

By Simon Johnson

In a surprise announcement early this morning, the 2011 Nobel Peace Prize and the Nobel Prize for Economics (strictly speaking: "[The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel](#)") were simultaneously awarded to the Institute of International Finance (IIF), "[the world's only global association of financial institutions](#)".

This is the first time the [Economics Prize has been awarded to an organization](#) – although the Peace Prize has been received [by various institutions](#) (including the Intergovernmental Panel on Climate Change, the International Atomic Energy Agency, and Lord Boyd Orr – [in part for his work with the Food and Agriculture Organization](#)).

[In its citation](#) for the economics prize, the [Royal Swedish Academy of Sciences](#) said the IIF won for [its work on capital requirements for banks](#), which proved that requiring banks to fund themselves with positive equity – and therefore have any kind of buffer against insolvency – would limit credit, be very bad for economic growth, and generally make all consumers less happy. Based on this single remarkable paper, the IIF earned the prize for its:

"achievements in the fields of consumption analysis, monetary history and for its demonstration of the complexity of stabilization policy".

Put more simply, the IIF's results showed that basic economics, modern finance, and pretty much all contemporary econometrics are completely wrong. (See also [this comment by Paul Pfleiderer of Stanford University](#).)

The Norwegian Nobel Committee, [awards of the peace prize](#), mentioned more broadly the IIF's

["extraordinary efforts to strengthen international banking and cooperation between regulators and those they are supposed to be regulating"](#).

Reaction to the prize was mixed, with the IIF itself seeming to feel that the financial sector was again under threat. Charles Dallara, managing director of the Institute, immediately wrote to the G20 that he "sees no merit in the idea that any levy on the [Nobel Prize] should be paid into general revenue" (see "A Fair and Substantial Contribution by the Financial Sector: Preliminary Industry Comment," on the IIF website.)

Josef Ackermann, CEO of Deutsche Bank and [chair of the IIF's board](#), is – by way of celebration – reported to be revising his group's return-on-equity goal up significantly ([from 20-25 percent where it currently stands](#) for the corporate and investment banking division). Presumably the return on zero equity will be substantial, at least in good years.

And Douglas Flint, Group Chairman of HSBC and also an Institute board member, is being even more assertive – [pushing immediately for negative capital requirements](#) for systemically important financial institutions. If these are not granted at once in London, he is apparently threatening to move his bank to Sweden.

The U.S. Treasury will no doubt welcome the clarity provided by these prizes for the department's own internal debates. Secretary Tim Geithner has done very little about seriously raising capital requirements, while endorsing higher capital in general terms – including in [his testimony to Congress in early 2009](#).

“Sec. GEITHNER: The most simple way to frame it is capital, capital, capital. Capital sets the amount of risk you can take overall. Capital assures you have big enough cushions to absorb extreme shocks. You want capital requirements to be designed so that, given how uncertain we are about the future of the world, given how much ignorance we fundamentally have about some elements of risk that, there is a much greater cushion to absorb loss and to save us from the consequences of mistaken judgment and uncertainty in the world.”

Now the banks have been proved right, the Treasury Department's [lack of effort on really making the financial sector safer](#) seems more justified. As a [senior official told John Heilemann of New York magazine](#),

“If we'd been for it, it probably would have happened. But we weren't, so it didn't.”

Made-Up Definitions

The Baseline Scenario » 2011 » April 4/2/11 at 12:13 AM James Kwak

By James Kwak

Many commentators who want to blame Fannie and Freddie for the financial crisis base their arguments on analysis done by Edward Pinto. (Peter Wallison bases some of his dissent from the FCIC report on Pinto; even [Raghuram Rajan](#) cites Pinto on this point.) According to Pinto's numbers, about half of all mortgages in the U.S. were “subprime” or “high risk,” and about two-thirds of those were owned by Fannie or Freddie. Last year I pointed out that Pinto's definition of “subprime” was one he made up himself and that most of the “subprime” loans held by Fannie/Freddie were really prime loans to borrowers with low FICO scores. Unfortunately, I made that point in an update to a post on the somewhat obscure [13 Bankers blog](#) that was mainly explaining what went wrong with a footnote in that book.

Fortunately, there's a much more comprehensive treatment of the issue by [David Min](#). One issue I was agnostic about was whether prime loans to people with low (<660) FICO scores should have been called “subprime,” following Pinto, or not, following the common definition. Min shows (p. 8) that prime loans to <660 borrowers had a delinquency rate of 10 percent, compared to 7 percent

for conforming loans and 28 percent for subprime loans, implying that calling them the moral equivalent of subprime is a bit of a stretch. Min also shows that most of the Fannie/Freddie loans that Pinto classifies as subprime or high-risk didn't meet the Fannie/Freddie affordable housing goals anyway — so to the extent that Fannie/Freddie were investing in riskier mortgages, it was because of the profit motive, not because of the affordable housing mandate imposed by the government.

Min also analyzes Pinto's claim that the Community Reinvestment Act led to 2.2 million risky mortgages and points out that, as with "subprime" loans, this number includes loans made by institutions that were not subject to the CRA in the first place. Of course, the CRA claim is ridiculous on its face (compared to the Fannie/Freddie claim, which I would say is not ridiculous on its face) for a number of reasons, including the facts that only banks are subject to the CRA (not nonbank mortgages originators) and most risky loans were made in middle-income areas where the CRA is essentially irrelevant.

Mainly, though, I'm just glad that someone has dug into this in more detail than I did.

"It's All Relative"

The Baseline Scenario » 2011 » April 4/2/11 at 12:33 AM James Kwak

By James Kwak

I finally saw *Inside Job* at a friend's house tonight. I don't have anything original to say about it. I thought it was a very, very good movie. There were lots of little things that weren't quite right (many of which were probably conscious decisions to simplify details for the sake of comprehension), but I don't think any of them were substantively misleading. I wouldn't have made some emphases or drawn some connections that Ferguson did. For example, the parallel between the rise of finance and the decline of manufacturing at the end felt a little shallow to me, not because they're not related, but because the causality could run down any number of paths. But everyone would tell the story a little differently. Overall I thought it was both a relatively accurate narrative of what happened and a compelling explanation of why it happened.

My favorite scene was when the interviewer (Ferguson, I assume) asked Scott Talbott, the chief lobbyist for the Financial Services Roundtable, about the "very high" compensation in the financial sector. Talbott said something like (I may not have the words quite right), "I wouldn't agree with 'very high.' It's all relative."

Moment of Blather

The Baseline Scenario » 2011 » April 4/5/11 at 9:25 PM James Kwak

By James Kwak

David Brooks's commentary on Paul Ryan's "budget proposal" is entitled "[Moment of Truth](#)." Brooks falls over himself gushing about his new man-crush, calling it "the most comprehensive and most courageous budget reform proposal any of us have seen in our lifetimes." "Ryan is expected to leap into the vacuum left by the president's passivity," he continues.

Gag me.

First of all, Ryan's plan is not "comprehensive" by any stretch of the imagination. Ryan's plan does limit taxes to 19 percent of GDP and outlays to 14.75 percent of GDP by 2050, producing a huge surplus. How does he achieve this budgetary miracle? In part, he does it by waving his magic wand. This is what the [CBO](#) has to say (emphasis added):

"The proposal specifies a path for all other spending [other than Medicare, Medicaid, and Social Security] (excluding interest) that would cause such spending to decline sharply as a share of GDP—from 12 percent in 2010 to 6 percent in 2022 and 3½ percent by 2050; the proposal *does not specify* the changes to government programs that might be made in order to produce that path."

If you look at Table 2 of the CBO report (p. 16), you'll see that the extended baseline scenario already shows non-entitlement spending falling from 12 to 7.5 percent,* so Ryan is pulling 4 percentage points out of thin air. But if you go back to Table 1 (p. 3), you'll see that those 4 percentage points are all it takes to balance the budget in 2040 and 2050. So if I can use the same magic trick as Paul Ryan, I can balance the long-term budget right now, without touching Medicare or Medicaid.** In other words, if you believe Paul Ryan, *there is no Medicare crisis* (at least not through 2050).

So, without further ado, here's my budget proposal: Leave everything the way it is, except that non-entitlement spending will do whatever Paul Ryan says it will do. Let's see if David Brooks calls me a courageous leader.

Now, the Ryan plan is not completely devoid of details. It would be more accurate to call it a Medicare-Medicaid proposal, because that's the main area where the plan actually says anything substantive. In particular, it converts Medicare into a voucher program. Beginning in 2022, 65-year-old beneficiaries would receive a voucher to spend on private health insurance. The value of that voucher would be set at the amount that the government is currently projected to contribute toward Medicare for a 65-year-old beneficiary in 2022. After that point, an individual beneficiary's benefit would go up each year by the percentage by which health care becomes more expensive because of aging. All vouchers would also go up by the amount of the consumer price index.

The result is that government health care spending in 2050 falls to 4.75 percent of GDP instead of rising to 12.25 percent — a difference of 7.5 percentage points. But let's think about how this has happened.

