

Testimony of Mark A. Calabria, Ph.D.
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Before the
U.S. House Committee on Oversight and Government Reform

On “Institutional limitations on the efficacy of government”
Wednesday, December 3, 2013 9:30 AM
2154 Rayburn HOB

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Hearing entitled “Institutional limitations on the efficacy of government”

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Committee on Oversight and Government Reform

United States House of Representatives

Chairman Issa, Ranking Member Cummings, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Need for hearing

Let me first commend the Committee for calling today's important hearing. It is commonly the case in Washington that policy-makers spend their time almost exclusively focused on narrow technical or political questions. The starting assumption is always “something must be done” rather than “can government actually solve the problem at hand”. I view this hearing as an important opportunity to remind members that government faces several inherent institutional limitations. These limitations do not change with the party in control or personalities and competencies of political appointees. These limitations should always be considered before governmental action is taken. As we have repeatedly learned the hard way, government can do substantial harm. Doing nothing should always be an option, or rather leaving the problem to be solved by the voluntary private sector.

After beginning with a very brief overview of some of the general institutional limitations of government, I will spend the bulk of my testimony focusing on that area with which I am most familiar: financial regulation. The following institutional limitations of government are well and long recognized in the economics and political science literature. As general observations and descriptions of government, they are widely accepted among scholars, even if the degree of their importance is open to debate. Nothing in the below is meant to imply that markets are “perfect” – the choice is always among various flawed human institutions.

Limitations of Government: Lack of knowledge

All action, whether public or private, takes place in an environment of uncertainty. Just as a firm does not know ahead of time how much it can sell and at what price, we do not know *ex ante* whether government programs will achieve their objectives and if they will do so at a reasonable cost. Firms, however, can learn quickly via market signals. If excess goods remain on the shelf, this suggests prices may be too high. It can also suggest consumers are not interested in the product in question. Either way firms can engage in a repetitive interaction with consumers that usually yields important insights as to which behaviors the firm should pursue.

As many government services are not priced, or are provided by monopoly, government lacks this important feedback mechanism. Almost any free service will generate a queue. In Washington, government programs are often judged on their spending levels. Yet spending levels are an input, not an output. Spending millions (or billions or trillions) on a particular problem gives us almost no insight into whether the problem has been alleviated. Businesses can also learn by failure. If there is no consumer interest in a business’ services, that business will not last long. Yet as we’ve repeatedly witnessed government programs can continue for decades regardless of their success or failure.

Limitations of Government: Missing or Perverse Incentives

Government programs can also be undermined by the incentives facing government employees. At one extreme, if government employees value their jobs then they actually face an incentive not to solve the problem they have been tasked with. In fact they have an incentive to allow the problem to grow worse, as such would offer a justification for ever larger budgets and power. That said I do believe most federal employees try in earnest to solve the problems they are tasked with addressing. I also believe, however, that since most federal employees see their compensation having little, if any, relationship to solving the social problem in question, federal employees face fairly weak incentives relative to employees of private businesses.

There is also little incentive to avoid failure among federal employees. Whereas the employees of Lehman Brothers were rightly punished for the failure of their firm, no federal bank regulators have lost their jobs due to the numerous regulatory failings that contributed to the financial crisis. The same holds for companies such as Fannie Mae. Despite its massive failure and rescue, the employees of Fannie Mae were not fired and still enjoy compensation levels in excess of federal employees and most private sector workers. Failure is a vital method of learning in the private sector. Public policy problems are often approached as if simple “engineering” problems; whereas the reality is that the most effective way to do anything, whether public or private, is likely unknown at first. We learn via trial and error. Where failure is suppressed, learning is blunted.

While the issue of “learning” is a critical product of failure, there are also important incentive effects. For too many government employees, misconduct is overlooked and rarely punished. For instance in the recent and continuing stories on NSA spying, to my knowledge, no NSA employee has been disciplined. It is also quite rare to see law enforcement officers held accountable for violations of citizens’ basic civil liberties.

The importance of incentives is merely to state the obvious, that when doing something is costly, most people will do less of that action. When doing something is rewarded, most people will do more of that action. This fact has nothing to do with the morality, honesty or laziness of the person in question. One of the worst errors repeatedly made in Washington is to simply assume that if we have the “right” people in government, then good things will happen. All people

respond in varying degrees to incentives. While there is a case to be made about the characteristics of persons attracted to government, the powerful incentives facing governmental actors will swamp those personal characteristics.

