implementing orderly resolution for banks that are insolvent. In major system crises, this typically involves government interventions that include revoking banking licenses,

firing top management, bringing in new teams to handle orderly unwinding, and – importantly – downsizing banks and other failing corporate entities that have become too big to manage. In Korea, nearly half of the top 30 pre-crisis chaebol were broken up through various versions of an insolvency process (including Daewoo, one of the biggest groups). In Indonesia, leading banks were stripped from the industrial groups that owned them and substantially restructured. In Thailand, not only were more than 50 secondary banks (“Finance Houses”) closed, but around 1/3 of the leading banks were also put through a tough clean-up and downsizing process managed by the government.

3. Addressing immediately underlying weaknesses in corporate governance that created potential vulnerability to crisis. In Korea, the central issue was the governance of nonfinancial chaebol and their relationship to the state-owned banks; in Indonesia, it was the functioning of family-owned groups, which owned banks directly; and in Thailand it was the close connections between firms, banks, and politicians. Of the three, Korea made the most progress and was rewarded with the fastest economic recovery.

7) If any country pursues (a) unlimited government financial support, while not implementing (b) orderly resolution for troubled large institutions, and refusing to take on (c) serious governance reform, it would be castigated by the United States and come under pressure from the IMF. Providing unlimited implicit guarantees does not help underpin financial stability.

8) At the heart of any banking crisis is a political problem – powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Serious countries do not do this.

9) As Larry Summers put it, in his 2000 Ely Lecture to the American Economic Association, “[I]t is certain that a healthy financial system cannot be built on the expectation of bailouts” (*American Economic Review*, vol. 90, no. 2, p.13).

10) Seen in this context, TARP was badly mismanaged. In its initial implementation, the signals were mixed – particularly as the Bush administration sought to provide support to essentially insolvent banks without taking them over. Standard FDIC-type procedures, which are best practice internationally, were applied to small- and medium-banks, but studiously avoided for large banks. As a result, there was a great deal of confusion in financial markets about what exactly was the Bush/Paulson policy that lay behind various ad hoc deals.

11) The Obama administration, after some initial hesitation, used “stress tests” to signal unconditional support for the largest financial institutions. By determining officially that these firms did not lack capital – on a forward looking basis – the administration effectively communicated that it was pursuing a strategy of “regulatory forbearance” (much as the US did after the Latin American debt crisis of 1982). The existence of TARP, in that context, made the approach credible – but the availability of unconditional loans from the Federal Reserve remains the bedrock of the strategy.

12) The downside scenario in the stress tests was overly optimistic, with regard to credit losses in real estate (residential and commercial), credit cards, auto loans, and in terms of the assumed time

path for unemployment. As a result, our largest banks remain undercapitalized, given the likely trajectory of the US and global economy. This is a serious impediment to a sustained rebound in the real economy – already reflected in continued tight credit for small- and medium-sized business.

13) Even more problematic is the underlying incentive to take excessive risk in the financial sector. With downside limited by government guarantees of various kinds, Andrew Haldane of the Bank of England bluntly characterizes our repeated boom-bailout-bust cycle as a “[doom loop](#).”

14) Exacerbating this issue, TARP funds supported not only troubled banks, but also the executives who ran those institutions into the ground. The banking system had to be saved, but specific banks could have wound down and leading bankers could and should have lost their jobs. Keeping these people and their management systems in place serious trouble for the future.

15) The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are “Too Big to Fail.” This lowers their funding costs, probably by around 50 basis points (0.5 percentage points), enabling them to borrow more and to take more risk with higher leverage.

16) The Obama administration argues that regulatory reforms, including the Dodd-Frank Act and associated new rules, will rein in the financial sector and make it safer. Unfortunately, this assessment is not widely shared.

17) There was an opportunity to cap the size of our largest banks and limit their leverage, relative to the size of the economy. Unfortunately, the Brown-Kaufman to that effect was defeated on the floor of the Senate, 33-61, primarily because it was opposed by the US Treasury. (See <http://baselinescenario.com/2010/05/26/wall-street-ceos-are-nuts/>, which contains this quote from an interview in New York Magazine: “‘If enacted, Brown-Kaufman would have broken up the six biggest banks in America,’ says the senior Treasury official. ‘If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.’”)

18) Regulation remains weak and many regulators are still captured by the ideology that big banks are good for the rest of the economy. Capital requirements will increase but are likely to remain below the level that Lehman had in the days before it failed ([11.6 percent tier one capital](#)). There will be no effective cap on the size of our biggest banks. They have an incentive to take on a great deal of leverage. This confers private benefits but great social costs – lowering economic growth, increasingly volatility, and making severe crises more likely.

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This testimony draws on joint work with Peter Boone, particularly “[The Next Financial Crisis: It’s Coming and We Just Made It Worse](#)” (*The New Republic*, September 8, 2009), and James Kwak, including “[The Quiet Coup](#)” (*The Atlantic*, April, 2009) and [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#).

*By Simon Johnson*

Just when it seemed that the debate over banking was winding down – with overwhelming victories on almost all dimensions for the people who run the world’s largest cross-border financial institutions – two of the biggest name policy heavyweights have entered the arena. Both voices are typically listened to most carefully within official circles and yet their messages today are diametrically opposed.

Which one is right?

Speaking on the side of greater reform for the biggest banks, Mervyn King – governor of the Bank of England – gave a forceful [interview to the British newspaper \*The Telegraph\*](#) at the end of last week.

“Why do banks in general want to pay bonuses? It’s because they live in a ‘too big to fail’ world in which the state will bail them out on the downside.”

In Mr. King’s view, casino-type banking caused the crisis of 2007-08.

“Financial services don’t like the word ‘casino’, but instruments were created and traded only within the financial community. It was a zero sum game. No one knew which ones were winners when the crisis hit. Everyone became a suspect. Hence, no one would provide liquidity to any of those institutions.”

“We allowed a [banking] system to build up which contained the seeds of its own destruction.”

And “reform” efforts so far do not amount to much.

“We’ve not yet solved the ‘too big to fail’ or, as I prefer to call it, the ‘too important to fail’ problem. The concept of being too important to fail should have no place in a market economy.”

Mervyn King is an opinion leader among central bankers and typically a leading indicator of what other officials will be thinking in 6-12 months. He has also been instrumental in pushing the British government towards taking more decisive action against large banks that wish to continue operating with dangerously high levels of leverage (i.e., a lot of debt relative to their equity).

The banking policy debate in the UK remains wide open, with the independent Vickers Commission due to deliver a report in the summer, but the Bank of England is clearly on the side of wanting higher capital requirements – 20 percent is the headline number for tier one capital discussed behind the scenes (in contrast with the Basel III, which looks like to imply no more than 10-11

percent for systemically important financial institutions). The thinking of the Bank's [Andrew Haldane](#) (responsible for financial stability) and [David Miles](#) (member of the Monetary Policy Committee) appears closely aligned with that of [Anat Admati and her numerous top-level finance colleagues](#) (if you haven't looked at their work before, [start with this page](#)).

