

Embrace Your Inner Teddy Roosevelt

An economic agenda for John McCain

BY IRWIN M. STELZER

John McCain is for low taxes, rapid economic growth, and free trade. Those are the underpinnings of everything else he deems important:

- Low taxes mean individuals keep more of their own money and therefore are freer to make choices and less dependent on government;
- Rapid economic growth, one of the results of low taxes, produces the strong economy needed to fund an adequate defense and permit America to play its destined role in world affairs; economic growth also provides opportunities for self-advancement and finances programs that help the deserving poor;
- Free trade fosters efficiency at home and strengthens America's prestige and position abroad.

The senator from Arizona is presenting himself as the inheritor of Teddy Roosevelt's view that America is "a great nation, forced by the fact of its greatness into relations with the other nations of the earth, and we must behave as beseems a people with such responsibilities." For him, domestic policy is inextricably bound up with foreign policy—only a nation with a strong, growing economy is sufficiently self-confident to bear what TR called "the heavy

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responsibility" of projecting "the cause of free self-government throughout the world," and has the wherewithal to discharge that responsibility.

Add to that his admiration of Ronald Reagan's efforts to define the role of government as an institution that will "stand by our side, not ride on our back." That means a government not as wildly expansionist, expensive, and

intrusive as George W. Bush's, nor one insensitive to the problems of hardworking or disadvantaged Americans who might fall on hard times. Surely, that will prove to be an appealing alternative to what is on offer by the Obama and Clinton camps: higher taxes, unnecessarily intrusive regulation, more government involvement in health care, education, child care, financial markets, infrastructure construction, and just about every aspect of life.

But if McCain is to persuade the American people that his vision of a great nation is superior to the Democrats' vision of a nation retreating from involvement with the world, inhabited by people increasingly dependent on an expanding state, he will have to give vent to his populist, reforming instincts, and to the basic decency that prompted him to ignore the so-called Republican base, oppose the Bush tax cuts as exces-

sively favorable to the already-comfortable, and support regularizing the status of immigrants.

The decency is instinctive. I once heard him reply, off the cuff, when challenged on the subject of his refusal to deport all illegals: "First, we don't have 12 million pairs

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The candidate and his mentor in Phoenix, March 3, 2008

TIMOTHY A. CLARY / AFP / GETTY IMAGES

of handcuffs in America. Second, what are we about as a nation if we don't welcome people who come here to improve their situations by working hard?" No cost-benefit analysis. Instead, a human reaction combined with personal observation of the work ethic of the new arrivals. And, again, a modern echo of TR, who used his first State of the Union address to declare: "We need every honest and efficient immigrant . . . who brings here a strong body, a stout heart, a good head, and a resolute purpose to do his duty well in every way and to bring up his children as law-abiding and God-fearing members of the community."

It is just this combination of instinct, humanity, and personal experience on which McCain must rely in forging a domestic program that might be called populist conservatism, repositioning the Republican party as "the party of Sam's Club, not just the country club," to borrow from Minnesota governor and vice presidential possibility Tim Pawlenty. Persuading voters to sign on to such an agenda will not be easy. It is not unreasonable for Americans in danger of losing their homes, or who fear that they might be next in line for some blow to their standard of living, to be a bit frightened by McCain's correct but scary statement that "it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers." Or to wonder why sauce for the Bear Stearns goose is not sauce for the beleaguered homeowners' gander.

McCain has two basic problems. The first is organizational: how to free himself from the influence of former Texas senator Phil Gramm. I am told that McCain is grateful to Gramm for taking him under his wing in his early days in Congress, which is admirable, and intimidated by Gramm's superior knowledge of economics, which is not. Gramm, it will be recalled, sponsored the legislation that freed investment banks from much of the regulatory oversight imposed on them by the Glass-Steagall Act. The rest, as they say is history: excessive leveraging and inadequate capital (\$32 of debt piled onto every dollar of capital in the case of Bear Stearns), sloppy lending

practices, and eventual recourse to the Fed's discount window—another way of saying that the investment banks can now offload their dicey loans onto the U.S. taxpayer. Then there is the unfortunate fact that, fairly or not, Gramm's reputation as an economic seer has not been enhanced by his role as vice chairman of UBS Warburg, which sensationally wrote off \$38 billion of bad loans a few weeks ago. Gramm is the McCain campaign filter through which economic policy suggestions must pass, and his "government is not the answer" ideology means that any policy proposals that reflect the candidate's populist humanity, or a nuanced economic calculus (see below), are unlikely to survive the filtration process.

