

# Visible Hands

*The surrender of free-market capitalism.*

IRWIN STELZER

**W**HEN HANK PAULSON, a successful investment banker turned Republican treasury secretary, caps his career by nationalizing two financial institutions so large that even Norman Thomas in his socialist heyday would have paused before taking them onto the government's balance sheet, and a conservative central banker agrees to bail out an insurance company to the tune of \$85 billion, you know that a fundamental change is underway. The day when that engine of capitalism, the financial market, was allowed to operate more or less unimpeded by government has passed. We are entering an era in which a high tolerance for risk is being replaced by the eager embrace of regulation, and where the overriding imperative, efficiency, has been replaced by an increasing desire for equity.

True, we have long had a Federal Reserve System that sets short-term interest rates; true, the institutions that have been nationalized—mortgage giants Freddie Mac and Fannie Mae—have always been “government-sponsored enterprises,” privately owned but with implicit federal guarantees; true, too, the government has long insured depositors at savings institutions against loss. But never before has Washington so systematically socialized the risks undertaken by the one-time masters of the universe, Wall Street's investment bankers, who until now more or less controlled the allocation of capital among its several capitalist claimants. It is not much of an exaggeration to say that capitalism as we have known it is no more, and that a New Capitalism is in the process of creation.

**‘**CAPITALISM WITHOUT failure is like religion without sin,” notes Allan Meltzer, one of the nation's most astute economists. Perhaps that was once true. But the New Capitalism has little room for the pain of failure. A host of measures have been introduced to make it easier for families delinquent in their mortgage payments to stay in their homes, an act of compassion (as some would

put it), or encouragement of profligate sinners to sin again (as the Old Capitalists would say). The Old Capitalists mourn the lost era of individual responsibility even as they acquiesce to it, for there is no support for a return to the harsher regime they favored, in which government did little to mitigate the pain of poor management, bad judgment, or just plain bad luck.

Far more significant than its new attitude toward individual failure is the New Capitalism's fear of recession. At the very first hint of an economic slowdown, Ben Bernanke, the chairman of the Federal Reserve Board—and ostensibly a conservative—eased monetary policy. He did not wait to determine whether a major downturn was brewing or for growth to turn negative. He was not willing to risk the sort of mild recession that has peppered the post-World War II period. Rather, a risk appeared, and the Fed felt it necessary to lower interest rates—never mind that such a move would drive down the dollar, and therefore drive up oil prices.

Under the Old Capitalism, the authorities in charge of monetary and fiscal policy correctly assumed that the public understood the ups and downs of the business cycle and was willing to endure the moderately bad times that often followed the very good ones. But the tolerable level of pain and risk has shrunk, so the central bankers who are supposed to ensure that our currency holds its value subordinated that goal to avoiding the pain of a bursting bubble. We may not be a nation of whiners, as Phil Gramm believes, but neither are we as tolerant of recession as we were only recently.

Nor is the New Capitalism willing to tolerate the risk of systemic upheaval. In the old days, we were, by and large, willing to let financial institutions ride the deregulation wave that affected so many industries, beginning with the successful deregulation of the airlines in 1978 and running through the electric, gas, and telephone industries thereafter. In 1999, banks were freed to expand into the securities and insurance businesses, from which they had previously been barred by the Glass-Steagall Act—

even though this increased the risk that they might fail. And, if they failed, they failed; depositors were protected. As for those consumers with funds at uninsured investment banks, the stock exchanges developed defenses like the Securities Investor Protection Corporation. No government intervention was thought necessary.

But, recently, Bernanke, Paulson, and President Bush (a long-time and vocal defender of free-market capitalism) decided that some investment banks—not banks in which ordinary folks maintain deposits—are too interconnected to fail. Let Bear Stearns go under and all of the companies with which it does business might be brought down with it. Failures of this sort were tolerable under the Old Capitalism—remember the collapse of Drexel Burnham and the downfall of its guiding genius, Mike Milken?—but now they provoke high anxiety. So the government organized a bailout, using taxpayer funds to prevent creditors of Bear Stearns from losing money, protecting the companies it did business with, and saving shareholders from a complete wipeout. Even the willingness of Paulson and others to allow Lehman Brothers to go under was based on the knowledge that the Fed and the Securities and Exchange Commission stood ready to mitigate any collateral damage.