Limitations of Government: Political Pressures

I need not remind members that political considerations can often trump policy considerations. Even if we can get the incentives correct and figure out the appropriate policy response, the political support may well be lacking for the policy in question. Just as businesses and government do not know the “right” answers ahead of time, nor does the public. Few members of the public have the time or incentive to become experts on public policy issues. What the public is likely to support or oppose is just as likely to be driven by emotion and misinformation as it is by informed debate and deliberation.

Those who do have a strong incentive to learn the details of a particular public policy are those likely to be highly impacted. I need not remind members that on any particular policy issue they are more likely to receive information from interested, but biased, parties than from those that are disinterested but objective.

An argument can certainly be made that the political process can yield results that mirror what is socially optimal. There is however a long literature in both economics and political science suggesting that this is unlikely to be the case in most instances. I would argue that anyone even remotely familiar with Washington knows that outcomes rarely match what anyone would envision as socially optimal.

Limitations of Government: Conflicting Objectives

Private firms are generally guided by a small number of objectively verifiable standards. For publicly traded companies this includes stock price. All private firms would engage in measurements of profit and loss. Measures of profit and loss would also serve as proxies for important objectives such as consumer satisfaction or loyalty. While one can of course debate both the accuracy and

adequacy of these measures, the point is that they are measurable and give private firms a clear direction of objectives.

In the case of government, conflicting objectives can leave program managers without any clear direction. Trying to achieve conflicting objectives can leave federal employees short of achieving either. Conflicting objectives also reduces government accountability. Failure to achieve one objective can always be attributed to attempts to achieve other objectives. Of course in too many instances government programs fail to achieve any of their stated objectives.

What should be our default?

As mentioned the starting assumption in Washington is almost always that government “must do something”. As governmental action is always based upon coercion or the threat of coercion, and market interactions are generally based upon voluntary mutual cooperation, I believe that if we as a society wish to minimize the use of coercion, our default setting should be to prefer private sector solutions over public, in the absence of strong, compelling evidence otherwise.

Government versus Market Regulation of Financial Markets

In what follows I will apply the above, particularly the importance of incentives, to the area of financial market regulation. Let me start off with an important clarification. I will not be making the case for self-regulation. That’s a straw-man, at best. No individual, whether a bank CEO, regulator or the President is capable of serving as a judge of their own actions. Unconstrained power generally ends badly.

What I will be making the case for is the regulation of financial companies by other market participants, as opposed to regulation by government. I will also address why the mixed option of both government and market regulation is actually worse than relying on either exclusively government or market-based regulation.

Before we move to the real world, let us begin with a simplified version. In free-market for banking services, the leverage and risk-taking of any one bank is limited by its cost of funds. The more highly leveraged, the mismanaged, or even the more fraudulently managed a bank, the higher the rate at which creditors charge to lend to said bank.

Keep in mind that cost of funding is the most crucial element of finance. The difference of even a few basis points can drive market structure, determining which firms survive and which fail. For those misbehaving firms that face a higher cost of funds, their growth and activities will be limited by this higher cost of funds.

Of course a higher cost of funds is only one element of market discipline. When creditors have substantial funds at risk in any one institution, they face a strong incentive to monitor and intervene in the management of said institution. Quite simply in a world where creditors have their own money on the line, they impose discipline; that is they regulate bank behavior. This is not simply a theoretical curiosity. One of the most robust empirical findings in financial research is the existence of market discipline when creditors are at risk. Another empirical regularity is the lack of market discipline where creditors are protected by government. This is the moral hazard created by government guarantees.

Of course creditors, as well as management, misjudge or make mistakes. Markets are not perfect. But then neither are governments. What makes the market superior at error correction are much stronger incentives facing market participants, as opposed to regulators. Creditors who have lent a bank millions, or billions, have a lot on the line. Regulators, who rarely lose their job because of a financial crisis, have little on the line.

In fact the problem facing regulators is not only weak incentives, but also perverse incentives. As an asset bubble builds, for instance, the broader public and their elected representatives, will pressure regulators not to interfere with the instant wealth creating machine that bubbles appear to be. My own experience, as staff on the Senate Banking Committee, during the growing housing bubble was a chorus of groups and individuals lauding the great wealth creation machine of homeownership. Democracy loves a bubble and whoa the regulator to dares to stand in front of one.