The second problem—and the more important one—is that McCain has to reconcile his free-market instincts with his capacity for indignation at the excesses that free markets seem to produce. The operative word is "seem." For it is not properly functioning markets that account for excessive executive pay, or some of the housing mess,

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A protestor outside Bear Stearns headquarters in New York

or the plight of workers displaced by free trade. It is market failure—imperfections in the market—that

are the culprits. Which means that McCain can quite comfortably propose solutions to several current economic problems, and plans for longer-term programs, without lurching into the mindless, big-government activism of a Clinton or Obama.

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Start with executive compensation, a subset of the issue of rising inequality of income distribution. Democrats find executive pay too high—which is why Obama supports an increase in the top marginal income tax rate to 39 percent from 35 percent, and a rise in the capital gains tax from 15 percent to somewhere between 20 percent and 25 percent, with exemption from that latter increase for “people with certain incomes.” His target is “those of us in the upper brackets [who] have benefited disproportionately from a globalized economy.”

McCain can allow himself his “anger” at executive compensation without descending to the politics of envy, and while remaining true to his free market principles. Rather than condemning high earnings, he can quite properly condemn the flawed process that produces some of those earnings. Free markets that reward performance are one thing; rigged compensation markets that allow the CEO’s pals on the board to approve large golden goodbyes for departing executives who have wrecked their companies, or compensate executives at levels proposed by consultants currying favor as they seek additional contracts, or backdate options so that incentives to good performance are magically converted into *de facto* guaranteed compensation, or conceal compensation levels in the legalistic jargon of reports to the SEC and shareholders—these might be how much corporate pay is set, but the process has about as much relation to free markets as Hillary Clinton’s tales have to reality, or Obama’s pastor’s sermons to racial conciliation. So the senator would be quite within traditional free-market bounds were he to aim what he calls his “capacity for anger” at such inequities and the income inequalities to which they contribute, and to call for government action to assist shareholders in bringing these boards and managers under their control.

He would be right, too, to defend the rewards that such high-flying—although recently grounded—risk-takers as private equity deal-makers earn at their trade. After all, market capitalism is all about rewarding adventurers who turn bloated companies into lean, mean, efficient machines. But McCain would be in no danger of sacrificing his free-market credentials were he to call for a reform of the system that taxes the incomes of private-equity entrepreneurs at rates below those imposed on the workers who clean their offices. And if that is a tax increase—the thing that for some reason rouses the ire of the legendary conservative “base”—he can propose equivalent reductions in other taxes, including the regressive payroll tax.

Then there is the problem created for McCain by the Bear Stearns deal, which allowed the company’s shareholders to receive \$10 per share for stock that would have been worthless in the absence of the taxpayer bailout engineered by the Fed’s Ben Bernanke and JPMorgan’s Jamie

Dimon, with the blessing of Treasury Secretary Hank Paulson. McCain agrees that the failure of Bear Stearns might have been contagious, and created chaos in the market: After all, other firms had trillions of dollars in trading relations with Bear Stearns and would have been battered by its collapse. But he told the audience of *Fox News Sunday*, “When I see greedy people like a guy cashing in millions of dollars on the backs of this Bear Stearns takeover, I get angry.” And he added in an interview with the *Wall Street Journal*, “I think it’s outrageous that someone who is the head of Bear Stearns cashes in millions and millions of dollars in stocks.”

