Why I Oppose the Wall Street Bailout

By: Dick Armey
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This week, Congress will vote on the largest federal bailout in history—$700 billion in spending authority to purchase the troubled assets of Wall Street's major investment houses. As a free market economist I unequivocally oppose this legislation because it violates the basic working tenets of free market capitalism and individual responsibility. Equally important to me, it likely violates our Constitution and stands in direct contradiction to the founding principles of our great nation.

Granting the Treasury broad authority to buy troubled assets from private entities poses a significant threat to taxpayers and fundamentally alters the relationship between the private economy and the federal government. Despite the sweeping breadth of the proposed bailout, there is virtually nothing in the bill that addresses the underlying problems that created the housing bubble and the oversized and over-leveraged financial services sector that grew with it. Taxpayers have become Wall Street's newest financier, with little more than a promise—and a report to Congress on "regulatory modernization"—that Congress will not let this happen again.

Indeed, many proponents of the bailout have tried to put the blame for this massive government intervention squarely on the market, asserting that free market capitalism has somehow failed and the only solution is more government intervention. Yet markets do not operate in a vacuum. In fact, government institutions can have a strong – and too often corrupting – influence on markets. In the specific predicament financial markets face today, there is a long history of government actions that have led to what is most accurately described as a government, not market, failure.

Some point to "unbridled greed" as the root cause of the crisis. There are plenty of bad actors to point to, but self-interest is in the very nature of human action, a constant that cannot provide an accurate explanation of the extraordinary distortions in the housing and financial markets. Self interest does indeed drive private economic behavior and the invisible hand of the market, but it equally drives so-called "public" political action. A more serious examination of the current financial meltdown suggests government excesses, not unbridled markets, played a determinant role in today's market meltdown.

The painful readjustments in the housing market are a direct result of failed government policies that fueled the housing bubble. A political bias that favored home ownership (through the tax code and programs such as the Community Reinvestment Act, coupled with the implicit—now explicit—federal guarantee of the government-sponsored enterprises Fannie Mae and Freddie Mac) led to a housing boom fueled by loans that were often not worth the paper they were written on. At the same time, ratings agencies, under the auspices of the SEC, vouched for the quality of these loans, allowing them to be bundled into new financial instruments and sold around the world. The Federal Reserve aided and abetted these distortions with loose monetary policies that distorted price signals, artificially boosting investments in the housing sector, and ultimately throughout the financial services sector as mortgages were securitized and repackaged for sale across the globe.

Despite the publicly-voiced concerns of many of us – both in and out of government – about Fannie and Freddie, the GSEs' defenders in Congress turned a blind eye to the inherent weaknesses in the system. The financial system held together as long as housing prices continued to increase. As the housing market weakened, it became evident that the value of mortgages underlying the new financial instruments was too low to meet the necessary financial obligations. As the true market value became evident, the market for these mortgage backed securities (originated by Fannie and Freddie) dried up as investors triggered a flight to safety. Considering the fact that many of these firms were leveraged by as much as 30-to-1, the retrenchment was severe.

The large government intervention that Congress is proposing would create changes whose effects will linger long into the future. The Treasury plan would fundamentally alter the workings of the market, rewarding poorly run investment firms at the disadvantage of prudent ones, and transferring the burden of risk to the taxpayer. At the same time, the $700 billion proposal does not offer fundamental reforms required to avoid a repeat of the current problem. Congress has been reluctant to reform the government sponsored enterprises that lie at the heart of today's troubled markets, and there is little to suggest their resolve to pass the necessary reforms will increase in the wake of a bailout.

In addition to the moral hazard inherent in the proposal, the plan makes it difficult to move resources to more highly valued uses. Successful firms that may have been in a position to acquire troubled firms would no longer have a market advantage allowing them to do so; instead, entities that were struggling would now be shored up and competing on equal footing with their more efficient competitors.

The financial services sector is over-leveraged and too large. Winding this down will, indeed, impose painful costs. Congress is seeking to explicitly transfer these costs to taxpayers, who will underwrite a new government plan devised to correct the old government plans. Taxpayers are being called upon to make a significant sacrifice, with little evidence to suggest that the troubled markets will be settled. In fact, there is evidence to suggest that the latest intervention will delay the required adjustments in the financial services sector. The $700 billion intervention is just the largest, latest in a series of failed bailouts with no guarantee that the desired outcome will even be achieved.

As a Public Choice professor, I used to begin class each semester with Armey's Axiom number one: "The market is rational and the government is dumb." Those quick to call for more regulation forget the power of markets, and refuse to acknowledge government culpability in the current mess. Time and again, governments the world over have attempted to outsmart the market and the current legislation is no exception. And time after time, markets respond, toppling the best-laid government plans as they move to correctly price the underlying assets in exchange.

The difficult question each of you faces today is simply this: do you believe that the political process, having produced many of the perverse incentives that resulted in our economy's current predicament, can solve these underlying distortions by essentially doing more of the same? I believe the answer to this question is unequivocally NO.

As an elected official who took the oath of office swearing to defend and uphold the Constitution, should you today feel a greater allegiance to a President, or a political party? I believe that answer is, emphatically, NO.

This is a big vote, one likely to be studied and second-guessed for decades to come. With an understanding of the intense political pressures each of you face in this tough election year, I ask you to oppose this bailout.

Sincerely,

Dick Armey
Chairman, FreedomWorks