Richard Posner is a circuit judge (formerly the chief judge) of the U.S. Court of Appeals (7th District), and according to an article in the *Journal of Legal Studies*, the single most cited legal scholar ever. In his spare time, he is a senior lecturer in law at the University of Chicago Law School and the co-writer of the high-profile *Uncommon Sense* blog (with Nobel Prize economist Gary Becker). Did I mention he writes books, too? *Fifty* books, by my count, on subjects ranging from antitrust to terrorism to intellectual property to the Clinton impeachment to the Supreme Court’s decision in *Bush v. Gore*. Judge Posner is a political conservative – surely America’s preeminent conservative intellectual when it comes to issues of law and economics. That makes his latest book, *A Failure of Capitalism*, especially interesting because he minces no words in labeling the crisis a “depression” and argues that more regulation of financial markets is both inevitable and desirable. Here’s a brief excerpt. — *Peter Passell*
Bailouts, easy money stimulus, a moratorium on foreclosures, and any other emergency measures taken to limit the length and severity of a depression are just damage control. And expensive damage control. The cures for depression are not worse than the sickness, but they are bad enough.

We need to begin thinking about ways of reducing the probability of another depression; most important, we need to insist on the formulation of the contingency plans that the Federal Reserve and the Treasury Department so tragically failed to formulate. We cannot just say, well, the last depression was three-quarters of a century ago so we don’t need to start worrying about heading off the next one until, say, 2080. That would not be prudent, not only because everything happens faster nowadays but also because low-probability events can occur at any time. The forces that led to the present depression do not have a memory to tell them to wait 80 years (1929-2009) before for gathering again. There were three big prevention failures this time: excessive deregulation, neglect of warning signs, and insouciance about the decline in the rate of personal savings and the safety of such savings. These are corrigible, at least to a degree.

The first two are related. The existence of multiple federal financial regulatory bodies – including the Federal Reserve, the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Housing Administration, the Federal Housing and Finance Administration, the Office of Housing Enterprise Oversight, the National Credit Union Administration, the Treasury Department and its agencies, such as the Comptroller of the Currency and the Office of Thrift Supervision, and 50 state banking and insurance commissioners – has led to a fragmentation of regulatory authority, a lack of coordination, turf wars, yawning regulatory gaps with respect to hedge funds, bank substitutes and novel financial instruments, and an inability to aggregate and analyze information about emerging problems in the financial markets.

Banks often are able by small changes in form to choose which agency to be regulated by. Consolidation of the regulatory agencies (as in Germany and the United Kingdom – and a partial consolidation was proposed by our Treasury Department in March 2008) would improve the government’s ability to regulate financial markets effectively and to spot financial crises in their incipience. An international financial regulatory authority may be necessary as well, given the interdependence of the banking systems of the different nations.

And because safe personal savings (and not just overpriced common stocks and over-mortgaged houses) are an important check against depressions, and heavy personal borrowing is a risk factor for them, consideration should perhaps be given to placing limits on credit card and mortgage credit, on easy credit generally, and on the right (which fosters over-indebtedness) to eliminate debts by
declaring bankruptcy. Other regulatory changes might be desirable, such as limiting leverage, raising credit-rating standards and changing how credit-rating agencies are compensated, forbidding proprietary trading by banks (that is, trading of their equity capital, which puts that capital at risk), adjusting reserve requirements to take more realistic account of the riskiness of banks’ capital structures, requiring greater disclosure by hedge funds and private equity funds, requiring that credit-default swaps be traded on exchanges and fully collateralized, and even resurrecting usury laws. Obviously, this is just a partial list.

But this is not the time either to reorganize or to reregulate the financial industry. The case against reorganization is the clearer: experience, as with the Department of Homeland Security, teaches that a major federal reorganization (not to mention a reorganization that would encompass both state and foreign regulation of financial intermediation as well) takes years to gel. And during those years of growing pains, the efficiency with which the mission entrusted to the reorganized entity will be performed will be lower than it was in the pre-reorganization regime. And this is apart from the fact that, in the present instance, the same small knot of senior economic officials that would design and supervise the reorganization has its hands full dealing with an economic emergency.