Inconsistency? Wobbling on his free-market principles? Hardly. McCain can argue that the pain inflicted by a Bear Stearns bankruptcy would extend to innocent third parties—counterparties to Bear’s trades, workers employed by firms dependent on smoothly functioning credit markets, “the average citizen” to use McCain’s formulation. The senator can take comfort—and courage when confronting Gramm—from the fact that economists who support free markets agree that “externalities,” to use the technical term, must be factored into the calculus underlying policy decisions, and minimized. As McCain intuited, it was appropriate to risk taxpayer money to avoid a possible collapse of Bear Stearns—not because of any sympathy for its executives and shareholders, but to avoid damage to innocent bystanders. But it was not a good idea to allow Dimon to raise his original \$2-per-share offer. McCain can quite properly say that *his* Treasury secretary would not have approved paying Bear Stearns \$10-per-share, even if the stock had once sold for \$170, especially since the company’s boss was playing bridge, with his cell phone turned off, when the deal was done. Save the financial system and innocent bystanders, certainly; reward the shareholders of a firm that had taken imprudent risks, certainly not.

McCain can also comfortably support increased regulation of investment banks—a return to the pre-Gramm era. The free market principle on which he can rely is that by insuring the banks against obliteration due to foolish risk-taking, the Fed has increased the likelihood that they will engage in just that behavior. Fear of just such a phenomenon is the reason insurance companies require their homeowner-clients to install smoke alarms, lest they become careless on the grounds that “we are insured.” The Fed has created what economists call “moral hazard.” Investment banks now know that they can take dicey paper to the Fed and trade it in for cash. And they have seen Bear Stearns do just that, in the process getting paid \$10 per share for stock that would otherwise be worthless. This opens the door to a sit-

uation McCain can properly label intolerable: Losses are nationalized, while profits from risky investments remain privatized. Make a bad deal, and the taxpayer gets the bill; make a good one, and the banker keeps the profit. So why not take more and more risks in the hope of ever-higher profits?

The only reason would be that regulators will not allow it. So long as the investment bankers can successfully rattle their beggars' bowls at the Fed's door, the Fed will have to make sure that they have sufficient capital, that they are not excessively leveraged, that their internal risk-management controls are adequate—there's more, but you get the idea: Accept taxpayer cash and the regulator will be knocking on your door. As Fed auditors have already done. They are now ensconced at JPMorgan, Merrill Lynch, Morgan Stanley, and Lehman Brothers, all of whom with the possible exception of Merrill have traded some of their paper for Fed cash (Merrill won't say).

None of these steps would have upset McCain hero Teddy Roosevelt, who understood that with government privilege comes government regulation. TR recognized that "a fortune accumulated in legitimate business . . . confer[s] immense incidental benefits on others. . . . The captains of industry . . . have on the whole done great good to our people. . . . The mechanism of modern business is so delicate that extreme care must be taken not to interfere with it in a spirit of rashness or ignorance." Roosevelt nevertheless contended that business entities that are granted the privilege and protection of corporate status must be regulated—"subject to proper governmental supervision" lest these businesses commit "real and grave evils."

The danger of creating moral hazard in the business community, then, can be reduced by regulation. But the danger of creating similar incentives to bad behavior—in this case a repeat of improvident lending by banks and borrowing by homeowners—poses a more difficult problem. McCain does not want to reward what he calls "people who speculated or people who engaged in unsavory

practices" and "those who acted irresponsibly." After all, there is something offensive about bailouts that "reward people who were irresponsible at the expense of those who weren't." Would that life were so simple.

Are people who bought houses in the hope of renting them at a profit evil speculators or investors adding to the supply of available homes? Are people who bought second homes imprudent, or preparing a retirement nest?

Are people who lied to lenders on their mortgage applications to be penalized even though the lenders had access to the borrower's tax returns and chose not to check the information, instead writing NINJA mortgages (No Income, No Job or Assets)?

These questions would be irrelevant if the housing and mortgage markets functioned as well as believ-

It doesn't take long for entire neighborhoods populated by upstanding citizens to be reduced to virtual slums. Which is why it is so odd that McCain's housing plan excludes doing anything about foreclosed properties.