In the debate so far, only one voice has been raised that rivals Mervyn King in terms of reputation in the international economics policy community — Jacques de Larosière weighed in last week, publishing a high profile [op ed piece in the Financial Times](#) (see also [this news coverage](#)).

De Larosière is the former managing director (MD) of the International Monetary Fund, 1978-87 – and widely regarded as one of the best MDs that the Fund has ever had. His advice is taken seriously at the top level of governments.

But his views last week raised eyebrows because he came out so strongly in favor of Europe's "universal banks".

"With the exception of certain institutions in Switzerland, Germany, the Netherlands and the UK that excessively inflated their trading books, these universal banks have proved resilient through the crisis."

It's not clear why Mr. de Larosière skips entirely the difficult experience of big banks (relative to their economies) recently in Belgium, Ireland, Iceland, and Greece.

He cites the more positive experience in Canada, France, and Italy, but this is also odd – given that the Canadian success with bank regulation is largely a myth ([as Peter Boone and I have explained](#)), and the French banks were very much involved in the shadow banking system (remember that it was problems at BNP Paribas Investment Partners in summer 2007 that really signaled the start of a great financial unraveling; here is [the company's timeline](#) and [their press release at the time](#)). Is Mr. de Larosiere really putting so much weight on the supposed success of Italian banks – with their large exposure to sovereign debt in Eastern Europe, in the Iberian Peninsula, and at home?

In the [authoritative recent assessment of European banks](#) by my colleagues Morris Goldstein and Nicolas Veron, there is no indication that banks in France or Italy were well regulated or better supervised. In fact, the unifying characteristic of the larger European banks is surely that they have become too big to be supervised effectively. If anything, the Goldstein and Veron work suggests that "too big to fail" is even more of a problem in Europe – with its universal banks – than in the United States.

According to Mr. de Larosière, new regulations more broadly and the capital requirements of Basel III specifically will have negative effects on the European economy.

"Given the cost of capital and the race for deposits, they [the banks] will have to increase the price of their lending, making credit more expensive."

This looks very much like a variant on the line that bankers are putting forward (e.g., Bill Isaac, [chairman of Fifth Third Bancorp, in the pages of the Financial Times](#), arguing for an increase in bank

dividends) – positions that have been completely and directly [refuted by Professor Admati and 16 other leading experts](#).

Who will prevail in the minds of officials responsible for financial stability in the US, Europe and elsewhere – King or de Larosière?

At least on the merits of the argument, King wins hands down.

But de Larosière has some powerful people at his back, including in his role as president of Eurofi. Eurofi describes itself as a think-tank but it appears to be more of a lobby organization, funded by [huge global financial institutions](#) (see the logos at the bottom of the page in that link), including Goldman Sachs, JP Morgan Chase, and Morgan Stanley from the American side. (Mr. de Larosière is also [described on Eurofi's website](#) as “the Advisor to the Chairman of BNP Paribas, a position he holds since 1998” – although I understand he actually retired from this position in December 2008.)

Unfortunately, the [latest indications from Europe](#) suggest that the regulators are again caving to pressure from the side of big banks, allowing another round of weak stress tests that will do nothing to ensure there is a safe level of equity funding in the financial system.

*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.*

## How Dumb?

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The Baseline Scenario » 2011 » March    3/11/11 at 10:38 PM    James Kwak

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By James Kwak

In his latest column, “Dumbing Deficits Down,” [Paul Krugman](#) has harsh words for Republican nonsense about the budget deficit:

Today’s Republicans just aren’t into rationality. They claim to care deeply about deficits — but they’ve spent the past two years putting cynical, demagogic attacks on any attempt to actually deal with long-run deficits at the heart of their campaign strategy.

But he’s only slightly less harsh toward President Obama:

The president and his aides know that the G.O.P. approach to the budget is wrongheaded and destructive. But they’ve stopped making the case for an alternative approach; instead, they’ve positioned themselves as know-nothings lite, accepting the notion that spending must be slashed immediately — just not as much as Republicans want. . . .

the White House is aiding and abetting the dumbing down of our deficit debate.

In this context, this concluding passage from the book I just read seems appropriate:

U.S. political leaders now seem determined to follow Nero's reputed example when setting budget policy. They dicker with trivial deficit reduction packages, and then on a regular basis stoke the fire by passing much larger tax cuts, while the long-term budget picture keeps getting worse. They know what is happening, as do the voters.

That's from *Taxes, Spending, and the U.S. Government's March Toward Bankruptcy* by Daniel Shaviro, a tax professor at NYU's law school (and [blogger](#)). Despite the apocalyptic title, the book is less about actual fiscal policy and more about the language we use to debate fiscal policy — and how that language is notoriously unhelpful, except perhaps for ideologues. For example, eliminating the mortgage interest tax deduction would increase tax revenue, which conventionally is thought of as “bigger government”; but it would reduce the distorting effects of government policy, which means the government would have a smaller impact on the economy.

The book was published in 2007 — that is, before the latest turn of the wheel, in which a \$900 billion tax cut is being rapidly followed by a spending cut that will range somewhere between \$10 billion and \$60 billion, yet could reduce GDP on the order of [one percentage point](#) this year.\*

My only quibble is with the last sentence: “They know what is happening, as do the voters.” On that point, I think Krugman may be right. If voters really knew what was going on, then at some point the politicians couldn't get away with the nonsense they continue to spout.

\* The Goldman report behind that link estimates that the House spending cuts would reduce annualized economic growth by 1.5-2 percentage points in calendar Q2 and Q3, which means an aggregate reduction of 0.75-1 percentage points, ignoring any effects in other quarters.

## Enough

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The Baseline Scenario » 2011 » March    3/12/11 at 8:33 PM    James Kwak

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*By James Kwak*

A friend passed on [this article](#) in *The Motley Fool* by Morgan Housel. It begins this way:

“*Enough*.

“That's the title of Vanguard founder John Bogle's fantastic book about measuring what counts in life.

“The title, as Bogle explains, comes from a conversation between Kurt Vonnegut and novelist

Joseph Heller, who are enjoying a party hosted by a billionaire hedge fund manager. Vonnegut points out that their wealthy host had made more money in one day than Heller ever made from his novel *Catch-22*. Heller responds: ‘Yes, but I have something he will never have: *enough*.’”

The rest of the article discusses the cases of Rajat Gupta and Bernie Madoff, the former accused (but [not criminally](#)) and the latter convicted of illegal activity done after they had already been enormously successful, professionally and financially.