The case against trying to reregulate financial intermediation at this time is a bit subtler and requires me to distinguish between two senses of “regulation.” In one sense it refers to the regulatory framework – the laws that establish the powers and limits of the regulatory body. In another sense, it refers to the regulatory regime – the actual administration of the regulatory scheme, which involves the exercise by officials of discretion within the limits set by the legal framework.

“Deregulation” usually refers to changing the regulatory framework in the direction of relaxing controls over the regulated firms in order to make the market freer and more competitive. In that sense, the deregulation
movement in the financial industry was largely completed in the 1990s. But because deregulation of the regulatory framework is usually (and in this instance) incomplete, “deregulation” can also refer to changes in the regulatory regime. And in that sense deregulation continued making long strides, which turned out to be missteps, in the 2000s.

Alan Greenspan, exercising the vast discretion reposed by Congress in the Federal Reserve, decided to push interest rates down and keep them down. He and his successor also decided to use a light touch in regulating banking practices, over which the Federal Reserve also has vast discretionary control. Notably, the Fed can increase a bank’s reserve requirements (and thus constrain its ability to lend) if it determines that the bank’s capital is too risky. The Bush administration took a decidedly hands-off attitude toward the financial sector, typified by the passivity of the Securities and Exchange Commission under Christopher Cox’s chairmanship. A regime of laxity inhabited a rickety framework.

**CHANGE WE CAN BELIEVE IN**

All this will now change. But until the new, bound-to-be-activist regulatory regime (in which Fed Chairman Bernanke, though a holdover, is likely to participate willingly) has had a chance to show what it can do within the existing regulatory framework, it is premature to alter the framework.

And for the further reason that while re-regulation is likely to be administratively less complex than reorganization (just count the federal and state agencies that would have to be included in one way or another in the reorganization for it to be maximally effective), it is more challenging intellectually. There is first the extraordinary diversity and complexity of modern financial intermediation. Commercial banks conduct little more than half the financial intermediation in the American economy. If they are forced to be safe, their competitors will eat them alive. But can hedge funds, private equity funds, investment banks, and all the other non-bank banks be placed under the identical regulatory regime as commercial banks? If not, won’t the differences distort competition?

It is easier to deregulate an industry than to reregulate it. Deregulation has a built-in momentum: allow an unregulated firm to compete with a regulated one, and the regulated firm will have a convincing case that it must be deregulated so that it can compete. One ends with a competitive industry. The competitive financial-intermediation industry that deregulation has created is complex and varied. The industry cannot readily be made homogeneous, yet its heterogeneity greatly magnifies the difficulty of designing and implementing a comprehensive system of regulation.

We could, in principle anyway, restore the regulatory framework of commercial banking that existed in the 1960s. Bank capital would consist mainly of zero-interest demand deposits and federal securities and would be used mainly to make short-term commercial loans. But we know that this model of banking would not be viable if other financial intermediaries were permitted, as they are today, to offer close substitutes for bank products. Does this mean, however, that money market funds, hedge funds and all the other non-bank banks must be placed under the same regulatory controls as commercial banks? Should they, for example, be required to have reserves? To pay zero interest to the lenders of their capital? If the answer to these questions is yes, that is the end of hedge funds, of money market funds, etc. If the answer is no, it is unclear just how much reregulation of commercial banks is possible. If there is an-
other answer, it will take much thought to work out.

There is a further and very serious complication. As far as I know, no one has a clear sense of the social value of our deregulated financial industry, with its free-wheeling banks and hedge funds and private equity funds and all the rest. The profits were, until the financial crisis of last fall, enormous, but undoubtedly contained a large amount of economic rent. When A sells B stock worth $10 a share, and the next day it is worth $15, the country is not $5 richer, though B is. Obviously a stock exchange and a credit system are enormous public goods (as we are learning anew in this depression), but the value added by the vast increases in recent years in the amount of speculative trading is unclear. Until we get a clear idea of what it is, we do not know what the costs would be of adopting a 1960s-style model of the financial system, or, more realistically, taking some large steps in that direction. Reregulation, like reorganization, should wait.

Short of comprehensive reregulation, a few piecemeal reforms may be feasible and helpful. But I am afraid that the list that follows is pretty small beer.

