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FIXING IT

The Economy

Rethink taxes, revisit the home-mortgage deduction, regulate the investment banks and hedge funds.

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Discussion of how to reform the financial system is the topic du jour. And just as the technology bust and corporate scandals begat Sarbanes-Oxley (a highly detailed set of new rules that has helped reduce accounting disasters but has done little to improve financial management), the credit/housing meltdown of 2007-2008 will likely bring with it a new set of rules that will alter certain practices but do little to change the culture that spawned the mess.

The economy today faces a bunch of head winds, from the weak dollar to rising commodity prices. But perhaps the main issue it faces is a lack of faith in the financial system and in the way things work generally. Stagnant wages, rampant inequality, and bewilderment at the cock-ups on Wall Street are likely behind the surge in pessimism about the nation's direction and the economy. And while the sources of such angst are legion, it strikes me that one of the main problems in recent years has been the excess in a particular kind of reckless speculation. The technology boom of the 1990s, which engendered the same level of financial lunacy as the subprime bubble, didn't cause as much psychological and economic damage when it burst. The reason for that may be that, at least in the financial arena, the profits this time have been massively privatized while the losses have been broadly socialized.

During the orgy of debt creation, leverage, and speculation of this past decade, the benefits went overwhelmingly to a few: hedge-fund and private-equity managers and high-level financial services employees, all of whom received massive bonuses based on short-term performance. Since the housing bubble burst, however, the populace at large is largely

shouldering the cost—and not just in the form of bailouts for the mortgage industry and investment banks and eroding home values. The Federal Reserve has sought to help the financial sector recover from its self-inflicted wounds by cutting interest rates sharply. And since these reductions have come at a time of high inflation and haven't translated into lower consumer borrowing costs, they're making us all poorer. We receive less interest on our savings, pay more for imports, and generally find our dollar-based assets being debased.

The current problems in housing and credit may defy quick fixes. But as long as we're reconsidering how to manage the financial system, it's worth taking a look at a few relatively simple measures that could reduce some of the perverse incentives encouraging reckless speculation, and that mitigate the effects and broad societal costs of such activity. Here are some suggestions to that end:

• *Rethink taxes*. The compensation and tax regimes for hedge funds and private-equity funds encourage managers to shoot for the moon. The current compensation scheme allows them to receive a 2 percent management fee and 20 percent of returns they can notch in a calendar year. And the tax law allows such managers to pay an absurdly low 15 percent capital-gains tax on money they make for managing other people's money. The compensation is a matter for managers to negotiate with their clients. But the tax break for such activity is one of the least defensible loopholes out there, given: (1) the sums many managers take home, (2) the scope of our fiscal morass, and (3) the tendency for private-equity and hedge funds to jump the shark and wreak havoc in the financial systems in ways that affect the economy at large. So, let's do away with the fiction that such managers are putting their own capital at risk. Most of the players in these industries notch ordinary returns, so let's tax their earnings at ordinary income-tax rates. Believe me, they'd still do the job. In the 1990s, when capital-gains taxes and ordinary income were higher than they are today, professional investors managed just fine.

• *Revisit the home-mortgage deduction*. The home-mortgage deduction currently applies to the first $1 million of housing debt and can be used for the purchase of a second home. This proposed fix may be an example of closing the barn door after the barn has burned down to the ground. But the home-mortgage deduction is another example of a tax policy that benefits relatively few while encouraging speculation that has broader negative effects on relatively many. (Roger Lowenstein made the case against it in a

2006 *New York Times Magazine* story.) Since only a small minority of Americans actually take the deduction (because you have to itemize your deductions in order to utilize it), it makes the after-tax cost of housing cheaper for the well-off while driving up the pre-tax prices of housing for everybody. The advent of interest-only loans provided speculators with tax-efficient means of speculating in housing. And we all know how well that worked. We should consider scaling back the home-mortgage deduction so that it applies only to primary residences (do taxpayers really need to be subsidizing the purchase of summer homes in the Hamptons?) and reduce the limit. Given that the median home price in the United States is about $200,000, the ability to deduct interest on up to $1 million goes far beyond providing an incentive for middle-class homeownership.

• *Regulate the investment banks and hedge funds*. We should consider establishing capital requirements and an FDIC-like body for investment banks and hedge funds. Currently, these institutions are largely outside the purview of banking regulations. But the walls separating the different components of the system have broken down. Financial institutions have taken on obscene levels of debt in an effort to goose profits. But as we've seen, when a firm like Bear Stearns, or publicly held vehicles like Carlyle Capital, sport $32 of debt for every dollar of equity, things don't have to go too badly in order for the boat to sink. The problem: In today's hyperconnected, hyperleveraged, and hypertraded financial market, the failure of one hedge fund or one investment bank can have catastrophic systemic implications. The bailout the Federal Reserve orchestrated last month wasn't a bailout of Bear Stearns; it was a bailout of the hundreds of firms that were counterparts to Bear. If they're going to come to the Fed for help and make a claim on public assets and public credit—as Long Term Capital Management did in 1998 and Bear and other investment banks did in 2008—then they should be required to submit to capital requirements and pay into a stabilization fund that can be tapped when the next disaster strikes.

None of these measures would prevent the next bubble from forming. (To do so would require an act of genetic human engineering on a massive scale.) But each of them would help restore some sense of equilibrium and sanity to a system that is full of imbalances. Economically, politically, and socially, American taxpayers can't afford to subsidize the reckless speculation that has been cleverly disguised as investment strategies.

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