Housel asks, why do people push on — legally or illegally — when they have more of everything than anyone could possibly need? He summarizes the happiness research as follows:

“Money isn’t the key to happiness. What really gives people meaning and happiness is a combination of four things: Control over what they’re doing, progress in what they’re pursuing, being connected with others, and being part of something they enjoy that’s bigger than themselves.”

Of course, even if that’s true (and I think it is, except for the first sentence, on which more below), that doesn’t mean that people realize it. And if people don’t understand the relationship between their actions and their personal outcomes, we have no reason to believe that they will behave in a utility-maximizing way.

That said, renowned economist Justin Wolfers was recently on [Planet Money](#) saying that money does, indeed, buy happiness. He was discussing a [paper](#) he did with Betsey Stevenson looking at datasets covering many countries over many years. They find a positive relationship between income and subjective well-being, whether in the form of life satisfaction or happiness (although the relationship appears somewhat weaker for happiness).<sup>\*</sup> In particular, they find that there is no satiation point, at least when making cross-country comparison (that is, the positive relationship persists even when you look only at countries that are at least moderately wealthy).

At one point in the Planet Money interview, I believe Wolfers did say that when it comes to happiness, someone (Kahneman, I think) had estimated that there is a satiation point at around \$75,000 per year. But, he went on, the issue is that we may want subjective states other than simple happiness. So, for example, we may want the subjective feeling of power, whether or not it actually makes us happy in the moment. And those other subjective states may not have satiation points, or they may have little to do with income.

But ultimately I agree with Heller. It is a great thing to have “enough,” and to know you have enough. And that is a feeling that for some people, apparently, no amount of money can buy.

<sup>\*</sup> The difference, put simply, is between whether you feel happy at this moment and whether you feel satisfied with your life as a whole. For more, see this fantastic [TED Talk](#) by Daniel Kahneman (which I have recommended before).

*By James Kwak*

From Congressman Spencer Bachus's [Media Center](#) (these are the actual titles of four consecutive press releases):

- [CONGRESSMAN BACHUS ANNOUNCES MAJOR GRANTS FOR TWO FIRE DEPARTMENTS IN SIXTH DISTRICT](#)
- [BACHUS: THE AMERICAN PEOPLE HAVE TOLD US TO CUT SPENDING AND DEBT](#)
- [BACHUS STATEMENT ON STOPPING THE TAX INCREASES, OPPOSING PORK-BARREL SPENDING](#)
- [CONGRESSMAN BACHUS ANNOUNCES \\$294,000 IN FIRE GRANTS FOR JEMISON VOLUNTEER FIRE DEPARTMENT](#)

## Who's Afraid Of Elizabeth Warren?

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The Baseline Scenario » 2011 » March 3/17/11 at 10:59 AM Simon Johnson

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By Simon Johnson

The next big political battle in Washington – after the budget debate is declared “over” – will likely feature the Consumer Financial Protection Bureau, in particular the fight to determine whether Elizabeth Warren can become as the agency's first official head.

But will this fight feature a classic left vs. right set-piece confirmation showdown in the Senate? Or it will it be resolved with cloaks and daggers closer to the White House – with Treasury Secretary Tim Geithner managing to prevent Professor Warren's nomination?

There is much to commend the left vs. right scenario. The Republicans, after all, want to argue that regulation is excessive in general and regulation of financial products is somewhere between unnecessary and dangerous for economic growth in particular. This theme came up during the Dodd-Frank legislative debate on financial reform last year but it was largely lost in the larger conversation.

Now Spencer Bachus, Republican chair of the House Financial Services Committee, has Elizabeth Warren firmly in his sights – with the [mortgage settlement negotiations](#) as the flashpoint.

In a recent letter to Secretary Geithner, [Mr. Bachus says](#),

“”In addition, reports about the role played by political appointees in the Treasury department

— including those affiliated with the [CFPB], an agency that does not yet have any regulatory or enforcement authority — raise further questions about the [mortgage settlement] process.”

No matter that the CFPB only became involved when state law enforcement officials, in the form of attorney generals, asked for provide advice. Mr. Bachus is taking the opportunity to follow up on what he is reported [to have said recently](#),

“In Washington, the view is that the banks are to be regulated, and my view is that Washington and the regulators are there to serve the banks.”

The industry is unhappy because the proposed settlement – or, you could say, their transgressions with regard to foreclosures — could cost them up to \$20 billion.

Mr. Bachus would not have a direct voice in any nomination hearing, of course, but there are plenty of Republican Senators who are inclined to share his views – including Senator Richard Shelby, the ranking minority member of the Senate Banking Committee (and, like Mr. Bachus, from Alabama).

Ms. Warren actually represents a much more nuanced view – arguing that transparency and simplicity, from the perspective of customers, creates a more even playing field and is good for the industry. At least some community bankers seem to be on her side. She is also good at explaining this view and a confirmation hearing would be the perfect place for the country to witness and hopefully participate in this discussion. (Read [her recent speech to the Credit Union National Association](#) and make up your own mind.)

As Senator Sherrod Brown (D, OH), also a member of the Senate Banking Committee, pointedly framed the issues for [the foreclosure debacle](#),

“No person or company is above the law. And that’s good for capitalism, it’s not anti-business, and it’s not a minor inconvenience that can be ignored in pursuit of bigger profits.”

But before you set aside time in the early summer for potentially gripping television from Capitol Hill, Ms. Warren has to get past Secretary Geithner.

If anything, Mr. Geithner at this stage is more pro-banking lobby than even Mr. Bachus. During the Dodd-Frank reform debate, Mr. Geithner would frequently argue that “capital, capital, capital” was all we really needed to fix the financial system.

Yet his team agreed to Basel III, which requires banks to have less equity funding than Lehman had the day before it failed. There is no sign that systemically important financial institutions will be required to have a significant extra capital buffer – although this is supposedly not yet decided. And despite the undecided capital standards and large evident problems still facing banks (the foreclosure fiasco, commercial real estate woes, continuing high unemployment), the Financial Stability Oversight Council – which Mr. Geithner chairs – is about to sign off on letting banks increase their dividends.

[This makes no sense at all in terms of economic policy](#), but this is exactly what Mr. Geithner is

presiding over. (If anyone you know at Treasury thinks this assessment is unfair, send them to [Anat Admati's webpage at Stanford](#).)

And having Elizabeth Warren on the scene – providing an alternative pro-consumer perspective – is apparently increasingly inconvenient to Mr. Geithner. For example, he has [expressed displeasure](#) at her engagement in the mortgage settlement process.

President Obama missed his best opportunity to reform the financial system when advisers – including Mr. Geithner – recommended that he defer to the [top 13 bankers in March 2009](#). His team further punted when they failed to push for real change in spring and summer 2010, when the financial legislation was before the Senate. Mr. Geithner and his people were instrumental in defeating the Brown-Kaufman Amendment, which would have limited the size and the leverage (debt relative to equity) of the largest banks in the United States.