Maybe, for example, the government should stop talking up homeownership. True, there is an argument and some evidence that homeownership creates external benefits because owners care more about the appearance of their houses and their neighborhood than absentee landlords do, and the entire neighborhood benefits. But since most ownned homes, as distinct from rented ones, are detached houses located in suburbs, homeownership promotes suburban sprawl, traffic congestion and carbon emissions.

The exemption from federal income tax of interest on residential mortgages (including home equity loans) and of real estate taxes is a heavy subsidy for homeownership. It is subsidy enough, or more than enough. There is no good argument for the government’s propagandizing for homeownership and pushing banks to make risky mortgage loans.

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**GOVERNMENT’S SAY ON PAY**

I mentioned earlier in the book that among the bubble factors were the level and structure of executive compensation. Efforts to place legal limits on compensation are bound to fail, or to be defeated by loopholes, or to cause distortions in the executive labor market and in corporate behavior. An example would be limiting bonuses to financial executives.

The fact that the banking industry paid billions of dollars in bonuses in 2008 is arousing the ignorant indignation of the press and the calculated indignation of politicians. As much as half the income of such executives consists of bonuses, and this enables a better matching of income to performance than flat salaries do. So to have eliminated all bonuses would have amounted to a 50 percent salary cut for many financial executives. The bonuses were smaller than in previous years, so there was a salary cut, and that was appropriate; it is unclear whether a greater cut would have been optimal.

Measures short of capping compensation
may be worth considering, though I cannot work up a great deal of enthusiasm for them. Initially, at least, they should be limited to executives of banks and other financial intermediaries, as that is where executive-compensation practices menace the entire economy. The effect would be to drive some financial executives (and prospective financial executives) into other fields, but that would not be a bad thing, as I explained earlier.

The biggest problem is that to be effective in reducing the likelihood of catastrophic bank failures, the limits on compensation could not be confined to CEOs and other senior officials. The actual trading decisions are made lower down in the corporate hierarchy. It is hard to see how the government could fix a salary schedule for the entire professional staff of a bank.

A simple, and I imagine an inevitable, reform would be to require corporations, both those that are publicly held (that is, their stock is traded on an exchange and the ownership of the stock is widely dispersed) and those that are privately held (otherwise the requirement will drive many publicly held firms private), to disclose the full compensation of all senior executives. This would include pension entitlements discounted to present value, health benefits, severance pay, private use of corporate facilities including airplanes, limousines and apartments, club memberships paid for by the corporation, and all other perquisites, monetized where possible and subject to public audit.

A second fairly modest reform would be to require that a substantial share of the compensation of financial executives be backloaded and tied to the corporation’s future performance. For example, a corporation might be forbidden to provide severance pay to its CEO (though it could pay a signing bonus, since that wouldn’t give an incentive to impart greater risk to the corporation) and required to pay a specified percentage of compensation in the form of restricted stock in the corporation – stock that the CEO could not sell (or redeem, in the case of a privately held corporation) for a specified number of years. Such a reform would combat the dangerous incentive of highly compensated CEOs to maximize short-term corporate profits and, to that end, to take excessive risks with the corporation’s assets.

The problem (it is the same as the problem of stock options) is that the performance of an individual employee in a large corporation,
even if he is the CEO, is unlikely to have a measurable effect on the value of the corporation's stock. An alternative that is receiving increasing attention, probably rightly so, is “clawback”: part of the employee's bonus is placed in an account, and if he or she has a bad year the account is reduced. This is an effective method of fitting pay to performance if the employee is solely or primarily responsible for specific transactions involving measurable profits or losses.

Consideration should perhaps be given to increasing the marginal income tax rate of persons who have very high incomes in order to reduce their appetite for risk-taking. Such incomes typically contain a good deal of economic rent. Think of the boxing champion who makes millions but whose next best job would be as a bouncer in a strip joint, paid the minimum wage. Taxing economic rents is efficient because it has, by definition (and in my example), minimal substitution effects. It will not deflect the taxpayer to a different occupation just because it taxes the income available to him only in his present one. An increase in income tax cannot very well be limited to financial executives – it would be like making them wear dunce caps – but I do not think there is a compelling objection to raising the marginal tax rate on all high earners. Taxes will have to be raised at some point in order to finance the anti-depression programs, and income taxes are more efficient taxes than, say, corporate taxes. The refusal or inability of the Bush administration either to raise taxes or to reduce spending caused a dangerous increase in the national debt. This is not the time to raise taxes, but we are an under-taxed nation.

