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Bailing On the Bailout

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This week, Wall Street was stunned as the House of Representatives rejected a bailout crafted by Treasury Secretary Paulson. The proposal would provide $700 billion in new spending authority to allow the U.S. Treasury to purchase the assets of failing investment banks. Despite the surprise victory, taxpayers are not in the clear just yet; the administration and Congress have embarked on an aggressive arm-twisting campaign to build the majority required to pass what would be essentially the same bill. The Senate may take up the bill as early as Wednesday. Despite the frantic calls for urgency, a better approach would be a more thoughtful examination of policy options for the overleveraged financial services sector.

Such a discussion is critical, because the bill that both grassroots America and Congress rejected includes no significant reforms to correct flaws that led to the meltdown and no guarantees that the bailout will work. Government policies and a loose money supply were clearly a part of the problem as many analysts and policymakers had been warning for years. Failing to improve these policies in any attempt to bail out Wall Street is a significant disservice to taxpayers.

Proponents of the bailout claim it will restore order to the shaky financial markets by allowing the government to buy "toxic assets" from struggling banks, cleaning up their balance sheets to get credit flowing again. The theory is that the government would purchase and hold these assets until the market stabilized and then sell them back to the private sector, hopefully, at a profit.

This is an important point for taxpayers, who must bear the costs of the program. If the government actually generates earnings, the costs to the taxpayer are reduced. Given the uncertainty surrounding the toxic assets, however, no one seems to be willing to put a price tag on the bailout. As the Congressional Budget Office put it, the "net cost is likely to be substantially less than $700 billion but is more likely than not to be greater than zero." A cost estimate that spans 11 orders of magnitude is impressive even for the government.

Many of the so-called toxic assets are assets for which there are no willing buyers—at current prices. In many respects, some of these may be more aptly described as mispriced assets that might find buyers if priced correctly in the market. But the bailout may preclude this as the government becomes the primary buyer. And if the government is hoping to recapitalize the banks through a bailout, it will have to overpay for assets—that is, pay a price higher than the market believes they are worth, which has significant implications for taxpayers. It also makes it difficult for private firms to take over poorly managed assets as potential targets are propped up through government intervention.

Clearly, these are difficult times for the financial markets. Yet it is not obvious that providing the Treasury a blank check to acquire assets does anything more than push the day of reckoning further down the road. Unwinding the problem is not easy, and right-sizing the financial services sector will not be costless. Importantly, avoiding similar run-ups in the future requires vital changes in the underlying policies that govern the housing sector as well as an overall review of the financial regulatory framework to eliminate any perverse incentives that have been created. Simply adopting a new government plan to correct the old government plans is insufficient.

Finally, the distinction between causality and correlation must be considered. Many point to the tight credit markets as an indication that a bailout plan is required. Yet markets may be a victim of the uncertainty generated by government machinations over a bailout bill, with many simply delaying activities to see if Congress will provide a guaranteed buyer that will overpay for assets rather than try to sell in a market where they receive only pennies on the dollar.

America was founded on the rule of law. As with past crises, many find themselves tempted to replace the rule of law with the rule of men. Paulson, the administration, and many in Congress are taking this path, opting for a significant—and constitutionally questionable—expansion of executive power. Before adopting such sweeping new policies, it would be prudent to examine alternative approaches, and there are many that have been suggested. These run the gamut from removing or raising the FDIC cap, to relying on bankruptcy proceedings, to changes in the tax code and changes in regulatory and accounting practices. Given the magnitude of this issue, Congress should examine these options before attempting to prop up a system that is clearly broken.

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