There are two ways that government spending on health care can go down. Either health care itself is getting less expensive, or the government is just paying for less of it. Hint: it's not the former.

“A private health insurance plan covering the standardized benefit would, CBO estimates, be more expensive currently than traditional Medicare. Both administrative costs (including profits) and payment rates to providers are higher for private plans than for Medicare. Those higher costs would be offset partly but not fully by savings from lower utilization. . . . Moreover, CBO projects that total health care spending for a typical beneficiary covered by the standardized benefit under the proposal would grow faster than such spending for the same beneficiary in traditional Medicare under either of CBO's longterm scenarios.”

So instead, what's happening is the government is just paying for less health care. It's doing this because the vouchers are designed to grow in value more slowly than the cost of health care. That's where all of the cost savings come from.

Think about it. Does this accomplish anything? Yes, we have added a positive amount to the government's fiscal balance. But we have done it by taking a *larger* amount from our aggregate household fiscal balance.

Let's try an example. Today, we pay \$100 in taxes; Medicare pays \$5 in expenses and buys us \$95 in health care. (That \$5 in administrative expenses is just to have a round number, not a real estimate.) Let's say that buys us all the health care we need.

The “Medicare crisis” is that thirty years from now, taxes will grow to \$150, but to get the future-world equivalent of \$95 of health care, the government will need to spend \$200: \$10 on expenses and \$190 on health care. In other words, we'll have a shortfall of \$50. Because Medicare is an entitlement program, that shows up as a \$50 government deficit.

Under the Ryan plan, we still pay \$150 in taxes, only now we get back a voucher worth \$150 that we can use to buy health insurance. Voilà! No government deficit. But to get a plan that is equivalent to what Medicare would have been, we now have to pay \$210 to a private insurer, which will spend \$20 on expenses and \$190 on health care.

In other words, we've taken a \$50 government deficit and replaced it with a \$60 household deficit.

This is the problem with thinking of everything in terms of “taxes” and “spending.” The categories make sense if the government is buying things we would not have bought individually, like national security. But if we're talking about things we would have bought anyway, the direction of the cash flows is irrelevant. All that matters is the bottom line. And the Ryan plan makes the bottom line worse.

Now, this is a simplification. Under the Ryan plan, we will not buy exactly the same health care that we would under Medicare. The Ryan plan will affect health care consumption, because poor seniors won't be able to afford the health care they get now. So it will reduce overall spending on health care — but exactly by depriving people of care they would have had under Medicare. I think

that's called "rationing." Now, I am in the camp that thinks that health care is already rationed today and will always be rationed, and we need to be honest about it so that we can ration it in the way that does the most good for the most people. But rationing it based on income is just about the worst way I can think of.

The other thing the Ryan plan does is it eliminates part of the insurance component of Medicare. Some insurance against being poor is still there: the funding comes via payroll taxes, but everyone gets the same benefit. (Actually, the benefits are a tiny bit progressive, since the top 8 percent by income get smaller vouchers.) But there's no insurance against volatility of health care costs. If health care grows more slowly than projected, beneficiaries will be better off than if it grows as projected (but probably still worse off than under traditional Medicare); but if it grows faster than projected, they will be even worse off. In other words, we've taken the risk of health care inflation and transferred it to households. Cost certainty for the federal government sounds great, until you realize it is exactly balanced by uncertainty for real people.***

So let's try to boil down the Medicare plan this way:

- If everyone buys the same health care they would otherwise, it makes us all worse off, because our bigger household deficits more than balance the smaller government deficit.
- People may buy less health care, but only because the poor will have to.
- On top of that, we're shifting risk from the government to individual households.****

And remember, if Ryan's magic "plan" for discretionary spending is to be believed, all of this is unnecessary.

There is really only one surprising thing about the Ryan plan: why is Social Security spared? The plan leaves Social Security benefits completely untouched while gutting Medicare and national defense at the same time (there's no way we get non-entitlement spending down to 3.5 percent without slashing defense budgets). Social Security is widely believed to be considerably *easier* to fix than Medicare, and prominent Democrats like Peter Orszag have come up with their proposals.

The only answer I can come up with is that it's pure politics: Ryan didn't want to be seen as attacking both pillars of support for the elderly with one blow. Yet frankly I would rather see modifications in Social Security than in Medicare. With Social Security, lower benefits are bad, but they are predictable (and indexed to an appropriate index). With Medicare, beside the fact that vouchers will be capped below the rate of health care inflation, there are other major risks: the risk that the private insurance market will not develop affordable plans for seniors (look what a great job they've done with the non-employer market so far) and the risk that health care costs will grow even faster than projected.

Yet Ryan decided to go after Medicare. And, according to David Brooks, "His proposal will set the standard of seriousness for anybody who wants to play in this discussion."

No. Seriousness means doing something about health care costs themselves — not transferring the fiscal problem to households. And while we may not all agree with the details, the Obama administration's health care reform bill took a serious swipe at those costs. And the Ryan plan

would largely cripple health care reform's efforts to ensure universal, affordable coverage, mainly by eliminating the individual mandate and subsidies for poor people. Instead of being serious about health care costs, Ryan's plan just tries to make them vanish, hoping we won't realize that they'll show up in our own household budgets.

But my daughter doesn't believe in magic. And she's only four years old. So neither should you.

* The drop from 12 percent is because 2010 government spending was high because of the stimulus bill.

** I'm referring to the extended baseline scenario, not the alternative scenario, which is more accurate in some ways. But I think this is appropriate here. The problem with the extended baseline scenario is that it is not politically feasible (i.e., we expect Congress to change current law because the extended baseline scenario is politically unpleasant). But the same problem applies to Ryan's proposal.

*** I'm also not sure if the Ryan plan preserves insurance against poor health. I believe there is a prohibition against medical underwriting, a requirement that plans charge the same amount to all members, and a risk-spreading mechanism that shifts money between plans. These should limit cherry-picking, although obviously not as well as the current single payer system.

**** You could say that this is irrelevant because the government's tax base is those same households, but you would be wrong. The government can shift burdens among income groups or even among generations to cope with sudden shocks (e.g., the post-World War II generations paid for World War II, and no one complained about that), while households can't.

Big Banks Have A Powerful New Opponent

The Baseline Scenario » 2011 » April 4/7/11 at 5:37 AM Simon Johnson

By Simon Johnson

As a lobby group, the largest U.S. banks have been dominant throughout the latest boom-bust-bailout cycle – capturing the hearts and minds of the Bush and Obama administrations, as well as the support of most elected representatives on Capitol Hill. Their reign, however, is finally being seriously challenged by another potentially powerful group – an alliance of retailers, big and small – now running TV ads (<http://youtu.be/9lUt-IY-XgM>, by Americans for Job Security), web content (http://www.youtube.com/watch?v=DiKoFzS_IXs, by American Family Voices), and this very effective powerful radio spot directly attacking “too big to fail” banks: <http://www.savejobs.org/audio18.html>.

The immediate issue is the so-called Durbin Amendment – a requirement in the Dodd-Frank financial reform legislation that would lower the interchange fees that banks collect when anyone

buys anything with a debit card. Retailers pay the fees but these are then reflected in the prices faced by consumers.

The US has very high debit card “swipe” fees – 44 cents on average but up to 98 cents for some kinds of cards. These fees are per transaction – representing a significant percent of many purchases but posing a particular problem for smaller merchants. This is estimated to be around \$16-17 billion in annual revenue.

Other countries, such as Australia and members of the European Union, have already taken action to reduce interchange fees – because the cost of such transactions is actually quite low (think about it: the “interchange fee” for checks, which also draw directly on bank deposits, is exactly zero). The United States severely lags behind comparable countries in terms of how consumers are treated by banks in this regard.

The legislative intent behind Senator Dick Durbin’s Amendment was quite clear: Fees should be lowered – to a level [commensurate with the costs of that particular transaction](#) – and it attracted bipartisan support on this basis (the vote was [64-33 in the Senate](#), of whom [17 were Republican](#).) The Federal Reserve was mandated with determining the reasonable fees through a regulatory rule-making process. There has been some foot-dragging by the Fed but ultimately the proposal is that interchange fees be capped at 12 cents.

The big banks’ formidable lobbying machinery naturally sprang into action, arguing the fee cap would hurt small banks and credit unions. Senators Jon Tester (D., Montana) and Bob Corker (R., TN) are offering legislation – as is Representative Capita – that would postpone implementation of the fee reduction for two years pending “further study”. The best way to kill something in Washington is to study it further.

This is an issue that cuts across party line – witness [the eclectic Dick Morris weighing in](#) for Durbin – but there are unfortunately supporters of the big banks on both sides of the aisle. Tea party-inclined congressional conservatives are arguing that the Fed should not get involved with the Market. But this is already a badly broken market, [as argued by Jim Miller](#), budget director under Ronald Reagan. “Too big to fail” banks are not a market – they are a government subsidy scheme because they are backed by implicit government bailout support (to be provided at below market cost whenever needed). These subsidies enable megabanks to borrow more cheaply and grab market share relative to smaller banks (e.g., those with less than \$10 billion of assets.) On top of this, and working closely with the biggest banks, Visa and MasterCard have around 90 percent market share for debit cards – hardly conducive to reasonable competitive outcomes.

