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How Big Finance Bought the Bailout Plan

By Paola Sapienza , Luigi Zingales

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Did political contributions from Wall Street torpedo efforts to save America's struggling homeowners? Weighing some new evidence.

Some 2.25 million foreclosures were filed in the United States last year and at least 1.7 million are expected in 2009. This dramatic housing crisis is at the origin of the current financial and economic woes the country is experiencing. But if you were to look at Washington, you would hardly notice.

Last February, Senator Dick Durbin (D-III.) introduced a proposal to redesign Chapter 13 in an attempt to help homeowners avoid foreclosure. In the past year, his proposal was largely ignored. In the meantime, Congress approved a \$168 billion tax cut for the first stimulus package, \$700 billion to help banks, and even held an emergency session after the election to help General Motors and Chrysler. Compare it to HOPE, the limited program for homeowners approved only in October with nominal success to date.

The change in administration does not seem to have altered the focus: \$825 billion for the new stimulus package and a new plan to commit between \$1 and 2 trillion to create an "aggregator bank" that will relieve banks of their toxic assets at taxpayers' expense. And what about the homeowners? At most, they'll get \$50 billion of the TARP leftovers. Why so much interest in helping Wall Street and so little interest in helping Main Street?

This is certainly not a reflection of the will of the American people. In a recent representative survey of 1,038 Americans, 62 percent of respondents said that the government should intervene to help homeowners who are defaulting. By contrast, 48 percent approve the government helping banks, and only 41 percent approve of the government helping GM. Even the self-declared Republicans, who vehemently oppose the bailout of GM (74 percent), are less averse to help homeowners (64 percent). Among Democrats, the percentage in favor of helping homeowners is overwhelming (80 percent), as it also is among independents (59 percent). So why do two completely opposite administrations follow the same path?

One possibility is that the government knows what is best for the economic recovery of the country. Banks -- the argument goes -- are essential to the functioning of the economy. Saving banks will allow them to continue lending, which will sustain the economy.

This is certainly true, but restructuring mortgages and avoiding unnecessary and inefficient defaults will also help

everybody. It will help the families who would otherwise lose their houses. It will help their neighbors who will not see the value of their homes depressed by a wave of foreclosures. It will help the economy, by supporting the consumption of all these families. It will also help banks, whose assets are directly and indirectly linked to the value of these mortgages. Hasn't the banking crisis started precisely from this sector? So why so little attention?

Another, more cynical explanation is that elected officials do not respond only to the will of the people, but also to political contributions. Is it just an accident that in 2008 the financial industry spent \$442.5 million in political contributions, while the automotive industry only spent \$17.3 million, and homeowners spent none?

Unfortunately, this cynical explanation finds support in a recent paper by three of our colleagues. They find that, controlling for ideology, the higher the amount of political contributions congresspeople receive from the financial industry, the more likely they are to vote for TARP. And it's not simply that representatives better predisposed toward the financial industry receive more money. In fact, political contributions did not seem to affect the vote of the 24 congressmen who retired in 2008.

This bias is no secret to the American people. In our survey, 50 percent of respondents said that former Secretary Treasury Henry Paulson was acting in the interest of Goldman Sachs, and not in that of the country. The result is a loss in the trust Americans have toward their government, their institutions, and the financial markets.

Given his campaign promise of change and the economic disaster that has resulted from Wall Street lobbying, President Obama should start with a temporary ban on banks' lobbying. Banks are using taxpayer dollars to lobby against the public interest. Second, he should drop the idea, so dear to Wall Street, of an aggregator bank and force banks' investors to bear the losses they created rather than shifting them to taxpayers. Last but not least, he should make helping homeowners his top priority – rather than just a talking point.

Yes, Obama can do it, unless Wall Street has captured him too.

*Paola Sapienza is professor at the Kellogg School of Management at Northwestern University and
and Luigi Zingales is professor at the University of Chicago's Booth School of Business.*