The suggested measures have drawbacks. For example, in practice, progressive taxation abounds with loopholes and distorts the allocation of resources. And unless it took the form of an excess-profits tax, which would be unmanageable, it would hit indiscriminately incomes that did and incomes that did not contain substantial economic rents.

Forcing greater transparency on financial corporations by requiring them to disclose the full value of their senior executives' compensation might turn out to be a case of closing the barn door after the horses have escaped. For in the wake of the financial crisis, the debate over CEO compensation has become so heated that efforts to conceal such compensation are likely to fail. Maybe the attainment of transparency can be left to the market, aided by aggressive financial media.

About all that can be said for the measures that I have suggested may warrant consideration now, while the depression is ongoing, is that they skirt the profound and intractable issues involved in deciding whether to reregulate financial intermediation.

A further point may be worth noting. The existing regulatory protections of investors and consumers, including corporate-governance regulations designed to align executives' incentives with overall economic welfare, and the existing regulation of mortgages and other forms of credit, should not be thought of as merely investor-protection or consumer-protection measures, akin to laws against fraud. They are also macroeconomic tools, like the Federal Reserve's power to raise interest rates – a power that failed to prevent the crisis of 2008.

But the point I particularly wish to emphasize is that the President and his advisers have their hands full dealing with the depression and with a series of urgent foreign and security policy issues. It is a temptation, but would I think be a mistake, for the new administration to try to emulate Franklin Roosevelt's astonishing first hundred days. The United States fortunately is in less desperate straits today and American government and the
American economy, and specifically the American banking system, are all immensely more complex than they were in 1933. It would take years for a new system of financial regulation administered by a newly consolidated regulatory administration to shake down.

The six or eight government responses to the depression that are or soon will be under way are enough for now. Let the comprehensive structural solution await calmer days.

The failure of the economics profession to have grasped the dangers that have now produced the first U.S. depression since the 1930s is excusable. Ideology has played a role in this professional blindness, but that is unavoidable because of the difficulty of empirically testing rival theories of depression and the political significance of depressions and responses to them.

The fact that finance and macroeconomics have become separate fields with some difficulties of intercommunication may have been the inevitable result of the relentless pressure for ever-greater specialization in academic disciplines. Even the failure of officials and of most academic economists to heed the abundant warning signs of the coming crash is, if not excusable, at least readily understandable; Cassandras rarely receive a fair hearing, and for reasons that only in hindsight can be seen to be mistaken.

What is inexcusable is the failure of the Federal Reserve and other economic agencies within the federal government to have prepared contingency plans for the possibility, remote as it seemed, that a crumbling of the banking industry would set the stage for a depression. When the financial crisis hit in mid-September 2008, the government was unprepared and responded with a series of improvisations that did avert the most catastrophic imaginable consequences of the crisis but could not avert a depression.

The improvisations were bumbling, incoherent, poorly explained; the President seemed absent, so far as attending to the economy was concerned, during the critical period. Even now, four and a half months after the crisis hit, the government has no coherent plan of recovery. In the absence of such a plan, it is, or soon will be, trying everything at once – flooding the economy with money, which may not work, trying to restore output and employment by massive deficit spending, which may not work either; bailing out the banking industry – or perhaps confiscating much of it (odd how saving the industry and swallowing it are discussed in the same breath); reforming the regulatory framework, and as part of the reform perhaps consolidating the myriad agencies that have a piece of the financial regulatory pie; and relieving mortgagors of some of the burden of their mortgages. All are measures with strengths and weaknesses that cannot be gauged in advance; all suffer from having to be adopted without having been thought out in advance; some, such as regulatory reform, are overly ambitious. And doubtless there is more to come. The atmosphere is electric with proposals for economic recovery – so many that the government may lack the intellectual resources to evaluate them.

I am not a forecaster. I do not know when the recovery from this depression will begin. But if it begins tomorrow, the trillions of dollars that the government has spent to speed recovery, and the restructuring of banking and its reform that will bring in their train untold problems and uncertainties, will overhang the economy for years to come, as when an expensive treatment cures a deadly illness but leaves the patient debilitated.