At the same time, some on the political left are confused (or captured) by the claim that lower interchange fees will hurt small banks and credit unions. This is pure smokescreen – banks with less than \$10 billion in total assets are specifically exempt from the provisions of the Durbin Amendment. This exemption was a smart political move but it also makes economic sense given the disproportionate size and power of our largest banks. Adam Levitin, writing on the Credit Slips blog, [makes a strong case that small banks will actually win](#) under the proposed cap, as this can level the playing field with larger banks to some degree:

“if they [small banks] end up with higher interchange revenue than big banks as a result of Durbin, that is a step toward undoing the troubling consolidation of financial services around too-big-to-fail institutions.”

See also [Levitin’s paper on credit unions, showing that they may also benefit – again as most have less than \\$10 billion in total assets](#).

Of course the big banks are threatening to punish customers in other ways if debit fees are capped, for example by ending free checking. But this makes no sense given that these banks have to compete with smaller institutions for retail business that will not be impacted by caps on debit fees.

The big bank vs. nonfinancial sector dispute has just started to get interesting.

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.

Taxes and Spending for Beginners

The Baseline Scenario » 2011 » April 4/10/11 at 7:00 PM James Kwak

By James Kwak

Over the long term, we are projected to have large and growing federal budget deficits. Assuming that is a problem, which most people do, there seem to be two ways to solve this problem: raising taxes and cutting spending. Today, the political class seems united around the idea that spending cuts are the solution, not tax increases. That’s a given for Republicans; Paul Ryan even proposes to reduce the deficit by *cutting* taxes. But as [Ezra Klein](#) points out, President Obama and Harry Reid are falling over themselves praising (and even seeming to claim credit for) the spending cuts in Thursday night’s deal. And let’s not forget the bipartisan, \$900 billion tax cut passed and signed in December.

The problem here isn’t simply the assumption that we can’t raise taxes. The underlying problem is the belief that “tax increases” and “spending cuts” are two distinct categories to begin with. In many cases, tax increases and spending cuts are equivalent — except for the crucial issue of who gets hurt by them.*

Social Security is probably the simplest example of this equivalence. The Social Security Trust Fund is scheduled to be exhausted around the late 2030s, but from that point the program’s revenues (from the payroll tax) will be sufficient to pay something like 75 percent of currently scheduled benefits for several decades.

So, you might say, we have two ways to fix this: tax increases (either increase dedicated taxes or

take money from general revenues, which will require raising some other tax) or benefit reductions. Needless to say, most Social Security proposals, such as that put forward by the recent [deficit commission](#), largely involve benefit reductions, although they also include modest increases in the payroll tax.

Plan A would simply be to cut benefits across the board by 25 percent starting in the late 2030s, so the amount being paid out equals the amount coming in from payroll taxes. This looks like a spending cut — we’re closing the fiscal gap by reducing spending — so Republicans and moderate Democrats should like it.

What if, instead, we leave benefits exactly where they are and impose a 25 percent tax on Social Security benefits? This looks like a tax increase, where we’re closing the fiscal gap by increasing taxes, meaning “bigger government” (cue the charges of “socialism”). But this tax increase is equivalent in every way to the spending cut above; it’s just another way of framing Plan A.

If a 25 percent across-the-board benefit cut is the “conservative” solution, then the “liberal” solution, Plan B, is to increase the payroll tax by 33 percent, from 12.4 percent to about 16.5 percent.** This is harder to see as a spending cut, but for most people it is equivalent to a spending cut. We pay more during our working years and get back the same amount when we retire; since cash is cash, this is equivalent to paying the same amount while working and getting back less in retirement.

In short, both Plan A and Plan B can be broken down into two components: (1) keeping currently scheduled benefits intact and (2) increasing taxes on someone to pay for it. The difference between them has nothing to do with cutting spending or raising taxes — it has to do with whose taxes get increased.

Under Plan A, we are imposing a tax on seniors equivalent to 25 percent of their Social Security benefits. This is a regressive tax because the richer you are, the smaller Social Security is as a component of your income. We are also raising all of the revenue from seniors, so it’s a large tax increase on a small base.

Under Plan B, by contrast, we are imposing an incremental tax on all wage earners equivalent to 4.1 percent of their wages. This is still slightly regressive because of the cap on earnings subject to the payroll tax, but it’s a lot less regressive than the tax in Plan A. It’s also a small tax levied on a broad base, so it is less of a shock to individual households.***

Now, there are still valid arguments to be made in favor of Plan A. You could argue that increasing the payroll tax rate will hurt the economy because businesses won’t hire as many workers. This is true, but it’s also true that increasing taxes on seniors will hurt the economy because they will buy less. You could also argue that progressive taxes are bad and taxes should be as regressive as possible, and hence Plan A is better than Plan B. I wouldn’t agree with you, but you could argue that.

But you can’t argue that Plan A is better than Plan B because Plan A cuts spending and Plan B raises taxes. When you’re dealing strictly with cash going back and forth between households and

the government, that distinction is nonsense.

Most Social Security proposals are more complicated to think about than Plan A and Plan B because they involve changes in the full benefit age, the benefit calculation formula, the index used for cost of living adjustments, and so on. But they all can be boiled down to the following: relative to current taxes and currently scheduled benefits, who gets more cash and who gets less cash? That's all that matters — not whether they increase taxes or cut spending.

Now, Social Security is near one end of the spectrum of government programs because it deals entirely in cash. As we move toward the other end of the spectrum, “taxes” and “spending” become somewhat more meaningful concepts. At the other end of the spectrum we might have national defense, for example. If we aren't bringing in enough revenues to pay for all the toys that Congress wants the Pentagon to have (which, in one of those quirks of American politics, is generally more toys than the Pentagon says it needs), there are significant differences between raising taxes and buying fewer toys. Since I lean noninterventionist in foreign policy (although I make no claim to be an expert there), I would have a strong preference for lower taxes and fewer toys.

In areas like national security, there is a valid debate to be had about whether the increased security we buy for the marginal dollar is really worth one dollar. That debate makes sense because money is being turned into something else — and that something else is something we wouldn't necessarily buy ourselves. In Social Security, by contrast, the dollar isn't being turned into anything, so you can't have a debate about whether we're underinvesting or overinvesting in dollars, like you can about missiles. (This is a bit of a simplification, since you can debate whether we are undersaving or oversaving, so it makes sense to look at the behavioral effects of changes in Social Security. But the absolute levels of inflows and outflows are still meaningless numbers.)

The Social Security example is important because all government programs are like Social Security to some extent. Cutting spending is equivalent to increasing taxes to the extent that it forces households to buy more of whatever they used to get from the government. Medicare is the obvious example, which I'll discuss more in a future post.

* This post is largely an application of some concepts discussed in Daniel Shaviro's excellent book, *Taxes, Spending, and the U.S. Government's March Toward Bankruptcy*, which I've [mentioned before](#). He discusses the issue of Social Security “taxes” and “spending” on pages 19-22.

** Actually, the real liberal solution would be first to remove the cap on the payroll tax, which would raise most but not all of the additional revenues necessary, but I'll stick with a 33 percent increase in the payroll tax rate for simplicity.

*** You could argue that taxing workers and taxing retirees work out to the same thing, since workers now are retirees later. But that argument has two problems. First, it assumes that workers now will increase their savings enough to pay the 25 percent tax on their future retirement benefits, which flies in the face of everything we know about actual savings behavior. Second, because Social Security is itself progressive, increasing the tax rate on benefits is more regressive than

increasing the payroll tax rate on wages.

Medicare for Beginners

The Baseline Scenario » 2011 » April 4/11/11 at 8:26 AM James Kwak

By James Kwak

This isn't a post explaining how Medicare works in detail. It's a post about why Medicare matters to you.

The basic "problem" with Medicare is that its liabilities are projected to grow faster than its revenues indefinitely because health care costs are growing faster than GDP (and Medicare's revenues are a function of wages).^{*} The "solution" proposed by Paul Ryan is to convert Medicare from an insurance program, which pays most of your health care expenses, to a voucher program, which gives you a certain amount of money that you can try to use to buy health insurance. I've described the main problems with this approach [already](#): it transforms a large future government deficit into an even larger future household deficit, and on top of that it shifts risks from the government to individual households. Today I want to look at this from a different angle.

We created Medicare in the 1960s because retired people did not have another viable way of getting affordable health insurance. Medicare forces workers to pay for retirees' health insurance, but since workers become retirees someday, it's in their own interests to do so, assuming the system remains in place.

Forty-five years later, the same factor that is creating the projected Medicare deficit — health care inflation — is also making it even harder for non-working people to get affordable health insurance. On its face, this should make it even more important to preserve the basic structure of Medicare, even if it requires a higher payroll tax: you pay now, but in return you get decent health insurance later. But instead of being concerned with ordinary people — the workers who will need Medicare when they retire — the political class is concerned with the abstraction called the government deficit. Hence its overriding concern is providing cost certainty to the government, even if it means eliminating Medicare's most important feature — guaranteed insurance.^{**} In addition, the political class seems to think that cutting spending is always better than increasing taxes — even though, to some extent, the two are equivalent.

