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## **Government Failure by Sheldon Richman**

To hear the media pundits and presidential candidates tell it, you'd think Adam Smith had been president for the last eight years and, with a Congress full of free-market advocates, had enacted an agenda of full-blown laissez faire.

Had that been the case, we would not be in the mess we are in economically. Alas, it has not been the case.

Politicians have an obvious interest in portraying the financial turmoil as the result of a government hands-off policy. They can't very well advocate government controls if such controls are responsible for the debacle we're now living through. The pundits just don't understand economics.

But believe it or not, the problems in the financial and housing industries are not a market failure. They are a government failure.

The U.S. government has heavily regulated the financial sector since the 1930s. (Banking has been under the government's thumb at some level since the founding.) Yes, some regulations have been tweaked over the years. In 1999 — under Bill Clinton — the New Deal's Glass-Steagall Act, which had separated investment and commercial banking, was repealed. But those regulatory changes were in response to specific problems caused by the regulations themselves. Separating commercial and investment banking was an arbitrary, artificial, and unnecessary decision by government officials, and it prevented banks from having the flexibility through diversification to better serve their customers in a competitive global economy. The changes were not part of any laissez-faire program, unless President Clinton was really a secret free-market advocate.

There was no general banking deregulation during the Bush years. On the contrary, the administration proposed to revamp regulatory oversight of the government-sponsored enterprises (GSEs) known as Fannie Mae and Freddie Mac, which were key agents in a decades-long effort to subsidize the housing industry by making it easy for low-income people with bad credit to get mortgages. These privileged corporations, by underwriting mortgages with an implicit government guarantee and selling bundles of them to investors around the world, put the

financial system on shaky ground. In 2005 some Republicans tried to create an “independent” regulator to replace the one at the Department of Housing and Urban Development (HUD), but Republicans and Democrats who feared that that might rein in their beloved GSEs blocked the effort. Both sides were wrong. Fannie and Freddie did pose a threat to economic well-being — as we can see now — but new regulation wasn’t the answer. Abolition was.

At any rate, why do the pundits think Republicans deregulated in the last eight years? Because they are blinded by words. The Bush administration and Republicans *talk* about the costs of business regulation. But that is not the same as *repealing* regulations. As economist Tyler Cowen wrote in the *New York Times*, there has been

continuing heavy regulation, with a growing loss of accountability and effectiveness.... When it comes to financial regulation, for example, until the crisis of the last few months, the administration did little to alter a regulatory structure that was built over many decades. Banks continue to be governed by a hodgepodge of rules and agencies including the Office of the Comptroller of the Currency, the international Basel accords on capital standards, state authorities, the Federal Reserve and the Federal Deposit Insurance Corporation. Publicly traded banks, like other corporations, are subject to the Sarbanes-Oxley Act.

### **Regulation and intervention**

Moreover, as Cowen points out, it has been long-standing government policy to make it easier for non-creditworthy people to get mortgages: “legislation that has been on the books for years — like the Home Mortgage Disclosure Act and the Community Reinvestment Act — helped to encourage the proliferation of high-risk mortgage loans.” In fact, banks could be penalized for appearing to avoid lending money to people with poor prospects for repayment, that is, for “red-lining.” The passionate advocates of this social-welfare policy now call such bank loans “predatory lending” and condemn the banks for the practice. Damned if you lend, damned if you don’t.

For years government policy has encouraged and even required lax lending standards. As housing values increased, HUD made possible insured, no-money-down mortgages. In this environment banks did little income verification and would even lend more than 100 percent of the value of the home. What, them worry? Before the ink was dry, they would sell the dubious mortgages to Fannie, Freddie, or a bank operating in the secondary mortgage market created by the GSEs. The promise of a government bailout hovered overhead all along, destroying the natural market discipline that would have checked such recklessness. Nothing concentrates the business mind like the threat of bankruptcy. Remove that threat and, as Ayn Rand would say, it’s deuces wild. (A similar thing happened in the S&L collapse.)

The current public discussion about what went wrong is preoccupied with regulation and deregulation. But critics of the administration can't quite make up their minds about where things went wrong. First they argued that the Bush regime engaged in an orgy of deregulation. They had to drop that line, however, because, as noted, the last act of significant banking deregulation was signed by Bill Clinton in 1999. So they changed to "someone was asleep at the switch." It's a vivid metaphor, but no one has come up with an actual instance of a regulator's being asleep at whatever switch he supposedly was asleep at. So now there's a new argument, voiced by Sen. Hillary Clinton: the Bush regime failed to *anticipate* the need for a new regulatory structure in the global economy. (We might wonder why Clinton's husband is not criticized for that.) But we've seen that Bush did want a new regulatory apparatus — not that it would have helped.

The preoccupation with regulation narrowly defined distracts attention from all the other ways governments intervene in economies. Subsidies and guarantees to businesses — and government-sponsored enterprises — are as disruptive and distorting as any regulatory restriction. Yet they get scant attention. The way the pundits and politicians talk, you'd think these things were consistent with *laissez faire*. But of course they cannot be squared with the free-market philosophy. The market is a profit and *loss* system. Any government measure that socializes losses sabotages the market while creating privileges for special interests. By that test (if no other), the Bush administration has been an enemy of the free market.

### **Downsides to the bailout**

Thus the bailout for Wall Street is merely the expected denouement of all that's gone before. Instead of requiring that the troubled firms go through a normal market adjustment and even bankruptcy if necessary, the power elite has proposed that the government spend at least \$700 billion buying their bad loans. This idea has so many flaws that a short article cannot document them all. The plan would simply reinforce the principle that government won't let big businesses fail. But that is what helped produce the mess in the first place: the shifting of risk from big business to the general public. Moral hazard — inviting risky activities through guarantees — would be intensified.

The bailout would be disruptive in other ways. The government will have to borrow the money, but that means less capital for real investment. Thus the plan throws good money after bad by sustaining companies that made poor — albeit, government-induced or government-required — decisions. If the Federal Reserve monetizes the debt, the public will lose purchasing power through inflation. That would make the bailout an implicit tax and every bit as destructive as an explicit tax.

One way or another, people who were prudent will be made to suffer for those who were not.

Finally, the bailout will (1) encourage firms to wait for a government solution rather than search for a private solution that may be more onerous, and (2) create uncertainty over what the politicians will do next. The economic cleansing will be slowed or may not take place at all. The day of reckoning will be put off and will be even more painful. But if the government gets out of the way, people will undertake the activities needed to put the economy on a sound footing. The scare talk about another Great Depression is just that. A recession was turned into the Great Depression because the Smoot-Hawley tariff collapsed world trade and the Fed contracted the money supply. If those bone-headed errors are avoided, there will be no repeat of the 1930s.

The corporate state, not the free market, created the current problems. We shouldn't even think of this as a failure of the welfare state. The government's mortgage policies were indeed pushed as a social-welfare program, but, as usual, low-income people were mere pawns in a scheme to subsidize bankers, homebuilders, the real-estate profession. The solution is not more government, but the end of all regulations and business privileges.

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**This article was originally published in the December 2009 edition of *Freedom Daily*.**