Regulators may also feel that speaking out against a bubble would undermine the confidence pushing said bubble. If confidence did evaporate, and the bubble burst, the regulator would be blamed. This was certainly the lesson the Fed took away from trying to pop the 1920s equities bubble. It is far easier to simply let the bubble build and move in afterwards to clean up the mess. This continues to be the policy of the Fed. Sadly this also reinforces bad behavior.

When regulators come in during a crisis and protect failing firms they stop the market process of eliminating bad behavior. As you are aware, Citibank has, for instance, been rescued four times now. Those rescues have guaranteed that its broken corporate culture will continue to infect our financial markets. Just as nature evolves, so do markets, in the absence of government keeping failed firms in existence.

This again speaks to the incentives facing regulators. While they will not lose their jobs because of a bank failure, they do suffer embarrassment and may even be over-looked for promotion. The incentive facing regulators is to either allow those firms to grow their way out of their problems or else to use taxpayer funds for a rescue of said bank.

Recent studies have found, for instance, that short-sellers, in the aggregate, identify more corporate fraud than does the SEC. Recall that such failed firms as Enron, Fannie Mae, Countrywide, WorldCom and others, were all identified as engaging in misbehavior first by market participants, not regulators.

If anything regulators have been repeatedly rewarded in the aftermath of financial crises by even more power. Probably no institution failed more in responsibilities than the Federal Reserve, yet Dodd-Frank extended the power of the Federal Reserve. If anything, the incentives facing banking regulators are to reward them after a crisis rather than punish them.

Regulators quest for stability and avoiding firm failure has lead regulators to repeatedly restrict competition, protecting incumbent firms and allowing such firms to retain monopoly profits. Today for a new bank to open it must receive approval from regulators and one of the factors which regulators use to approve or disapproval new charters is the competitive impact on incumbents.

The logic is that giving banks some monopoly power encourages them to be more risk-averse and to protect their franchise value. This logic is not without some basis in reality. However the cost of this protection is both higher costs for consumers and the protection of bad business practices that would otherwise be eliminated by competition.

Even when regulators aren't intentionally trying to reduce competition, regulatory barriers can have that impact, often causing tremendous harm. Take for instance the regulation of mortgage brokers, one group associated the financial crisis. Professor Morris Kleiner, at the Humphrey School of Public Affairs of the University of Minnesota, has found that leading up the mortgage crisis, the more stringent was a state's regulation of mortgage brokers, the higher was the rate of mortgage defaults. The lesson here is that regulation, rather than protecting the public good, creates market power, which reduces the effort of incumbent firms. We have witnessed similar results in the federal regulation of credit rating agencies.

Financial regulation is often justified because it is claimed that banks are inherently unstable. Nothing could be further from the truth. The foundation of our federal system of banking regulation, created in the progressive and New Deal periods was a reaction to widespread failures among small banks. The reason for such failures was the restrictions imposed on bank branching by states. Such restrictions reduced both geographic and scale diversification by banks. As recently as the 1990s some states continue to restrict banks to a single location. Obviously that makes said bank highly vulnerable to local economic conditions.

Countries without such restrictions have fared better during times of economic distress. For instance Canada, which suffered a similar decline in GDP during the Great Depression, did not witness one bank failure during that time, and that is despite not having a central bank or deposit insurance at that time. What it did have was a geographically diversified banking system. This is not result is not limited to Canada. Empirical studies of the period support these results across countries. More recent studies from both the IMF and World Bank also find that the more extensive a country's bank safety net, the more frequent and severe are its financial crises.

What we have essentially created in the US is a system of local monopolies, insulated from competition. That would be bad enough if it were not also impossible for politicians to resist redistributing those monopoly profits to favor constituencies, ultimately resulting in financial failures driven by politics, not economics. This is one reason why a mixed system is more unstable. Government cannot resist the temptation to redistribute the monopoly rents created by the barriers to entry it imposes.

Another reason is, as I've mentioned, the regulators incentive to cover up their own mistakes via bailouts reduces market discipline. If creditors know regulators will not allow Citibank to fail, then creditors will reduce their monitoring and disciplining of Citibank. This also creates the perverse incentive for banks to become larger and more complex in order to be perceived as Too-Big-To-Fail.