To put it another way, think about it from the perspective of someone who is working now. She may have a stable job, a good income, and decent health insurance through her employer. But someday she is going to stop working. In a world without Medicare, or one where Medicare has become a voucher system, that means she has to buy insurance on the individual market. And the most important thing about the individual market — more important than the high prices and the lousy policies — is that *no one has to sell you a health insurance policy*. If you have the wrong medical profile, you could be simply uninsurable. That's how a free market works.^{***}

This is an enormous source of financial insecurity. If you are forty years old and healthy now, you simply cannot insure yourself against the risk that you will be uninsurably unhealthy when you are sixty-five. And this is not a poverty problem. If you have a major illness, you will not be able to pay for all of your medical care without insurance unless you are truly, deeply rich; being merely affluent or “high net worth” won’t cut it. In other words, the upper-income need Medicare just as much as the poor.

So how much would you pay just for the certainty that, when you turn sixty-five, you will be insurable? How much would you pay on top of that for the certainty that your premiums will not depend on how healthy you are? How much would you pay on top of *that* to have heavily subsidized premiums when you retire (Part A is paid for by current workers and Part B is subsidized by general revenues)? Right now we pay 2.9 percent of our wage income. I would pay a lot more than that — again, because it protects me from a risk from which I cannot protect myself any other way.

That is the question that matters. I believe that if people were to understand the options, they would rather pay considerably more than 2.9 percent of their wages today to get real Medicare in the future than pay 2.9 percent of their wages today to get a voucher in the future — especially when the voucher is designed to be worth *less* than they need to buy health insurance, and there is no assurance that they will even be able to find an insurance policy that they can use the voucher on.

In short, Medicare is a great, great thing for participants, by which I mean both workers and retirees. The very factor that threatens its fiscal stability — health care inflation — makes it an even better thing for workers. Because the risk of future health care inflation (and therefore the financial risk of future bad health as well) is so much greater than it was in 1965, we should be willing to pay more to insure ourselves against that risk — especially when we have no other way of insuring ourselves.

I realize that simply raising payroll taxes periodically to compensate for health care inflation is not a complete solution. In the long run, we need to find a way to control health care costs (something, incidentally, that Medicare does better than private insurance companies today). We need more effectiveness research and, more importantly, we need incentives to push providers toward actually applying effectiveness research. (A single payer system could solve this problem, but I’m not holding my breath.) But in the meantime, the insurance component of Medicare — by which I mean not that Medicare is an insurance program, but that Medicare insures you against the risk of not being able to buy insurance — is more valuable than ever.

As Jonathan Oberlander discusses in *The Political Life of Medicare*, political elites have been primarily concerned with cost control since Medicare’s beginnings, even while the public was willing to pay more for better benefits. Today, the public should be willing to pay more to preserve Medicare’s most important benefit. Someone in Washington should be willing to take up this fight. But who?

* Medicare Part A is paid for by a dedicated 2.9 percent payroll tax. Part B is paid for by

beneficiary premiums and by general revenues, but general revenues also grow with GDP, not with health care costs.

** This is not just a Republican position. For example, Alice Rivlin co-signed an earlier version of the Ryan Plan, although she [opposes the latest version](#).

*** Things may not be quite so bad today. The Affordable Care Act (i.e., “ObamaCare”) prohibits medical underwriting and pricing of policies based on health characteristics, and it also provides subsidies for lower-income households to buy insurance. *But* — the Ryan Plan eliminates the individual mandate and the subsidies, which are the very mechanisms that make insurance affordable for people with modest incomes, such as many seniors.

Update: Here’s another way to put it. Medicare is like an insurance company that sells a unique product. You pay 2.9 percent of wages while you work. In exchange, you get a decent policy that kicks in at age 65 and covers you until you die; during that period, you only have to pay an artificially low premium as well as some cost sharing. No one else sells that policy for any price, nor should you trust any insurer that sells that policy for any price, because the only entity that could reliably deliver on such an open-ended, long-term promise is the government.

Now, Medicare is realizing that it’s not charging enough for that policy. Paul Ryan says that therefore we should scrap the whole thing. Instead, the first question to ask should be whether Medicare can raise prices. Given the fact that there is no even remotely comparable substitute available on the market, how much would you be willing to pay for it? I think most people would pay more than 2.9 percent. That should be the first option on the table.

The Vickers Commission Report On Banking

The Baseline Scenario » 2011 » April 4/11/11 at 10:14 AM Simon Johnson

By Simon Johnson

Will the Vickers Commission report on UK banking – with a preliminary report released today – have a major positive impact? Not likely in our assessment – see [today’s Daily Telegraph](#).

The fight to reform the banking system in the US and more broadly is largely over – and the bankers won. A number of sensible ideas were put forward – including on creating a resolution authority, reducing the scale and scope of big banks, and significantly increasing capital requirements. As reviewed [by Peter Boone and me in this morning’s Financial Times](#), all of these initiatives have essentially failed.

Who Wants a Voucher?

By James Kwak

In [yesterday's post](#), I compared two ways of solving the long-term Medicare deficit: (a) increasing payroll taxes and keeping Medicare's current structure or (b) keeping payroll taxes where they are and converting Medicare into a voucher program. As a person who will need health insurance in retirement, I prefer (a), but others could differ.

Today I want to ask a different question. Let's say Medicare does become a voucher program along the lines proposed by Paul Ryan. So workers pay 2.9 percent of their wages and in retirement they get a voucher. According to the [CBO](#), if you turn 65 in 2030, that voucher will pay for 32 percent of your total health care costs, including private insurance premiums and out-of-pocket expenses (see pp. 22-23). Would you rather have that deal or nothing at all?

At that point, I think a large and powerful minority of people would prefer to just get rid of what's left of left of Medicare. If you're young, why would you want to pay 2.9 percent of your wages for forty-five years in order to get back a voucher that will only cover a small fraction* of your health care costs for about twenty years? The Ryan Plan converts Medicare from an insurance program to a cash-shuffling program (you pay payroll taxes, you get back a voucher). At that point, since Medicare can't magically create value, the only thing to look at is whether you get back more cash than you put in, which depends mainly on how much money you make. If you're young and have a high income, it's pretty certain you won't get back what you put in, since your contributions are a function of your income and your benefits aren't; you would be better off investing the 2.9 percent in an index fund and using the returns to pay for health insurance in retirement.

In other words, when you convert Medicare to a voucher program, it becomes largely just a redistribution program. Low wage earners will do better than they would without the voucher program and high wage earners will do worse.

There is still a modest amount of insurance, in two forms: (1) Since you don't know for sure what your future income will be, the voucher program protects you against your income falling in the future. (2) Since the vouchers are like indexed annuities (the index is designed to be too low, but at least they pay out until you die), they protect you against living for too long. These features are similar to Social Security, and they certainly aren't worthless, so people in the middle will probably be better off with the voucher program.

But a voucher program eliminates three other types of insurance that traditional Medicare gives you: protection against (3) being medically uninsurable when you retire, (4) not being able to afford health insurance when you retire, and (5) health care inflation after you retire.** If you have a high income, there is a good chance that those are the protections you want from Medicare. High-income people aren't worried about (1) and (2), because those only affect how much cash they have to buy insurance with, and they already have a lot of cash. They are worried about (3), (4), and (5), because those affect whether they will be able to buy insurance at all.

As a result, high earners will begin asking why they should be contributing to low earners' vouchers instead of just putting the 2.9 percent in their own savings accounts to fund their own individual vouchers. Around 2024, when it becomes clear that "Medicare" is just an insufficient voucher program, Republican presidential candidates will begin campaigning on a platform of converting Medicare into individual, tax-advantaged health savings accounts. The rich will back those accounts (and they will be positioned to the poor as an "ownership opportunity") and even the redistributive part of Medicare will melt away.***

For the record, I think that even the voucher program would be better than nothing precisely because it still has a small insurance component and it still has a redistributive component. Those are good things. But a voucher program will have much less political support from the upper class than traditional Medicare has today, and that support will only weaken when people realize how insufficient the vouchers really are. At that point, "Medicare" will be just an unpopular payroll tax funding an unpopular voucher system.

Of course, this is probably part of the plan: first eliminate the parts of Medicare that matter most to people, so it becomes easier to eliminate the whole thing later.

But I would put this in a different light. The real problem today is an individual market that makes it difficult for people who are not covered by employer plans to buy decent health insurance at an affordable price. If we were to look at that problem and design a solution, would we come up with Paul Ryan's voucher program? Of course not. No one would think that would be a good idea, because it doesn't solve the real problem. The problem it does solve is current Medicare's projected fiscal deficit — which is an artifact of the way we're currently trying to solve the real problem.

If we were starting from scratch, we might have a single payer system. More likely, we would have a traditional Medicare system — just with a higher payroll tax and stricter cost controls. We would pay more than we currently pay and we would get an insurance policy that isn't as flexible as the one we currently get. But we would still be solving the real problem. The Ryan Plan doesn't even try.