Will Mr. Geithner go for the trifecta? He was instrumental in bailing out the big banks without any strings. He held back serious attempts at legislative reform. Will he now prevent Elizabeth Warren, our potentially most effective modern regulator, from even coming up for a vote in the Senate?

*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.*

## Important Matters

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The Baseline Scenario » 2011 » March 3/18/11 at 11:44 AM James Kwak

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*By James Kwak*

I know you can't wait to hear my thoughts on the NCAA basketball tournament, but I've put them on my [personal blog](#). I used to have a personal blog, and one my friends said he preferred it to The Baseline Scenario, so I started a new one recently for things that don't have to do with economics, politics, business, the law, or the like. I post to it occasionally — just whenever I have something I want to say that doesn't feel like a Baseline Scenario post. You can visit it or not, as you choose.

## Two Cakes

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The Baseline Scenario » 2011 » March 3/18/11 at 9:04 PM James Kwak

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*By James Kwak*

[Eric Dash](#) of DealBook reports on the latest stress tests conducted by the Federal Reserve, which

apparently went swimmingly, at least for some of the healthier banks. I have no independent basis on which to assess the accuracy of those test results, so I won't.

What I did notice is that JPMorgan Chase and Wells Fargo are using the green light from the Fed to start buying back stock: \$15 billion for JPMorgan, 200 million shares (about \$6 billion) for Wells. Does something seem wrong with this picture to you? Me, too.

Last summer, the argument from the big banks was that higher capital requirements were bad because they would reduce the amount of bank lending. The argument is pretty simple: Say you have a 5 percent capital requirement, \$5 in capital, and \$100 in assets, so you're barely adequately capitalized. Then say your regulator increases your capital requirement to 10 percent. Now you either need to raise \$5 more in capital or, since that could be difficult, you have to shrink your assets to \$50 — which means you're lending half as much money as before. The rules are much more complex than that, but that's the basic concept. And, so the story goes, less lending means less economic growth means fewer jobs. Most infamously, the [Institute of International Finance](#) put out a "report" claiming that higher capital requirements would mean 9.7 million fewer jobs in the U.S., Japan, and Europe over five years.

But for this argument to even make sense, as many people pointed out at the time, bank lending would have to be constrained by capital at the margin. And the banks knew this was false at the time, because at the same time in other contexts they were saying that they were purposefully overcapitalized (e.g., [Bob Diamond](#) of Barclays saying his bank had 13 percent Tier 1 capital and almost 10 percent core capital). Now, this was not necessarily duplicitous at the time: the banks could plausibly say they were overcapitalized because of regulatory uncertainty — they didn't know how high the capital regulations would turn out to be.

Well, now they know. To go back to our earlier example, it's as if the banks had \$15 in capital for \$100 in assets because they weren't sure how much the capital requirement would go up, and then the regulator said the capital requirement would be only 10 percent. So they have two options. They can expand the balance sheet up to \$150 by borrowing \$50 and lending it out (more lending = more growth = more jobs); or they can buy back stock. They're buying back stock — that is, they're taking \$5 in cash from the asset side and using it to buy back \$5 in stock from the liability side, leaving \$95 in assets and \$10 in capital — which is the same as saying, "we have more capital than we know what to do with." Capital requirements could be 15 percent (in my simple example) and lending still wouldn't be affected, because at the margin lending isn't constrained by capital.

So it seems like the whole crusade against capital requirements was based on a fiction that's been quietly dropped. I think that's called eating your cake and having it too.

## Incentives Don't Work

*By James Kwak*

Driving home from school today, I listened to a [Fresh Air interview](#) from two months ago with Atul Gawande, by now perhaps the most famous doctor in the policy intelligentsia. The interview was based on a [New Yorker article](#) discussing how some doctors and even some health care payor organizations are trying to reduce health care costs for the most expensive people while improving outcomes. In Camden, New Jersey, one doctor found that one percent of people generate thirty percent of health care costs.

One refrain you heard incessantly during the health care reform debate was that we have high health care costs because of overconsumption and we have overconsumption because people don't bear a high enough share of their marginal health care costs, so the solution is to increase copays and deductibles. This is what Economics 101 would tell you: people respond to incentives. But Gawande discussed one large company that tried this year after year, but only saw their costs going up. The problem was that while most members responded to the higher copays and kept their costs more or less steady, the 5 percent of members who generated 60 percent of the costs behaved differently. Or, rather, they also reduced consumption (of doctor's visits and prescription medications), but as a result they often had catastrophic outcomes. These were people with heart disease on cholesterol-lowering medications, and when they went off their medications they ended up in the hospital with heart attacks and then with congestive heart failure.

If incentives worked on this level, we should have solved the problem already. Employers all want to bring health care costs down, so if any insurer could bring health care costs down they would have a competitive advantage, and so insurers should be trying to bring health care costs down. But it's not working. One explanation is that insurers don't have enough market power compared to providers (like large hospital chains); I believe Uwe Reinhardt has explained the situation this way.

Another way of looking at the problem is to note that there is no one who is trying to bring costs down directly. Sure, insurers try to do it, but they do it through the types of monetary incentives that economists love: higher copays, lower payments for various procedures, etc. But that's not actually what most companies do when they have a cost problem. If you run an auto company and it's costing too much to build a car, you don't lower the transfer price that you pay to that factory and let incentives solve the problem. You go and figure out what the problem is and you engineer a solution, whether by redesigning the manufacturing process, reengineering the product to use cheaper parts, negotiating lower wage costs, negotiating lower input costs, or something else. That's how you solve most problems in the business world — not by tweaking some clever incentive scheme.

This is a high-level analogy for what Gawande is talking about: doctors and health care organizations identifying their most expensive patients or members, figuring out what's wrong with them, and getting them the right treatments. In the few examples that Gawande discusses, it results in cost reductions on the order of 20 percent with better outcomes. It seems that for the people who consume the most health care dollars, you can save money simply by focusing on giving them better care — because right now their big problems are things like coverage gaps that prevent them from getting basic care, not being on the right medications, and ending up in the emergency room for catastrophic problems. Maybe for most people you would not save money

simply by providing better care, but for the few people who consume most of the system's resources, maybe you would save money. The problem is that with few exceptions, no one is trying to do that. That's what we need an incentive for.

## Dividend Lost

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The Baseline Scenario » 2011 » March    3/24/11 at 5:15 AM    Simon Johnson

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*By Simon Johnson*

Four types of people were directly affected by the Federal Reserve's [decision at the end of last week](#) to allow major banks to increase their dividends and to buy back shares. Three of these groups – bankers, bank shareholders, and government officials – were somewhere between happy and delighted. The fourth group, US taxpayers, [should be much more worried](#) (see also this cautionary letter to the Financial Times [by top finance academics](#)).