Foreclosed home for auction in Woodstock, Georgia

ers in free markets would hope. Were that the case, McCain's preference for a policy that relies on lenders and borrowers to renegotiate payment terms to their mutual satisfaction, and the improvident to go broke or homeless, would be well founded. But these real-world real estate markets are so riddled with imperfections that McCain should have no difficulty supporting interventions that would be unacceptable in markets unafflicted by such massive problems.

First, incentives are improperly aligned. Government interference in markets can be minimized only if we get

the incentives right. Here, we are dealing with a market in which brokers earn their livings from commissions for originating mortgages, but bear none of the risks of failure of the borrower to pay. So it should come as no surprise that many borrowers were encouraged to take out loans they had little chance of repaying.

These borrowers were beset by another type of market failure: information asymmetry. The mortgage broker or lender possessed significantly more information than the person on the other side of the transaction, the borrower, and had an incentive to misrepresent that information to the borrower, who had every incentive to believe what he or she was told. Misguided, perhaps, but not in all cases venal. Imagine what it is like for a poor person, encouraged by a bank branch opened in their neighborhood at the insistence of the U.S. government, never before confronted with a legal document, with no basis for guessing the future course of interest rates, being offered an opportunity to realize the American dream. There are some scoundrels out there, and it would be wonderful if we could separate those mangy goats from the white-as-the-driven-snow sheep. But we can't, at least not completely.

The third complication is that even if we could identify the bad guys, and do what McCain would dearly love to do—confine help to “deserving homeowners,” as he calls them—we would have made a grave error. The housing market is a classic case of one characterized by externalities. Acts by any one homeowner impose uncompensated costs (or unrewarded benefits) on another. Keep your house neatly painted and your lawn tidily mowed, and the value of your neighbors' houses goes up. Get evicted or walk away from a house because you can't afford to keep up the mortgage payments, and it will soon fall into disrepair, either because banks are notoriously inept at maintaining properties, or because the evicted family will engage in spiteful vandalism, or because thieves strip out and sell such stuff as copper plumbing and wires. Neighbors, all responsible, all up-to-date on their mortgage payments, will see the value of their properties take a dive. It doesn't take long before entire neighborhoods, although populated by upstanding citizens, are reduced to virtual slums. Which is why it is so odd that McCain's housing plan, sketched in Memphis

on Friday, specifically excludes doing anything about foreclosed properties.

When markets malfunction because incentives are misaligned, information asymmetry exists, *and* there are large externalities imposing costs on innocent bystanders, government intervention is called for: not to replace the invisible hand with the long arm of government, but to replace an atrophied hand with one capable of functioning. Mortgage brokers who misled borrowers can be prosecuted; lenders can be made to retain some of the

risk associated with any loan they make rather than securitize the entire loan and pass the risk off as part of a bundle; rating agencies can be barred from accepting fees from lenders, eager for an AAA rating for the securitized bundle of loans that they plan to peddle, or rating agencies can be required to assume some of the risk of nonpayment.

Yes, these are regulations. But of a special kind. They are aimed at making markets work better, so that further government intrusion is not necessary to protect consumers. Yes, there is a risk of creating moral hazard, or of creating government agencies that don't die a natural death when they are no longer needed. But policy-making always involves balancing competing priorities and concerns. And in the cases laid out above the greater risk is harming the innocent if we focus exclusively

on punishing the guilty.

The goal in each instance is not to abandon markets but to improve them, a goal that can also be applied to assist workers displaced by trade carried on in a market in which one of our major trading partners undervalues its currency, or to tackle global warming with taxes or other programs that force users of fossil fuels to pay the cost of the externalities they produce. John McCain was either typically candid or equally typically in a humorous, self-deprecatory mood when he said he knows little about economics. No matter. His instincts, informed by his understanding of how markets work and what to do when they malfunction, and his understanding of the benefits sound domestic policies confer on America's ability to pursue a vigorous foreign policy, allow us to hope that his advisers will let McCain be McCain, a candidate who will worry less about country club and “base” Republicans, and a bit more about the mass of Sam's Club Republicans. ♦

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