* For someone entering the workforce today, the initial voucher at age sixty-seven will pay for far less than 32 percent of her health care costs — and that percentage will continue to fall — because the vouchers are indexed to the CPI, not to GDP, let alone health care inflation.

** The Affordable Care Act gives you some protection from (1) and (2), but the Ryan Plan eliminates the parts of the ACA that give you that protection. Nothing protects you from (3).

*** You might ask why this wouldn't also happen with Social Security. Well, it might. But compared to Medicare, Social Security has a couple of things in its favor (politically speaking). First, it's less progressive in two respects: payroll taxes are capped and the benefit formula is based on your contributions. So while it is redistributive, it's not *that* redistributive, which helps it maintain the support of the upper-middle class. Second, and more importantly, Medicare has gotten the reputation of being a complete fiscal basket case, which makes radical transformation possible.

Since Social Security's deficit could be solved with relatively moderate tweaking, it makes it harder to argue for radical changes.

My Medicare Deficit Solution

The Baseline Scenario » 2011 » April 4/13/11 at 3:39 PM James Kwak

By James Kwak

David Brooks, perhaps realizing that it was a bad idea to swallow a politician's PR bullet points whole, is now backpedaling. The Ryan Plan, which he [originally hailed](#) as "the most comprehensive and most courageous budget reform proposal any of us have seen in our lifetimes," now has the principal virtue of [existing](#): "Because he had the courage to take the initiative, Paul Ryan's budget plan will be the starting point for future discussions."

As I've [discussed before](#), the Ryan Plan is just one bad idea dressed up with the false precision of lots of numbers: changing Medicare from a health insurance program to a cash redistribution program that gives up on managing health care costs. Here's the key chart from the [CBO report](#):

Figure 1.

Shares of Spending on Health Care for a Typical

65-Year-Old with a Standard Health Insurance Profile

Here's how to read that chart. In 2030, under current law, a 65-year-old Medicare beneficiary's health care will cost \$60. (Obviously, this is using an index, not real dollars.) Medicare will pay \$35 and the beneficiary will pay \$25 in Part B premiums and cost sharing. Under the CBO's more likely "alternative fiscal scenario," her health care will cost \$71, of which Medicare will pay \$41. Under the Ryan plan, the same health care purchased in the private market will cost \$100; "Medicare" will give her a \$32 voucher, and she'll pay the last \$68 on her own.

The bottom line is that the Ryan Plan increases beneficiary costs more than it reduces government costs. In a weird sense, it's a bizarrely pro-government plan: it helps the government's bottom line at the expense of ordinary people.

So what should we do? Most importantly, we have to recognize that there are two separate problems, and they are not equal. The primary problem is health care inflation. The secondary problem is the long-term Medicare deficit. That's a secondary problem because it's largely a result of the primary problem.

Of these two, the Medicare deficit is the easier problem to solve: index the payroll tax to actual health care costs. This should automatically solve the Medicare deficit because as Medicare's costs go up, its funding will go up at the same rate.*

This may sound like just raising taxes whenever the government wants to spend more. But the key is that the more taxes you pay, *the more you get back*. To see this, assume for now that Medicare is a pure price taker: it has no impact on health care costs but just has to pay what the market charges. Then, if health care costs go up by 5 percent, your taxes go up by 5 percent, but the expected value of your future Medicare benefits also goes up by 5 percent. You get all the insurance benefits of traditional Medicare, but now that insurance is worth 5 percent more, so you should be willing to pay 5 percent more.**

Raising taxes can have macroeconomic effects, but *anything* that solves the Medicare deficit problem will have macroeconomic effects: any solution involves either higher revenues or lower spending. Furthermore, increasing payroll taxes in line with health care costs is no different in substance than increasing premiums for employer-sponsored plans in line with health care costs, which has been going on every year for decades.

As [commenter JD Johnson](#) said previously, the assumption that Medicare is a price taker isn't quite right because Medicare itself, as the largest insurance program in the country, has an impact on health care costs. So at the same time we should use Medicare to try to bring down system costs. But the question of bringing down overall system costs should be separated from the question of Medicare funding. And when it comes to Medicare funding, indexing the payroll tax to health care costs not only fills the budgetary gap, but it's also fair: it maintains balance between the amount you pay and the value of your benefits. And most importantly, it balances the Medicare budget without eliminating the insurance benefits of Medicare, which are crucial to its long-term political support.

The primary problem — system costs — is harder, and I don't have a better answer for that than the many health economists who have studied the problem. The first thing to point out, though, is that using Medicare to bring down system costs is exactly the approach of the Affordable Care Act — see [Ezra Klein](#) for all the details.

Robert Pear in the *Times* lists the following as some additional proposals in the air:

1. Increase the age of eligibility for Medicare to 67, from 65.
2. Charge co-payments for home health care services and laboratory tests.
3. Require beneficiaries to pay higher premiums.
4. Pay a lump sum to doctors and hospitals for all services in a course of treatment or an episode of care. The new health care law establishes a pilot program to test such "bundled payments," starting in 2013.

5. Reduce Medicare payments to health care providers in parts of the country where spending per beneficiary is much higher than the national average. (Payments could be adjusted to reflect local prices and the “health status” of beneficiaries.)
6. Require drug companies to provide additional discounts, or rebates, to Medicare for brand-name drugs bought by low-income beneficiaries.
7. Reduce Medicare payments to teaching hospitals for the cost of training doctors.

I think those are all reasonable ideas except for #1. The problem with raising the eligibility age is that it makes the primary problem *worse* by shifting 65- and 66-year-olds from Medicare back onto their employers or into the individual market. I think #4 and #5 are the best, but the others should be on the table.

At the end of the day, we’re not sure how to bring down system costs, although lots of people have good ideas. The rate of cost growth will come down someday, one way or another; it’s not possible to have an economy that is 100 percent health care. My point is that while we’re trying to slow down health care inflation, as health care becomes more expensive, it makes sense for people to pay more for benefits that are becoming more valuable at the same time. It doesn’t make sense to eliminate the insurance component of Medicare because 2.9 percent is some magical ceiling dictated by the Founding Fathers.

My post earlier this week on the equivalence of tax increases and spending cuts received a large amount of criticism from the left because the example I used for illustrative purposes was increasing the Social Security payroll tax rate instead of eliminating the cap on wages subject to the tax. And there I was just trying to illustrate a principle. So this time I’m sure many people will object to the idea of raising the Medicare payroll tax, preferring to raise taxes on the rich instead.

In some abstract sense, I would prefer to raise taxes on the rich instead. But I think we should look other places rather than Medicare to make the tax system more progressive. Medicare, like Social Security, is a progressive system even though its taxes on their own are not. Because everyone gets the same benefit, there’s already a large amount of redistribution going on; in addition, that benefit is worth more to poor people, because they are less likely to have other sources of insurance. A flat percentage tax seems like a fair way to pay for it, but more importantly it’s the way we’ve paid for it for forty-six years, so for political reasons it doesn’t seem to me worth changing. Making the payroll tax itself progressive would also reduce political support for Medicare. If we want to “tax the rich,” we should do things like converting major tax deductions like the mortgage interest deduction into refundable credits or raising the tax rates on capital gains and dividends.

* There’s also the problem of Part B, which is funded by beneficiary premiums and general revenues. In principle, I think the answer is to increase the payroll tax to cover the contribution from general revenues and use the money freed up from general revenues to reduce some other tax in a progressive way (maybe extending the EITC phase-outs to reduce the super-high marginal tax rates that hit you as your earnings increase through the phase-out range). That has the benefit of strengthening the link between Medicare’s funding and costs, which is important for indexing.

** There is a demand elasticity issue, which is that as the price of health care increases the amount

of it you want to buy may go down. I don't have a perfect solution for this because Medicare is a one-size-fits-all program. But I think it's mainly just a theoretical problem, for two reasons. First, the price elasticity of health care is very low, so the effect is small. Second, the fact is that when shopping today for an insurance plan that will cover you when you retire in the future, there is no other alternative that has a lower P and a lower Q. So given the alternatives that are actually available, forcing people to pay 5 percent more for a health care plan that's worth 5 percent more does not deprive them of some other product they could buy that better suits their preferences.

Could Goldman Sachs Fail?

The Baseline Scenario » 2011 » April 4/14/11 at 7:11 AM Simon Johnson

By Simon Johnson. [This link to MIT Sloan's website provides a partial transcript and video](#) covering the points made below.

If Goldman Sachs were to hit a hypothetical financial rock, would they be allowed to fail – to go bankrupt as did Lehman – or would they and their creditors be bailed out?

I asked this question on Sunday to four leading experts (Erik Berglof, Claudio Borio, Garry Schinasi, and Andrew Sheng) from various parts of the official sector at the Institute for New Economic Thinking (INET) Conference in Bretton Woods – and to a room full of people who are close to policy thinking both in the United States and in Europe. In both the public interactions (for which [you can review video here](#)) and private conversations later, my interpretation of what was said and not said was unambiguous: Goldman Sachs would be bailed out (again).