The bankers' reaction is obvious. They are officially released from the financial hospital ward that was set up for them in 2008. No matter that this was a very comfortable place with few conditions relative to any other bailout in recent US or world history – there were still restrictions on what banks could do and, naturally, bank executives chafed at these constraints.

In particular, banks were required to build up the equity in their business – insolvency is avoided, after all, while there is positive equity in a business. When shareholder equity is exhausted, creditors face losses.

You might think that the people who run banks have an incentive to keep equity at a high level – providing a cushion against future losses and effectively protecting creditors. And banking did operate in this fashion back when government was much smaller and effectively unable to save large financial institutions.

But that was in the nineteenth century – when banks had capital levels in the range of 30-50 percent (and functioned fine at that level). In the twentieth century, the equity in banking has tended to decline relative to debt; this is what it means when people say leverage has gone up.

A thinly capitalized bank is like buying a house with very little money down and a mortgage for 98 percent of the purchase price (and such levels of leverage, up to 50:1, were common in the run-up to 2008). If the house price goes up, you have done very well relative to your initial investment. Of course, if the house price goes down, you are under water faster when there is less equity in the business – and creditors are more likely to face losses (depending on your cash flow and broader incentives to default.)

The Fed's decision on dividends effectively lets the banks pay out shareholder equity, making the banks more highly leveraged. Bank executives and other key personnel are paid on a "return on

equity” basis, so this increases their upside, i.e., what they will make as long as the economy and their sector does well. (Look at Figure 2 on p.15 of the just [updated paper by Admati, DeMarzo, Hellwig, and Pfleiderer](#); their analysis has become central to the debate.)

Up to a point, this also makes bank shareholders happy – their equity (left in the business) will have more leverage and therefore also higher upside. The shareholders should, of course, worry about the bank executives taking on more leverage than is optimal from an owners’ point of view, but it really does not seem that even the more articulate shareholder groups are paying sufficient attention, e.g., to who supervises risk management at the board level.

And if the bank is presumed “too important to fail”, there is considerable downside protection for bankers and their shareholders – as well as for the creditors.

One group that should be more concerned about this arrangement is those government officials who are directly charged with ensuring financial system stability and who are well aware of the externalities involved in bank capital decisions. Any individual bank will want to keep its equity levels low – because its executives and owners are not worried about system-wide spillover costs, i.e., what happens to other banks when any one bank fails.

The Fed was naturally worried about bank equity during the crisis – most officials were unhappy, for example, when banks paid big bonuses in 2008 and 2009; higher wage compensation means lower bank profits and hence less shareholder equity (before the decision on whether this should be retained or paid out).

The Fed has also agreed to the higher capital requirements of Basel III (although these are not enough). And, by all accounts, it will impose some form of “capital surcharge” on the country’s largest banks (the details are not yet announced, but these are also unlikely to prove sufficient). The term “surcharge” is a misnomer; this is not any kind of charge or tax, but really just the requirement that big banks finance themselves more with equity relative to debt – because of the dramatic ways in which they can damage the system.

Yet the impression conveyed by Fed officials last week was more one of triumph than the wary caution that one would expect. Our nations’ leading practical thinkers on this issue have really convinced themselves that bank equity levels now are more than fine – so they can be reduced by payouts to shareholders. This is despite the fact that the “stress tests” just used to this purpose are highly suspect because they were run by the banks themselves and the results will not be published in any detailed way; this is disturbingly similar to the European bank stress tests of summer 2010, which were a complete disaster (see Section V of the [Fed’s technical paper, pp.18-19](#)).

Top Fed officials really seem to think:

1. The events of 2007-8 were rare and cannot happen again anytime soon. “Do you really think supervisors could make the same mistake again?” is one refrain. This ignores completely all dimensions of political economy (the power of banks) and cognitive capture (the power of ideas put forward by bankers).

2. The Fed made money on their various and extensive interventions. This is true, very narrowly defined, but such calculations are – as they should know – highly suspect because they are not risk adjusted. Ask yourself this: if the Fed and other government officials were to repeat this kind of support for the financial system 10 or 20 times, how often would it go well?
3. There are no other first-order costs worth considering. This is outrageous and unacceptable – what about more than 8 million jobs lost and a deep recession that will end up increasing net federal government debt held by the private sector by around 40 percentage points of GDP?

The US taxpayer has a much greater burden of debt as direct result of lost tax revenues due to the deep recession; the Bush stimulus of 2008 and the Obama stimulus of 2009 had little effect relative to the loss of tax revenue, 2008-11.

But who in modern American political life really cares about the taxpayer? Apparently not the Federal Reserve.

Perhaps just Senator Sherrod Brown (D., OH), a member of the Senate Banking Committee, who said on Wednesday,

“I’m concerned by both the process and the outcome of the Fed’s decision. How did the Fed conduct these tests, and how did each tested bank fare? What effects will this decision have on the current financial stability of these banks and their preparations to meet enhanced capital requirements in the coming years? And why, in a time of slow economic growth, are banks increasing leverage rather than lending?

“Given the success of the first set of U.S. stress tests, and the failure of the more opaque European stress tests, the Fed should have been as open and transparent as possible with the American public. Unfortunately, at this point its actions have raised more questions than they have answered.”

*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.*

## Convenient Arguments

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The Baseline Scenario » 2011 » March    3/27/11 at 1:21 PM    James Kwak

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*By James Kwak*

Here’s my solution to our national debt. We have a one-time, 100 percent tax on all wealth (net worth) of all United States residents, with a \$10 million per-person exemption. With household wealth at around \$60 trillion, that should be plenty to pay off the accumulated debt and shore up Social Security and Medicare for the next century.\* The government promises never to do it again.

Since we only care about future behavior, a one-time wealth tax should have no impact on people's incentives to work, and hence no distorting effect on the economy.

Don't like that idea? How about this one. The Federal Reserve creates \$20 trillion in money but, instead of crediting it to large banks' accounts at the Fed, it credits it to Treasury's account. Again, no more debt. Again, the Fed promises never to do it again.

Yes, those are stupid ideas. They are stupid because no one would believe that the Treasury or the Fed would never do it again. If the Treasury were to go and confiscate wealth from billionaires and double-digit millionaires, they would leave the country (along with many other people who wanted to be double-digit millionaires).\*\* If the Fed were to hand \$20 trillion to the Treasury, everyone would start dumping dollars and it would become impossible for the government to borrow money at low interest rates the next time it needed it. People's actions (working, buying bonds) depend on their expectations of future government actions. The fact that the government has never done something doesn't prove that it never will, and if it did it once that wouldn't prove that it would do it again, but in either case it's persuasive evidence.