The last hundred years of banking regulation has been a continued trend of replacing market discipline with regulation. The result has been more bank failures, not less. This year marks the 100th anniversary of the Fed. We have had over twice as many bank failures in the last 100 years than we did in the 100 before the creation of the Fed. This result holds even once you control for number of banks. Even President Obama's first CEA director, Christina Romer, has found that the economy since the Fed has been no more stable than before its founding. We also witnessed those states with their own deposit insurance schemes having higher bank failures during the Great Depression.

In the absences of government provided safety nets, banks and their creditors would take off-setting precautions. We witness similar behavior in the hedge fund industry, where the typical hedge fund is leveraged two to one, whereas the typical bank is leveraged ten to one. Of course bank leverage was not so high before the creation of the federal bank safety net. In fact the closer you are to politics, the more highly leveraged an institution becomes. Freddie Mac's credit guarantee business was leveraged over 200 to 1 during the crisis. In the absence of an implied government guarantee, no company would be allowed by creditors to become so highly leveraged.

One of the rationales given for bank regulation is the possibility of contagion. That is having troubles at one bank spread to another. Let me be crystal clear. There is not one example in US banking history of a healthy, solvent bank failing due to a run. Contagion failures are the unicorns of finance. It's badly managed & insolvent banks that fail and they do not bring others down with them.

Bad policy and macroeconomic disturbances can also create bank failures. The highest year ever for bank failures, 1933 where over 4,000 banks failed, was a direct result of President Roosevelt's move to take the US off the gold standard. Like depositors in Greece today, depositors in 1933 did not wish to see their currency devalued. Recall the FDIC was created under the Banking Act of 1933, signed in June. Bank failures continued throughout that year. The FDIC was created to keep poorly run and undiversified small banks in business. As FDR, who opposed creation of the FDIC, recognized, this would create more failures not less.

I've mentioned that banks can fail in mass due to a common shock, such as currency devaluation or bursting real estate bubble. One characteristic of a stable financial system is one where the probability of failure across institutions is not highly correlated. Quite simply you want a diversity of balance sheets and business models. Regulation has generally pushed for uniformity.

Regulating all the banks, or financial institutions, the same will increase the likelihood they all fail in mass, as they will respond similarly to the same shocks, such as real estate bubbles. Given the appropriate due process and rule of law considerations, I believe US banking regulation will always push for a high degree of uniformity, ultimately turning what would be small shocks into systemic ones.

I've also set aside the question of whether regulators or politicians even know the correct regulatory scheme to implement. Of course no one knows this ex ante. One of the great advantages of markets is their superior ability to create knowledge, because they can coordinate the thinking and opinions of millions of individuals. Given the slowness of regulators to even recognize problems in the housing market, regulators clearly face severe knowledge problems, even assuming they faced appropriate incentives.

Broader lessons

This hearing is occurring in the aftermath of an unsuccessful roll-out of health care reform. While I am not an expert in health care, I believe the preceding offers a few lessons for the structuring of government programs.

First we should always ask whether government should be involved in the particular area. We should also ask ourselves what exactly is the problem we are trying to solve and what is the primary driver of the problem. For instance if the problem is that some people cannot afford a particular good, which we deem to be essential, then the most direct solution is a direct transfer of funds. The evidence is overwhelming that the market can provide health care, housing, education or any number of goods. The problem facing many households is that lack the income to purchase those goods and services. This is not a market failure.

The most important lesson is to get the incentives correct. Failure must be punished and success rewarded. That is only possible if failure and success can be readily observed. Outcomes should be measurable, observable, verifiable and should relate directly to the policy question at hand. Conflicting objectives should be avoided. For instance expanding access to health care, that is increasing demand, is in direct conflict with reducing costs.

As government lacks the feedback mechanisms of market institutions, additional checks and balances should be implemented. This is often achieved via requirements under the Administrative Procedures Act, but those requirements have often been ignored or eroded. Feedback mechanisms can sometimes be reproduced by the use of competition among agencies or service providers. Avoid monopolies. Also avoid government guarantees that result in moral hazard, that is increased risk-taking by individuals because they are not insured against the adverse outcomes of their own actions.

Let me close with a reminder. Analysis must be based upon the actual imperfect workings of real world markets. But analysis must also be grounded upon the actual imperfect workings of government. Identifying market failures is the beginning of analysis, not the end. Thank you.

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Committee on Oversight and Government Reform
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Name: Mark A Calabria

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2011. Include the source and amount of each grant or contract.

None

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

None

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2010, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

None

I certify that the above information is true and correct.

Signature:

Mark A Calabria

Date:

December 2, 2013