This is very bad news – although admittedly not at all surprising.

Why wouldn't policymakers allow Goldman Sachs to fail? The simple answer is that it is too big. Goldman's balance sheet fluctuates around \$900 billion; about 1 ½ times the size that Lehman was when it failed. All sensible proposals to reduce the size of firms like Goldman – including the Brown-Kaufman amendment to Dodd-Frank – have been defeated and regulators show no interest in tackling Goldman's size directly.

The largest financial institution we let go bankrupt post-Lehman was CIT Group, which was about an \$80 billion financial institution. Some people thought CIT should be bailed out; fortunately they did not prevail – and CIT restructured its debts in November-December 2009 without any discernible disruptive effect on the economy.

Supposedly, the Dodd-Frank financial reform legislation expanded the resolution powers of the FDIC so that it could handle the orderly wind-down of a firm like Goldman, imposing losses on creditors as appropriate – without having to go through regular corporate bankruptcy (after more than 2 years and over \$1 billion in legal fees, Lehman's debts are still not fully sorted out).

Speaking to a press conference at INET on Friday evening – which I attended – Larry Summers, former head of the National Economic Council, emphasized the importance of this resolution authority.

But the resolution authority would not be helpful in the case of Goldman Sachs because it is a global bank operating on a massive scale across borders. Such a case would require a cross-border resolution authority, meaning some form of ex ante commitment between governments. As this does not exist and will not exist in the foreseeable future, Goldman is as a practical matter essentially exempt from resolution.

For a bank like Goldman there remain the same unappealing options that existed for Lehman in September 2008 – either let them fail outright or provide some form of unsavory bailout.

The market knows this and most people – including everyone I’ve spoken to over the past year or so – regards Goldman and other big banks as implicitly backed by the full faith and credit of the US Treasury. This lowers their cost of funding, allows them to borrow more, and encourages Goldman executives – as well as the people running JP Morgan, Citigroup, and other large bank holding companies – to become even larger. No one I talked with at the INET conference even tried to persuade me to the contrary.

Given that this is the case, the only reasonable way forward is to follow the lead of Anat Admati and her colleagues in pressing hard for much higher capital requirements for Goldman and all other big banks. If they have more capital, they are more able to absorb losses – this would make both their equity and their debt safer.

Professor Admati was also at the same INET conference session (her video is on the same page) and made the case that Basel III does not go far enough in terms of requiring financial institutions to have more capital.

Claudio Borio from the Bank for International Settlements argued strongly that requiring countercyclical capital buffers – that would go up in good times and down in bad times – could help stabilize financial systems. But when pressed by Admati on the numbers, he fell back on defending the current plans, which look likely to raise capital requirements to no more than 10 percent tier one capital (a measure of banks’ equity and other loss-absorbing liabilities relative to risk-weighted assets).

Given that US financial institutions lost 7 percent of risk-weighted assets during this cycle – and next time could be even worse – the Basel III numbers are in no way reassuring. Tier one capital at the level proposed by Basel III is simply not sufficient.

Even among smart and dedicated public servants, there is a disconcerting tendency to believe bankers when the latter claim that “equity is expensive” – meaning that higher capital requirements would have a significant negative social cost, like lowering growth.

But the industry’s work on this topic – [produced by the Institute of International Finance last summer](#) – has been [completely debunked by the Admati team](#).

Intellectually speaking, the bankers have no clothes. Unfortunately, the officials in charge of making policy on this issue are still unwilling to think through the implications; capital requirements need to be much higher.

For more on the discussion at this INET session, [see this page](#).

An edited version of this material 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.

"Fiscal Conservatives" Dodge \$10 Trillion Debt

The Baseline Scenario » 2011 » April 4/20/11 at 5:44 PM Simon Johnson

By Simon Johnson. This post comprises the opening paragraphs of my column today on Bloomberg; the rest is available here: <http://www.bloomberg.com/news/2011-04-19/fiscal-conservatives-dodge-10-trillion-debt-simon-johnson.html>

Washington is filled with self-congratulation this week, with Republicans claiming that they have opened serious discussion of the U.S. budget deficit and President Barack Obama's proponents arguing that his counterblast last Wednesday will win the day.

The reality is that neither side has come to grips with the most basic of our harsh fiscal realities.

Start with the facts as provided by the nonpartisan Congressional Budget Office. Compare the CBO's budget [forecast](#) for January 2008, before the outbreak of serious financial crisis in the fall of that year, with its [latest version](#) from January 2011. The relevant line is "debt held by the public at the end of the year," meaning net federal government debt held by the private sector, which excludes government agency holdings of government debt.

In early 2008, the CBO projected that debt as a percent of gross domestic product would fall from 36.8 percent to 22.6 percent at the end of 2018. In contrast, the latest CBO forecast has debt soaring to 75.3 percent of GDP in 2018.

What caused this stunning reversal, which in dollar terms works out to a \$10 trillion swing for end-year 2018 debt, from \$5.1 trillion to \$15.8 trillion?

To read the rest of this post, [click here](#).

By Simon Johnson

On Monday Standard & Poor's [announced that its credit rating](#) for the United States was "affirmed" at AAA (the highest level possible), but that it was revising the outlook for this rating to "negative" – in this context specifically meaning "that we could lower our long-term rating on the U.S. within two years" ([p.5 of the report](#)). This news temporarily roiled equity markets around the world, although the [bond markets largely shrugged it off](#).

While S&P's statement generated considerable media attention, the economics behind their thinking is highly questionable – although, given the random nature of American politics, even this intervention may still end up having a constructive impact on the thinking of both the right and the left.

It is commendable that S&P now wants to talk about the U.S. fiscal deficit – one wonders where they were, for example, [during the debate about extending the Bush-era tax cuts at the end of last year](#).

The main problem is that S&P did not lay out even the most basic numbers or even point readers towards the nonpartisan and definitive Congressional Budget Office analysis of medium- and longer-term budget issues.^[1] This matters, because the CBO numbers definitely do not show debt exploding upwards immediately from today – if you'll take the time to look at [Table 1.1 in the latest CBO report](#), the line "debt held by the public at the end of the year" (meaning private sector holdings of federal government debt; excluding government agency holding of government debt) makes it clear – debt as a percent of GDP rises to 75.5 percent at the end of 2013 and then increases very little through 2019.

There are two serious budget issues made clear by the CBO's analysis. First, the big increase in debt in recent years has been primarily due to the financial crisis. To see this, compare the January 2011 CBO forecast (cited above) with its view from January 2008 ([see page XII, Summary Table 1](#)), before the seriousness of the banking disaster – and ensuing recession – became clear. At that point, the CBO expected federal government debt relative to GDP to reach only 22.6 percent (compare with 75.3% for the same year, 2018, from the 2011 projections.)

In other words, the financial crisis will end up causing government debt to increase by more than 50 percent of GDP over a decade. This is the major fiscal crisis of today and our likely tomorrow (for more on this, [see this column](#)).

S&P does mention this issue, but somewhat elliptically, when it says "the risks from the U.S. financial sector are higher than we considered them to be before 2008" (p.4). And S&P does put "the maximum aggregate financial sector asset impairment in a stress scenario at 34% of GDP, compared with our estimate of 26% in 2007" (p.5).

But there is no indication of where these numbers come from – and no sense that S&P is focused on the likely medium-term fiscal cost of financial disaster (as seen in the CBO numbers), as opposed to any kind of “up-front” commitment by the government (part of which would not constitute ultimate losses).

A future financial crisis, given the nature of our economy, could well cause a debt increase of more than 34% of GDP – just look at what happened this time in the US or the way in which Ireland was ruined by big banks and the relevant politicians gone mad. There is no way that the S&P’s stress scenario is sufficiently negative.

To be fair, the CBO also does not present a realistic stress or alternative scenario along these lines; this is a problem with current CBO scoring methods that needs to be addressed. The International Monetary Fund is already pressing, for example in its latest Fiscal Monitor (see [Appendix 3, particularly the web of risks shown on p.84](#)), for all countries to recognize more fully the probable future fiscal costs implied by contingent liabilities of all kinds arising from large and reckless financial sectors.^[2]

There is of course a longer run budget issue – beyond 2020 – which is mostly about healthcare costs. S&P follows the current consensus by flagging the Medicare component of this and the CBO’s own projections on this front are undoubtedly scary (see [this CBO webpage](#); or jump direct to [the document and study the picture on its front page](#)).

But the real threat to the economy is healthcare costs more broadly, not just the Medicare component. For more on this see [the analysis by James Kwak](#) (my co-author) writing about an important [letter from Doug Elmendorf \(head of the CBO\) to Congressman Paul Ryan](#) on the latter’s budget proposal. In James’s words, “The bottom line is that the Ryan Plan increases beneficiary costs more than it reduces government costs.”

The real danger to the United States economy – and to its federal budget – is that we will somehow derail growth, either by letting too big to fail banks become irresponsible again or by allowing healthcare costs to continue to rise on their current trajectory or in some other way.