So if no one could propose a one-time wealth tax with a straight face, how come people can propose a "one-time" corporate tax amnesty with a straight face? Yet that's just what multinational corporations are pushing for; see this [article](#) by Peter Coy and Jesse Drucker or Drucker's [Fresh Air interview](#). The U.S. has a top average tax rate of 35 percent, but multinational corporations have gotten very good at shifting their income to overseas subsidiaries in places like Ireland and Bermuda that have much lower corporate tax rates, often avoiding U.S. corporate tax entirely. According to [David Kocieniewski](#) of the *Times*, for example, G.E.'s U.S. tax rate is 7.4 percent, and that's including taxes it will not pay until it repatriates profits to the U.S. For 2010, it's claiming a refund of \$3.2 billion.

The "solution," according to those same companies, is for the U.S. to offer a tax amnesty that will allow them to repatriate profits (which they have to do in order to, for example, pay dividends or buy back stock in the U.S.) at much lower tax rates — like zero. The lobbyists' talking point is that if the companies have more cash in the U.S., they will invest it in ways that will create jobs. This doesn't even pass the laugh test: as Coy and Drucker report, U.S. nonfinancial companies are already sitting on over \$1 trillion in liquid assets within the U.S.

We've tried this before. In 2004, Congress passed a similar tax amnesty (companies were allowed to repatriate profits at a tax rate of 5.25 percent). Companies brought back lots of profits, the Treasury got a small bump in tax revenues, and companies learned that they should stash even more profits overseas and wait for the next amnesty. According to research by Thomas J. Brennan, the amount of profit stored overseas reached its 2004 peak as early as 2006 and has only grown since.

Tax amnesties may look good because they increase tax revenue in the very short term. But this is just an example of why, as Daniel Shaviro argues, it's stupid to look just at the annual deficit, or even the next five or ten years. A tax amnesty unambiguously reduces the present value of future tax revenue, even leaving aside the incentive effects.

And how about those incentive effects? If we're going to pretend that a tax amnesty for corporations won't have any impact on their future behavior, then why don't we pretend that a one-time wealth tax won't have any impact on future behavior, either? In either case, there's a short-term effect and a long-term effect. The same people who argue for the tax amnesty by pointing to its short-term effect would be horrified by a one-time \$20 trillion Fed bailout — because of its long-term effect on the Fed's credibility and the ability of the government to borrow money.

In other words, there are plausible arguments that can be made on either side of most issues, and people pick and choose the arguments they like to suit their political objectives.

By the way, there is a real substantive question as to whether we should even have a corporate tax. Much as we may like the idea of taxing corporations, the corporate tax flows through to real people, and no one is quite sure how it flows through. It also includes some obvious distortions, like the double taxation of dividends as opposed to interest on debt, which encourages higher leverage. I would be open to eliminating the corporate tax altogether and replacing it with more progressive income tax rates or a wealth tax. But as long as we have a corporate tax, it's crazy to have it in a form that favors multinational corporations with expensive lawyers and shell subsidiaries all around the world and that penalizes domestic businesses without expensive lawyers. If nothing else, paying lawyers and setting up shell subsidiaries cost money and provide no economic value.

But instead of dealing with serious issues, it seems like the IRS is going after individuals for — get this — falsifying their income on stated-income loans. Yes, they're going after *borrowers*. [Joe Nocera](#) tells the story of Charlie Engle, who is going to jail because an IRS agent saw him in a movie about ultra-marathoners and wondered how he found time to train for it; because the IRS sent an “attractive female undercover agent” after Engle on suspicion of money laundering; because Engle or his broker falsified his income on a mortgage application; and because the broker testified against him and got a shorter sentence, despite pleading guilty to falsifying *multiple* mortgage applications (since when do you give the more senior person a plea to testify against the more junior person in the conspiracy?). The kicker is that Engle is going to have to pay \$262,500 in restitution to Countrywide, the “victim” in this affair.

I like taxes more than the next guy. As Oliver Wendell Holmes is reputed to have said, “I like paying taxes. With them I buy civilization.”\*\*\* I'm generally not sympathetic to complaints about overreaching government bureaucrats. But this is ridiculous.

\* I haven't actually done the calculations; if it's not enough, just lower the exemption.

\*\* They would also sue, but if the wealth tax were an act of Congress, I don't think they'd have much of a case. Since we're in fantasy land, we could pass the tax by an amendment to the Constitution. As law professors say, don't fight the hypothetical.

\*\*\* And according to [Ed Darrell](#), he probably did say something like that.

**Update:** And here's [Daniel Shaviro himself](#) on the topic.

*By James Kwak*

In the [Times](#), Neil Barofsky, Special Inspector General for TARP, performed the admirable feat of fitting a clear, comprehensive, sober critique of how TARP was implemented and what its long-term impact will be in fewer than 1,000 words. It's a perspective I mainly agree with,\* and it highlights the different priorities that the administration put on aid to large banks and aid to homeowners, even though both were goals of the bill.

Back in late 2008 and early 2009, there was a lot of talk about how a true solution for the problems of the banking system would require a solution for the problems of homeowners, since the banks' losses were largely the result of mortgage defaults. One of the major technical achievements of the administration was showing that it was possible to stabilize the financial system and restore the banks to short-term profitability *without* doing much for homeowners. As Barofsky says, and as the *Times* reports in [yet another article](#) today, the administration's programs to help homeowners obtain loan modifications had little impact on the behavior of the banks that service mortgages and foreclosures continue unabated. [Real housing prices](#) have fallen below the previous lows of 2009 and now look likely to overcorrect on the downside.\*\*

Housing modifications are admittedly more difficult than bailing out banks. It's administratively easier to write a few \$25 billion checks and create unlimited low-interest credit lines for a few of the Federal Reserve's existing customers than to intervene in millions of mortgages. But the financial crisis was a time of bold action on other fronts. Treasury and the Federal Reserve were willing to push the limits of the law, for example in J.P. Morgan's takeover of Bear Stearns. (See the chapter in Steven Davidoff's book [Gods at War](#) for the details.) Henry Paulson threatened to declare the nation's largest banks insolvent if they didn't agree to sell preferred stock to the government. By contrast, as law professor Katherine Porter says in the *Times* article, "The banks were so despised, and TARP was so front and center, you could have actually done something. In the midst of real boldness in bailing out the banks, we get this timid, soft, voluntary conditional program."

The lesson we learned is that homeowners were only a priority insofar as their health mattered to the banks' health. When those two things became unmoored, the administration was willing to declare victory.

\* The main thing I don't agree with is Barofsky's implied criticism of the Bush administration for using TARP money to buy preferred stock from banks rather than buying mortgage-backed securities directly. While I have often criticized various aspects of the preferred stock purchases, I think it was a more direct way to stop the panic of September-October 2008, and at that point a program to purchase MBS would probably have been an even more blatant transfer to the banks.

\*\* I'm all for prices falling from bubble levels, but the policy goal should have been preventing them from falling through the long-term trend.

