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Lessons Unlearned?
Who Pays for the Next Financial Collapse?

It's an old story. Come a financial collapse, somebody's got to pay to get the nation's financial house back in order. While many on Wall Street made millions losing money for their companies, every young American is now saddled with tens of thousands of dollars of additional government debt. While buyers walked away from homes when they went underwater, others who had mustered large down payments simply absorbed their losses—in some cases, wiping out years of saving. While speculators who borrowed to buy stock or real estate shrugged off debt by declaring personal or corporate bankruptcy, those who invested in their 401(k)s helplessly watched their retirement savings erode.

Real loss and suffering run through the country's financial straits, and so does a profound sense of unfairness. Once the downward spiral started, prudent investors, savers, and reasonable risk-takers got little direct government help, mainly because they were still standing. But their losses were no less real. First, the recession hit their pocketbooks and portfolios. Then many of them lost their jobs or watched friends and families lose theirs. Next, interest rates on their bank deposits fell, while fees on credit cards rose.

The crowning blow, of course, came when these model taxpayers got the honor of subsidizing the big risk-takers who got us into this mess. A Treasury Department watchdog says that taxpayers probably will never recoup tens to hundreds of billions of dollars transferred to failing companies. The Government Accountability Office released a study stating that the federal government is unlikely to recover much of the $81 billion invested in automobile companies and their related financing companies.

The apparent lesson from all of this? Irresponsibility pays. The ironic truth? Building a more vibrant economy requires fewer, not more, people playing by the "heads I win and tails you lose" rule. It means "de-leveraging" the economy: reducing the extent to which some people, through borrowing and similar efforts, can undertake unnecessarily risky gambles with others' money. This isn't easy, since at the same time we want more borrowing if it helps stimulate saving flowing to sound investment, we also want investors, financial managers, and financial institutions to exercise due prudence by having more of their own money at risk.

Why de-leverage? Recessions are less severe when more investors, risk-takers, and consumers can stand fast like dominos that don't fall once a potential crisis gets under way. This helps explain why the burst of the stock bubble in 2000 didn't lead to nearly so severe a recession: more of the losses were borne directly by those who first incurred the losses.

All this means that some unity exists behind seemingly disparate headlines about financial, corporate, and tax reform. In effect, those fights rage over who bears the costs of the next recession.

One well-publicized battle has been over opening up financial institutions' books—especially where the government makes explicit or implicit guarantees that these companies won't go under. While some officers at large financial institutions worry that regulation could stifle innovation and growth, others twist that legitimate fear into an excuse to resist reforms that would expose their freedom to gamble with our money and our guarantees.

Some of the same financial institutions that once ate our lunch also oppose stricter capital standards. But they are wrong. To protect against future collapses, we must demand that lenders keep greater reserves on hand relative to the size and riskiness of their portfolios. Similarly, we need greater ownership of banks by stockholders who would bear a larger share of the cost of failure.

Paul Krugman, among others ("Bubbles and the Banks," http://www.nytimes.com/2010/01/08/opinion/08krugman.html) looks to reforming banks to help deter future financial collapses. But the implications of financial reform extend far beyond the banks.

Across the board, individual and corporate borrowers must also put more of their own skin in the game. This means higher down payments for homes and greater collateral and equity stakes for those who flip real estate or whole corporations for quick profit. If the government continues offering new homebuyers' credits, it needs to ensure that they get added to minimum down payments, thus reducing risks of default later. And the auto industry must dump lending strategies that turn their financial arms' IOUs into public obligations whenever the economy slows and throngs of car-buyers can't pay off their loans.

Meanwhile, corporate and financial managers—just like the rest of us—need to experience risk's perils, not just its rewards. While Kenneth Feinberg, Washington's "pay czar" for bailed-out corporations, may have trouble enforcing cuts in the compensation packages of top managers, he clearly set one right example by requiring that extravagant cash bonuses be converted into incentive pay in company stock that can't be sold for years. Stockholders and mutual fund managers need to demand similar reform across the entire corporate sector.

Finally, the president and Congress—just barely getting their toes wet on this issue—need to look hard at how our tax code subsidizes borrowing so heavily and then do something about it. Any future tax reform clearly should remove the ingrained bias that favors corporate debt and discourages corporate equity.

Even then, major incentives remain for individuals and partnerships to borrow heavily—deducting interest payments while avoiding tax on gains in the value of their assets. Gaming like this leads to far too many financial transactions that make little or no real economic sense, while once again shackling everyone else with additional risks and tax burdens.

Now that a recovery is under way, some lobbyists probably hope public pressure for financial, corporate, and tax reform will subside or that the confusing technical details behind reform will weaken Congress's will to act. But, in many ways, reform is needed more than ever during a recovery, when growth requires getting savings into the hands of sound investors who can spur more growth. Without reform, there's little to prevent losses from the next recession being laid, once again, at the feet of the prudent investors, businesses, and consumers.