It is disappointing to see S&P miss the opportunity to bring clarity to this issue. The organization still seems hampered by some of the same weak analytics that contributed to their misreading of subprime mortgages and associated derivatives.

Will their broad brush and somewhat indiscriminate warning spur politicians to sensible debate and eventual action – both with regard to the financial system dangers (the medium-term issue) or with regard to healthcare costs (the longer-term issue)?

Perhaps, but this sort of “warning” may also whip up debt hysteria of a kind that can quite easily lead to policies that quickly undermine growth.

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

[1] Disclosure: I'm on the Congressional Budget Office's Panel of Economic Advisers. This Panel meets twice a year to discuss economic forecasts. Attendance at the panel is paid.

[2] Disclosure: I attended a Fiscal Forum at the IMF last week where these issues were discussed. I was paid an honorarium.

Blog Archive

The Baseline Scenario » 2011 » April 4/24/11 at 7:17 PM James Kwak

By James Kwak

Last month a reader pointed out that many of the links in the [blog archive](#) were broken. The problem is that [Feedbooks](#), the service I was using, no longer allows you to transform RSS feeds into PDFs. I fixed the links up through April 2010, but the problem is that I no longer have an elegant way of creating new PDF archives. Basically I need something that will allow me to type in an RSS feed and will generate a PDF from that feed.

For example, this is the feed for [May 2010, in forward chronological order](#). When I type that feed URL into Chrome, I get raw XML. When I type it into Firefox, it gives me truncated versions of each post. When I type it into Safari, it gives me full posts, but in its infinite wisdom, it sorts them in reverse chronological order; the sort by date feature only allows reverse chronological. When I type it into Google Reader, I get full posts in the right order, but I lose the post dates (they are replaced by the current date). Bloglines is like Safari — it insists on reverse chronological. RSS 2 PDF only gives me post titles. FeedShow displays nothing.

If I could get any of these to work in any browser, I could just convert that to a PDF and be done. Any suggestions?

Update: To be clear, saving a web page (or anything) as a PDF is not the problem. It's trivial on a Mac (and not that hard on a PC, either). The problem is getting the full text of all the posts in the feed, in the proper order, with the proper dates, on one web page.

Allocative Efficiency for Beginners

The Baseline Scenario » 2011 » April 4/25/11 at 1:05 PM James Kwak

By James Kwak

I was catching up on some old Planet Money episodes and caught [Allen Sanderson](#) of the University of Chicago talking about how to allocate scarce resources. The first day of introductory economics, he says, there are always more students than seats. Say there are forty extra people, and he can only accept ten more into the class. He asks the class: how should the ten slots be allocated? You can easily guess the typical suggestions: by seniority, because seniors won't be able to take the class later; by merit (e.g., GPA), because better students will contribute more to the class and get more out of it; to the first ten people outside his office at 8 am the next day, since that is a proxy for desire to get in; randomly, since that's fair; and so on. Someone also invariably suggests auctioning off the slots.

This, Sanderson says, illustrates the core tradeoff of economics: fairness and efficiency. If you auction off the slots, they will go to the people to whom they are worth the most, which is best for the economy as a whole.* If we assume that taking the class will increase your lifetime productivity and therefore your lifetime earnings by some amount, then you should be willing to pay up to the present value of that increase in order to get into the class. An auction therefore ensures that the slots will go to the people whose productivity will go up the most. But of course, this isn't necessarily fair, especially when you consider that the people who will get the most out of a marginal chunk of education are often the people who have the most already.

Sanderson is quite reasonable on this topic. He says that the discipline of economics has focused almost entirely on efficiency rather than fairness because the former is more susceptible to analysis, but that there is still no way to decide what the right balance of efficiency and fairness is.

But I think the picture is still a bit more complicated. Even if we assume for a moment that allocative efficiency is the only thing we care about, it's far from clear that an auction will give it to us. If people could (a) predict their increased productivity from taking the class, (b) predict their increased lifetime earnings, (c) discount those earnings to the present (which implies knowing the proper discount rate), and (d) *borrow up to that amount of money at the risk-free rate*, then, yes, everything would work out OK. But this is clearly not the case, since then people would be bidding thousands if not tens of thousands of dollars to get into the class.

Still, you might say that people's willingness to pay for the class — even if it's just that one person is willing to pay \$60 and another is only willing to pay \$5 — is a valid proxy for the value of the class to them. So instead of thinking in terms of lifetime productivity, we're thinking of the class as a short-term consumption good, and it would provide \$60 of utility to one person and \$5 of utility to the other. (Note that we've given up the idea of maximizing the ultimately economic impact of the class.) But then we have to ask whether money is a valid proxy for utility, and at this point the chain of reasoning breaks down. My willingness to pay for various goods *might* reflect their relative utility to me, but saying that different people's willingness to pay for the same good reflects the relative utility of that good to those people is a much greater leap. Most obviously, a rich person will be willing to pay more for some goods than a poor person, even if those goods would provide more utility to the poor person. Assume for example that the rich person has a wool overcoat, the poor person has no overcoat, and the good in question is a cashmere overcoat.

This may seem obvious, but the point is that allocative efficiency in dollar terms does not translate into allocative efficiency in utility terms. The whole justification for allocating resources in dollar

terms is that it's the best available proxy for allocating resources in utility terms. That may be true, but the two are still not identical.

By the way, in practice Sanderson just lets everyone into the class, and eventually enough people drop so that there are seats for everyone.

* What you do with the auction proceeds doesn't matter, so you could just give them to charity. According to Ronald Coase, you should get the same allocative result if you distribute the slots randomly but then let people trade them among themselves. You will still get allocative efficiency, only now the distributional benefits are shared with the lucky recipients of the slots. In practice, however, this won't work because of endowment bias (the tendency to overvalue things you have and undervalue things you don't have.)

\$3 Billion Banks

The Baseline Scenario » 2011 » April 4/26/11 at 7:30 AM James Kwak

By James Kwak

Jon Macey is no friend of regulation. In 1994, he wrote a paper titled "[Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty](#)" arguing, in no uncertain terms, that the SEC was obsolete: "the market forces and exogenous technological changes catalogued in this Article* have obviated any public interest justification for the SEC that may have existed" (p. 949). This diagnosis was not confined to the SEC, either.

"The behavior of regulators in [the financial services] industry is due to exogenous economic pressures that, left alone, would result both in major changes in the structure of the financial services industry and in the need for regulation. However, these economic pressures threaten the interests of bureaucrats in administrative agencies and other interest groups by causing a diminution in demand for their services and products. In response to these threats, pressure is brought to bear for 'reforms' that will eliminate the 'disruption' caused by these market forces.

"The net result of this dynamic is as clear as it is depressing. One observes continued government intervention in the financial markets long after the need for such intervention has ceased. Such intervention stifles the incentives of entrepreneurs to devote the resources and human capital necessary to develop new financial products and to develop strategies that assist the capital formation process by helping markets operate more efficiently."

So what does Jon Macey think of big banks?

In a new Feature** in the [Yale Law Journal](#), Macey, along with James P. Holdcroft, Jr., argues that banks should be broken up into pieces no bigger than \$3 billion. According to Macey and Holdcroft, the basic problem is that the government cannot credibly commit not to bail out too-big-

to-fail banks in a crisis. Or, more precisely, the only way it can commit not to bail out TBTF banks is to break those banks up before the crisis hits. Their proposed limit is 5 percent of the FDIC Deposit Insurance Fund, which itself is 1.15 percent of total insured deposits, so the limit would work out to \$3 billion as of 2010. (Actually, that limit would apply to bank liabilities, so you could have a bank of any size you wanted, as long as the rest of its capital was equity.)

So, according to Macey and Holdcroft, the most notorious proposal of *13 Bankers* – limiting banks to 4 percent or 2 percent of GDP (about \$540 billion or \$270 billion), depending on their function – was far too timid. While we would have broken up six banks, the Macey-Holdcroft proposal would break up over two hundred.

There is no inconsistency between this proposal and Macey’s general skepticism about regulation. What he is skeptical about is the government’s ability to precisely engineer desired market outcomes. Instead, what he prefers is a simple rule that makes possible free market competition without the distorting effect of implicit government subsidies: “Our proposed approach does not require any restrictions on activities of banks or on the location of those activities of any kind. Our only restriction is on the size of financial institutions.”

Of course, the chances that the government will break big banks into \$3 billion pieces is no greater than the chances of those banks being broken into \$270 billion pieces. What Macey and Holdcroft really demonstrate is the logical outcome of a free-market approach to the financial system. What is strange, by comparison, is the bizarre alliance of pseudo-technocratic centrists and anti-government conservatives supporting today’s behemoth banks.

* I have no idea why every law review article refers to itself as an Article. As I learned it, capitalization was only for the *names* of unique things, not for any old referent to a unique thing. Obviously “this Article” refers to a unique article, but so does “this cupcake” in the sentence, “Do you want to eat this cupcake?” and we don’t capitalize “cupcake.”