In essence, risk has been transferred from the shareholders and creditors of the banks to the taxpayers. That risk has, in the jargon of Wall Street and the academic community, been socialized. This might not trouble left-leaning politicians, who often see government restrictions as an acceptable substitute for individual responsibility; but it is remarkable that policymakers on the right, who once fought it bitterly, are not only accepting, but actually abetting, this shift. The New Capitalism is not defined by ideology—witness Paulson working with liberal Democrat Barney Frank to develop massive new government interventions in and regulations of the mortgage markets. Instead, we seem to be approaching a new consensus.

Of course, if economic players know that the government—read, taxpayers—will bear losses resulting from their risky behavior, they will be tempted to take chances they would otherwise avoid. Run into trouble because you have lent imprudently, and you can take the bad IOUs to the Fed; issue highly leveraged instruments that impair your balance sheet, and the government will pay off some of your debt or even pump capital into your enterprise. The effect of the

government's unwillingness to tolerate threats to the financial system is to socialize losses while allowing profits to remain private, possibly spurring even more reckless behavior.

To offset this moral hazard, former opponents of government intervention are now introducing a new, more pervasive regulatory structure to control market forces. Swarms of Federal Reserve System officials are descending on what had been largely unregulated investment banks to ensure that the availability of bailouts does not prompt them to take on too much risk or too much debt. The SEC is declaring certain securities off-limits to short sellers, and state regulators are arranging the mergers of insurance companies lest coverage for certain financial risks become unavailable. There's more, but you get the idea. Under the New Capitalist regime, Wall Street is a subsidiary of Pennsylvania Avenue and Capitol Hill.

**T**HE NEW CAPITALISM has affected not only our tolerance for risk, but also our sense of the appropriate role of social justice in the free market. Never mind that free trade increases total economic welfare, and has raised more people out of poverty more quickly than at any time in recorded history. More than one billion relatively low-paid workers have entered the international labor market in the past decade, in a process that has come to be called globalization. These workers, whose wages and living standards have only begun to inch up from subsistence levels, compete directly with low-skilled workers from the United States and other developed countries. This new competition depresses wages in advanced economies, and threatens the jobs of workers who have done nothing wrong except to be in the wrong line of work at the wrong moment in economic history.

Meanwhile, the very same globalization that is sapping the real incomes of some workers is lifting the earnings of many in the managerial class, as the premium paid for their skills and education grows. A Goldman Sachs deal-maker can make millions arranging mergers among his American clients; he can make hundreds of millions arranging deals across national boundaries. A CEO of a local or national brewery can make a fine living supervising his regional or national distributors and brewmasters; a CEO of an international brewery can spread his talents over millions more in assets and thousands more employees, and demand to be compensated accordingly.

These forces alone could explain the

emergence of a dissatisfied, hard-put-upon working class. But their dissatisfaction is exacerbated by reports that something is amiss in America's boardrooms. Few begrudge Warren Buffett his billions, earned by shrewd investing, or Bill Gates his billions, earned by creating a great company that has changed the way the world works, shops, and plays. But, when CEOs wreck their companies and nevertheless stroll into the sunset and onto golf courses with hundreds of millions in bonuses, the Old Capitalism cannot survive. The voters' sense of fairness is offended so greatly that a significant government effort to redistribute wealth seems justified.

That effort, now underway, is taking three forms: a reappraisal of the efficacy of free trade; a radical revision—some dare call it "reform"—of the tax structure; and direct regulation of the lowest and the highest incomes.

The New Capitalism rejects the notion that free trade is an unambiguously good thing. Whatever else free trade has done, it has not shared its benefits in socially acceptable ways. Adam Smith teaches us the virtues of the international division of labor that free trade makes possible: "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage." But, if free trade maximizes economic efficiency, it also creates losers as well as winners. In addition to the aforementioned executives, the winners are consumers, as any stroll down the aisles of Wal-Mart will make clear. The losers are producers that cannot compete with overseas suppliers and the workers they employ.