## What Is Spencer Bachus's Game?

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The Baseline Scenario » 2011 » March 3/30/11 at 10:46 PM Simon Johnson

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*By Simon Johnson*

Representative Spencer Bachus, Republican chair of the House Financial Services Committee, [famously remarked](#) in December,

“in Washington, the view is that the banks are to be regulated, and my view is that Washington and the regulators are there to serve the banks.”

With regard to the Consumer Financial Protection Bureau (CFPB), this apparently now implies that Mr. Bachus will use any means possible to change the topic away from substance – how banks treat their customers – to imagined procedural issues.

Specifically, [Mr. Bachus is wrongly accusing Elizabeth Warren](#) of misleading Congress with regard to the role of the CFPB in the negotiations over how to settle allegations that mortgage foreclosure practices have been abusive (see also this [news coverage](#)).

On March 16, 2011, Ms. Warren told the House subcommittee on Financial Institutions and Consumer Credit that the CFPB provided advice in these negotiations. Mr. Bachus and his colleagues have just discovered some [specific slides](#) that were apparently used as part of this advice.

Impressed by the lucidity of these seven (7) slides, Mr. Bachus and Ms. Shelley Moore Capito (chair of that subcommittee) have jumped to the conclusion that the CFPB must be the primary architect of the government's position.

This is patently ludicrous.

First, there is [no settlement agreement yet firmly on the table](#).

Second, there is obviously no unified federal government position on this issue – in fact, the [Office of the Comptroller of the Currency \(OCC\) is most definitely](#) not taking advice from Ms. Warren or anyone sensible.

Third, the CFPB is very far from being any kind of decision maker in this process; that power rests with Attorney Generals, the Department of Justice, the OCC, and other federal agencies. Either you have the legal power to offer a settlement or you don't. The CFPB does not.

Fourth, a close look at Ms. Warren's calendar ([by Ben Protess of the NYT](#)) suggests she is not the prime architect of the settlement agreement – not unless she can mastermind a complex legal document while spending very little time on it.

Fifth, although the Bachus-Moore letter cites the Protess NYT article, it does so in a way that is selective and misleading. Specifically, Representatives Bachus and Moore quote Iowa Attorney General Tom Miller – to whom the CFPB slides are apparently addressed – as saying that Ms. Warren has been a “very active participant”. But here is the full quote from the article in context ([see the final paragraphs](#)):

“In a recent interview, Mr. Miller said Ms. Warren’s involvement was “appropriate” given the consumer bureau’s “expertise” in mortgage servicing. “It would be strange to say, ‘We’re going to quarantine you.’”

“He acknowledged that Ms. Warren has been a “very active participant” in talks about the servicing settlement, but he said the proposal ultimately was the creation of the state attorneys general – not Ms. Warren.”

“We form our own opinions and make our own decisions about the foreclosure and servicing case,” he said.”

Sixth, read the transcript of the March 16 hearing (which follows the Bachus-Capito letter in the [same pdf, as posted on the committee’s website](#)) and determine for yourself who is misrepresenting what. This is how the exchange between Representative Bachus and Ms. Warren actually reads (pp.34-35):

“Chairman BACHUS. You have engaged in – you have given input and advice into these [mortgage servicing standards]. Is that correct?”

“Ms. WARREN: When we have been asked by the Secretary, by the Department of Justice and others, we have given advice about mortgage servicing. Yes, sir.”

And here is her exchange with Representative McHenry directly on the question at hand (pp.53-54).

“Mr. MCHENRY: I am reclaiming my time. Are you engaged in these discussions on the settlement?”

“Ms. WARREN: The negotiations with private parties are entirely directed by the Department of Justice, by the State Attorneys General, by other Federal agencies.”

“Mr. MCHENRY: So you are not engaged in these discussions?”

“Ms. WARREN: We do not negotiate with private parties. We have been asked for advice, Congressman. And wherever we can be helpful, we are not only glad to be helpful, we are proud to be helpful.”

On top of all this, the first paragraph of the Bachus-Capito letter is beyond bizarre. The Representatives argue that “political appointees” should not be involved in the “regulatory enforcement process.” But surely all the people responsible for the financial sector, inside and outside Treasury – e.g., heads of the OCC, FDIC, SEC, Chair of the Federal Reserve Board and of course the Treasury Secretary – are political appointees and therefore subject to congressional confirmation and scrutiny (which is, generally speaking, a good thing).

Representatives Bachus and Capito claim to be concerned that “When political appointees involve themselves in enforcement matters, they may pressure regulatory officials to take actions benefitting a particular political constituency or advancing a particular agenda at the expense of sound policy.”

But the real issue here is how a powerful politician – proudly holding the explicit view that “Washington and the regulators are there to serve the banks” – is pressuring regulatory officials of all kinds to take actions that benefit his particular political constituency.

## Comment Unthreading

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The Baseline Scenario » 2011 » March 3/30/11 at 11:00 PM James Kwak

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*By James Kwak*

I’m sorry to those who liked it, but I decided to turn off threaded comments. There were just too many examples of people “responding” to the first comment with something that, while perhaps related to the original post, was not related to that comment, apparently to get their input up to the top of the comment list. I decided this was a simpler solution than trying to block those people.

**Update:** Many people use the “@” symbol to show that they are replying to a previous comment. So if you want to reply specifically to a comment by “agreenspan,” for example, put “@agreenspan:” at the beginning of your comment.

## Lessons from the Oracle

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The Baseline Scenario » 2011 » March 3/30/11 at 11:26 PM James Kwak

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*By James Kwak*

[I wrote this post a month ago but just realized I never clicked "Publish." It's about a book that was published more than two years ago, though, so it shouldn't have gotten any more stale.]

I recently finished reading *Snowball*, Alice Schroeder's 2008 biography of Warren Buffett. It wasn't a bad read, although at over eight hundred pages it was on the long side and began to seem repetitive; the impression I got was that Buffett had the same kinds of relationships with his family and friends for a long time, and not much changed over the decades.

The big question about Buffett for people like me — people who invest in low-cost index funds, that is — is whether he is smart or lucky. After all, since Burton Malkiel's *Random Walk Down Wall Street*, the main argument against stock-picking skill has been that in a coin-flipping tournament featuring thousands of players (and with survivorship bias), *someone* is bound to win time after time after time.

The answer, at least the one from the book, is that Buffett is smart. And that shouldn't be too surprising. I recently read a pile of papers about active mutual fund management, mainly from the *Journal of Finance*, and I'd say that while there's no consensus per se, the general trend has been that there are some mutual fund managers who can beat the indexes and can more than cover their costs.\* There aren't many of them, they are outnumbered by the ones who do worse than the indexes, and they are probably hard for you and me to find, but they exist. And I say this despite the fact I didn't want it to be true.