** Don’t ask.

Bond Market Blackmail

The Baseline Scenario » 2011 » April 4/26/11 at 11:19 AM James Kwak

By James Kwak

Like probably most people, I have not been following the saga of Iceland and its banks’ foreign depositors, so I was grateful for [Planet Money’s podcast](#) last week on the topic. The background, as I understand it, is something like this:

1. Iceland’s banks offered high-rate savings accounts to depositors in other countries, notably the United Kingdom and the Netherlands. These accounts did not have an explicit government

guarantee.

2. In 2008, the global financial system nearly collapsed, Iceland's banks failed, and depositors got more or less wiped out.
3. Iceland, unlike Ireland, did not guarantee its banks' liabilities. It did, however, choose to bail out domestic depositors in those banks — but not foreign depositors.
4. The U.K. and the Netherlands both chose to bail out their citizens who had deposited money in Iceland's banks.
5. The U.K. and the Netherlands then tried to get the Icelandic government to pay them back. They negotiated a settlement, but that was rejected by a popular referendum in Iceland. Then they negotiated another settlement (which would have cost Iceland about \$6,000 per person), but that was also rejected.

Now, there is a legal question about whether or not Iceland has an obligation to bail out foreign depositors in its banks. Remember, there was no explicit government guarantee. The question is whether bailing out domestic but not foreign depositors is illegal discrimination under international law.* Apparently that's a close question, but it's not relevant for my purposes.

The *economic question*, as the podcast framed it, is whether paying off the U.K. and Dutch governments will help Iceland attract foreign investment in the future. They had a bond investor from Vanguard — ordinarily just about my favorite financial institution — saying that a vote against the settlement would make investors less likely to lend money to the Icelandic economy in the future.

Now, this may be true (although I doubt it). But think about what this is really saying.

Some people — largely retail investors — lent money to Iceland's banks, either deciding that the high interest rates made up for the lack of a government guarantee or not bothering to check if there was a government guarantee. They lost their money (or they would have, if their home governments hadn't bailed them out). The lesson I think people should learn from this is: **MAKE SURE THERE'S A GOVERNMENT GUARANTEE!!!!** In other words, lenders should be smarter in the future.

Vanguard Bond Guy is saying something different, however. He's essentially saying that foreign investors will only lend money to some country's *private institutions* if that country promises to bail out foreign investors should those *private institutions* fail. That's the only light in which his statement makes any sense. In the future, lenders to Icelandic institutions will only care about the chances of their future loans being paid back. Whether Iceland pays off the U.K. and the Netherlands now can only matter as a signal about Iceland's future behavior. And the only signal it could possibly send is that Iceland recognizes some hitherto nonexistent obligation to bail out its private institutions whenever they default.

This is both obnoxious and crazy. It's obnoxious for the same reason the campaign against strategic homeowner defaults is obnoxious. If you made a zero-money-down loan to someone and he walks away, it's your fault. The lesson you should learn is that you shouldn't make zero-money-down loans; you shouldn't suddenly invent some principle that people should pay debts they no longer owe when it's not in their own interests.

And it's crazy because — what does it say about capitalism? The theory of the financial markets is that they allocate capital to the places where it will be used most efficiently. If Bond Guy is right, that's not true: they allocate capital to the places where the government provides the strongest implicit guarantees. You want capital? Then your government has to bail foreign creditors out of their bad decisions. How is that good?

Now, maybe the credit markets will refuse to lend money to Icelandic companies, which would be bad for Iceland. I don't know; I don't have their phone number. But if so, then the credit markets are not doing what they are supposed to be doing, at least according to their most ardent defenders. Instead, they will be punishing Iceland for *lenders'* failure to read the terms of their contracts carefully.

* What international law? you may ask, especially since Iceland isn't (yet) a member of the EU. I don't know.

The FDIC's Resolution Problem

The Baseline Scenario » 2011 » April 4/28/11 at 9:04 AM Simon Johnson

By Simon Johnson. Links to the articles mentioned below are available here:

<http://economix.blogs.nytimes.com/2011/04/28/the-problem-with-the-f-d-i-c-s-powers/>

Under the Dodd-Frank financial reform legislation (Title II of that Act), the Federal Deposit Insurance Corporation (FDIC) is granted expanded powers to intervene and manage the closure of any failing bank or other financial institution. There are two strongly-held views of this legal authority: it substantially solves the problem of how to handle failing megabanks and therefore serves as an effective constraint on their future behavior; or it is largely irrelevant.

Both views are expressed by well-informed people at the top of regulatory structures on both sides of the Atlantic (at least in private conversations). Which is right? In terms of legal process, the resolution authority could make a difference. But as a matter of practical politics and actual business practices, it means very little for our biggest financial institutions.

On the face of it, the case that this resolution authority would help seems strong. Tim Geithner, the Treasury Secretary, has repeatedly argued that these new powers would have made a difference in the case of Lehman Brothers. And a recent assessment by the FDIC provides a more detailed account of how exactly this could have worked ("The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd Frank Act," FDIC Quarterly, Volume 5, No.2, 2011.)

According to the authors of the FDIC report, if its current powers had been in effect in early 2008, the agency could have become involved much earlier in finding alternative – i.e., non-bankruptcy related – ways to "solve" the problem that Lehman Brothers had very little capital relative to likely

losses and even less liquidity relative to what it needed as markets became turbulent.

The FDIC report lays out a series of steps that the agency could have taken, particularly around brokering a deal that would have involved selling some assets to other financial companies, such as Barclays, while also committing some funding to remove downside risk – both from buyers of assets and from those who continued to own and lend money to the operation that remained. In extremis, the FDIC argues that it could have handled any ultimate liquidation in a way that would have been less costly to the system and arguably better for creditors (who will end up getting very little through the actual court-run process.)

But there are two major problems with this analysis: it assumes away the political constraint and it ignores the most basic reality of how this kind of business operates.

At the political level, if you wish to engage in alternative or hypothetical history, you cannot ignore the presence of Hank Paulson, then Secretary of the Treasury. Mr. Paulson steadfastly refused, even in the aftermath of the near-collapse of Bear Stearns, to take any proactive or preemptive role with regard to strengthening the financial system – let alone intervening to break-up or otherwise deal firmly with a potentially vulnerable large firm.

For example, in spring 2008 the International Monetary Fund – where I was chief economist at the time – suggested ways to take advantage of the lull after the collapse of Bear Stearns to reduce downside risks for the financial system. Compared with the hypothetical variants discussed by the FDIC, our proposals were modest and did not involve winding down particular firms. Perhaps in retrospect we should have been bolder, but in any case our ideas were dismissed out of hand by the Treasury Department.

Senior Treasury officials took the view that there was no serious systemic issue and that they knew what to do if “another Bear Stearns”-type situation developed – it would be rescued by another ad hoc deal, presumably involving some sort of merger. (Bear Stearns, you may recall, was taken over by JP Morgan Chase at the 11th hour, with considerable downside protection provided by the Federal Reserve.)

Mr. Paulson was very influential given the way the previous system operates and his memoir, *On The Brink*, is candid about why: he had a direct channel to the president, he was the most senior financial sector “expert” in the administration, and he chaired the President’s Working Group on Financial Markets. Under the Dodd-Frank Act, however, he would have been even more powerful – as chair of the Financial Systemic Risk Council (FSOC) and as the person who decides whether or not to appoint the FDIC as receiver.

It is inconceivable that the FDIC could have taken any intrusive action in early 2008 without his concurrence. It is equally inconceivable that he would have agreed.

In this respect Mr. Paulson was not an outlier relative to Tim Geithner or other people who are likely to become Treasury Secretary. The operating philosophy of the US government with regard to the financial sector remains: hands-off and in favor of intervention only when absolutely necessary.

In addition, as a senior European regulator pointed out to me recently, the idea that any agency from any one country can handle a “resolution” of a global megabank in an entirely orderly fashion is quite an illusion. Similarly, the same person argued, even if we had agreement across countries on how to handle resolution when cross-border assets and liabilities are involved (which we don’t), it would be a major mistake to assume that such resolution would really be without systemic consequences.

These financial firms are very large – more than 250,000 employees in Citigroup currently, operating in 171 countries and with over 200 million clients (according to Citi’s website). The organizational structures involved are very complex – it is not uncommon to have several thousand legal entities with various kinds of interlocking relationships.

Sheila Bair, head of the FDIC, has herself pointed out that “living wills” for such complicated operations are very unlikely to be helpful (see “Bair eyes tougher rules for big banks,” Financial Times, April 18, 2011). Perhaps if the financial megafirms could be simplified, resolution would become more realistic. But any attempt at simplification from the government would need to go through the FSOC and here Treasury has a decisive influence.

And the market has no interest in pushing for simplification – anything that makes it harder to resolve a big bank, for example, will increase the probability that it will receive a “too big to fail” subsidy of some form in the downside scenario. Many equity investors like this kind of protective “put” option.

FDIC-type resolution works well for small- and medium-banks and expanding these powers could help with some situations in the future. But it would be a complete illusion to think that this solves the problems posed by the impending collapse of one or more global megabanks.

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.