Of course, America has always been characterized by massive job destruction and even more massive job creation, as resources move from where they are no longer needed (or are less needed) to where they are most needed: That is what keeps an economy growing. But, if that is more or less where the Old Capitalism left the matter, the New Capitalism is groping for policies to transfer some of the winners' gains to the losers (John McCain's federally funded retraining programs), or to limit the competition faced by, and the pain inflicted on, losers by instituting de facto protectionist measures (Barack Obama's insistence on labor standards that would increase the costs of our trading partners). Call those measures what you will—reductions in the gains brought by trade, or a necessary offset to the imperfections of the interna-

tional trading regime, or a moral obligation that winners have to losers—they are one way the New Capitalism rejects the distributional results of the Old.

And only one way it has set about redistributing incomes to offset perceived inequities. Henceforth, government will undertake previously unheard-of intrusions into the paneled boardrooms of corporate America, controlling the methods by which executive salaries are set. Board members, especially those serving on compensation committees, should no longer be friends of, or dependent on the good will of, the executives whose salaries they determine: They must be independent. And independent as judged by regulators. Auditors cannot build lifelong, cozy relationships with the executives and directors whose bookkeeping they are charged with reviewing; they must make way for other independent auditors after a number of years. Executive compensation must be transparent and somehow related to performance. In the case of investment banks and insurance companies that now benefit from being able to trot over to the Fed and trade in the dicey IOUs and mortgages they have on their balance sheets for hard cash, regulators are able to insist that the banks operate prudently, which gives them a say in setting executive compensation. And, horror of horrors: Executives now must attest to the accuracy of the financial statements on which they ask the public to judge their performance.

There is a risk in all of this, of course. As the great F.A. Hayek wrote, "It is questionable whether a society which will recognize no reward other than what appears to its majority as an appropriate income, and which does not regard the acquisition of a fortune in a relatively

short time as a legitimate form of remuneration for certain kinds of activities, can in the long run preserve a system of private enterprise." But it can preserve a modified private enterprise system, a New Capitalism that accepts the legitimacy of such incomes because it is satisfied that those incomes are reasonable and fair. "Unfair" may be difficult to define, but, as Justice Potter Stewart said of pornography, we know it when we see it. The New Capitalism is not rejecting high incomes; it is merely demanding that they bear a reasonable relationship to the value produced by their recipients—which is what should happen in a properly functioning economy anyway.

The New Capitalism is not only attempting to regulate incomes so that incompetent executives do not benefit from golden goodbyes when the government has to bail out the firms they have damaged. More importantly, it is elevating equity to a role co-equal with, or perhaps superior to, efficiency as a guide to policy. It might maximize efficiency for government to minimize its interference in economic affairs, which is the position of defenders of the Old Capitalism (proponents of deregulation and low taxes on high earners); and efficiency, in the form of rising productivity, is the driving force behind increasing material well-being. But man does not live by efficiency alone, at least not New Capitalist man. There is something offensive about the multimillion-dollar birthday parties that some hedge fund operators favor in an era in which middle-income families are struggling.

No matter. For whatever reason—good or bad—we are about to see equity given greater weight relative to efficiency as New Capitalists recast the tax structure

erected in the last days of the Old Capitalism. Old Capitalists worry that if the marginal tax rate on the highest earners is raised from 35 to 40 percent, the wealthy will be less inclined to invest and take risks. New Capitalists, who would distribute those funds to the middle class, think it is worth sacrificing a small bit of efficiency to gain a great deal of fairness. This is the one area in which the Old Capitalists have not capitulated, and are mounting a last-ditch effort to preserve the Bush tax cuts. They will lose, whether to a President Obama or to a Democratic Congress that will drive an only apparently reluctant President McCain back to the position that he took when first confronted with the Bush cuts: They just don't seem fair.

None of this is to say that the New Capitalism will produce material results superior to the Old Capitalism, which has, after all, greatly improved living standards and reduced poverty. Or that its new regulations, new trade regime, new tax structure, or new emphasis on fairness will satisfy those who are driving and those who are acquiescing in these changes. I have my doubts on both scores: The New Capitalists have not entirely met the burden of proof that rests on those who would change a system that has done so much to improve the lot of those fortunate enough to live under it. But there can be no doubt that the world has changed. Capitalism as we knew it even until a few years ago is no more, and we who are saddened at some of the changes had better learn how to make the New Capitalism function as well as it can, rather than curse those who have capitulated to its demands. ♦

*Irwin Stelzer is director of economic policy studies at the Hudson Institute.*