But the image you get of Buffett isn't that he's a great stock-picker; it's that he's a great manager, and he had some luck. Yes, in the early years (the 1950s and 1960s), he seems to have made a killing buying stocks with very low price-to-earnings ratios — as low as one, in some cases. He was able to do that because he consumed data voraciously, and he was able to find undervalued stocks that other people didn't find. But Buffett himself acknowledges that since then it's gotten much more difficult to invest that way, presumably because of the increased availability of information, a much larger asset management industry, and computers.

So most of the book is about Buffett's ability to judge whole businesses and find the ones that, *in his hands*, could be worth more money. Along the way, he had some luck: he won a newspaper war in Buffalo whose outcome was by no means predetermined, the Federal Reserve didn't shut down Salomon in the early 1990s (by shutting it out of bids for Treasuries), and so on. And as with many business titans, a lot of the story involves having good underlings, like Ajit Jain at Berkshire Hathaway or Jack Byrne at GEICO. Part of this could just be the bias you get reading a biographical narrative; stories of corporate drama involving larger-than-life figures are more exciting than details of passive investments. But also, at the scale Buffett operates at, you just can't make that much money through passive investing.

One thing I found interesting about the book was that it didn't make Buffett out to be some kind of business superman, either. Sure, he's better than most. But he could be inconsistent, or insufficiently cold-blooded. He talks about hanging on to Berkshire Hathaway's textile mills for much longer than he should have because he couldn't bear to pull the plug. He donated money to reproductive rights organizations, but backed down when right-to-life groups boycotted one of his companies, shutting down Berkshire's charitable contributions program. He generally seems like a fine person, but neither a hero nor a money-making machine, just someone who was right more often than not and who was lucky enough to find the thing in life he was best at.

\* If you're interested, see for example Werners, "Mutual Fund Decomposition: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses," *Journal of Finance* 55 (2000), which finds that actively managed funds do hold stocks that beat the market, although in aggregate that advantage is more than eaten up by fees and costs; Kosowski et al., "Can Mutual Fund 'Stars' Really Pick Stocks? New Evidence from a Bootstrap Analysis," *Journal of Finance* 61 (2006), which finds that the top mutual funds do have persistent superior performance; Fama and French (yes, *that* Fama and French), "Luck Versus Skill in the Cross-Section of Mutual Fund Returns," *Journal of Finance* 65 (2010), which finds that a few fund managers can more than cover their costs.

## The Myth Of The Resolution Authority

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The Baseline Scenario » 2011 » March    3/31/11 at 2:51 PM    Simon Johnson

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*By Simon Johnson*

Back when it really mattered – last spring, during the Dodd-Frank financial reform debate – Senator Ted Kaufman of Delaware emphasized repeatedly on the Senate floor that the proposed “resolution authority” was an illusion. His point was that extending the established Federal Deposit Insurance Corporation (FDIC) powers for “resolving” (jargon for “closing down”) financial institutions to include global megabanks simply could not work.

At the time, Senator Kaufman's objections were dismissed by “experts” both from the official sector and from the private sector. Now these same people (or their close colleagues) are falling over themselves to argue resolution cannot work for the country's giant bank holding companies. The implication, which these officials and bankers still cannot grasp, is that we need much higher capital requirements for systemically important financial institutions.

[Writing in the March 29, 2011 edition of the National Journal](#), Michael Hirsch quotes a “senior Federal Reserve Board regulator” as saying:

“Citibank is a \$1.8 trillion company, in 171 countries with 550 clearance and settlement systems,” and, “We think we're going to effectively resolve that using Dodd-Frank? Good luck!”

The regulator's point is correct. The FDIC can close small and medium sized banks in an orderly manner, protecting depositors while imposing losses on shareholders and even senior creditors. But to imagine that it can do the same for a very big bank strains credulity.

And to argue that such a resolution authority can “work” for any bank with significant cross-border is simply at odds with the legal facts. The resolution authority granted under Dodd-Frank is purely domestic, i.e., it applies only within the United States. The US Congress cannot readily make laws that apply in other countries – a cross-border resolution authority would require either agreement between the various governments involved or some sort of synchronization for the relevant parts of

commercial bankruptcy codes and procedures.

There are no indications that such arrangements will be made – or that there are serious inter-governmental efforts underway to create any kind of cross-border resolution authority, for example, within the G20.

For more than a decade, the International Monetary Fund has been on the case of the eurozone to create a cross-border resolution mechanism of some kind within their shared currency area. But European (and other) governments do not want to take this kind of step. Rightly or wrongly, they do not want to credibly commit to how they would handle large-scale financial failure – preferring instead to rely on various kinds of ad hoc and spontaneous measures.

I have checked these facts directly and recently with top Wall Street lawyers, with leading thinkers from left and right on financial issues (US, European, and others), and with responsible officials from the United States and other relevant countries. That Senator Kaufman was correct is now affirmed on all sides.

Even leading figures within the financial sector are now honest on this point. Hirsch quotes Gerry Corrigan, former head of the New York Federal Reserve Bank, and an executive at Goldman Sachs since the 1990s.

“In my judgment, as best as I can recount history, not just the last three years but the history of mankind, I can’t think of a single case where we were able execute the orderly wind-down of a systemically important institution—especially one with an international footprint.”

It is most unfortunate that Mr. Corrigan did not make the same point last year – for example, when he and I both testified before the Senate Banking Committee on the Volcker Rule (in February 2010).

In fact, rather tragically in retrospect, Mr. Corrigan was among those [arguing most articulately that some form of “Enhanced Resolution Authority”](#) (as he called it) could actually handle the failure of Large Integrated Financial Groups (again, his terminology).

The “resolution authority” approach to dealing with very big banks has, in effect, failed before it even started.

And standard commercial bankruptcy for global megabanks is not an appealing option – [as argued by Anat Admati in the New York Times’ Room for Debate in January](#). The only people I have met who are pleased with the Lehman bankruptcy are bankruptcy lawyers. [Originally estimated at over \\$900 million](#), bankruptcy fees for Lehman Brothers are [now forecast to top \\$2 billion](#) (more [detail on the fees here](#)).

It’s too late to re-open the Dodd-Frank debate – and a global resolution authority is a chimera in any case. But it’s not too late to affect policy that matters. The lack of a meaningful resolution authority further strengthens the logic behind the need for larger capital requirements, as these would provide stronger buffers against bank insolvency.

The Federal Reserve has yet to announce the percent of equity funding – i.e., capital – that will be required for systemically important financial institutions (so-called SIFIs). Under Basel III, national regulators set an additional SIFI capital buffer. The Swiss National Bank is requiring 19 percent capital and the Bank of England is moving in the same direction.

Yet there are clear signs that the Fed's thinking – both at the policy level and at the technical level – is falling behind this curve.

This time around, officials should listen to Ted Kaufman. In his capacity this year as chair of the Congressional Oversight Panel for TARP (e.g., [in this hearing](#)), Mr. Kaufman has been arguing consistently and forcefully for higher capital requirements.

*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.*