Luigi Zingales, Paola Sapienza
Stop Subsidizing the Street
Bailouts hurt much-needed entrepreneurship in the banking sector.
29 April 2009

The word for “crisis” in Chinese, weiji, is written with two characters: one (wei) means danger; the other (ji) means opportunity. That’s because every crisis challenges the status quo and in so doing creates the opportunity for something new to emerge. “This process of Creative Destruction,” wrote economist Joseph Schumpeter, “is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.”

We have experienced the destruction wrought by the financial crisis. Now it’s time to focus on the opportunities it brings. The first place to look is the site of the greatest destruction: the banking sector. While finance will remain a pillar of a well-functioning economy, it’s unlikely that banking will survive for long in its current form. The current banking model is broken. Citigroup has been on the verge of failing in three of the last four downturns: this is hardly a viable business model.

Even more important is that Americans are rapidly losing trust in their banks. A survey we conducted at the end of March showed that only 29 percent of Americans trusted banks, down from 34 percent three months earlier and 42 percent a year ago. Twenty percent of respondents felt that a bank had cheated or misled them in the previous 12 months, while 10 percent had withdrawn their FDIC-insured deposits and squirreled away the cash. The word “credit,” speaking of telling etymologies, comes from the Latin credere, which means “to trust.” Trust is essential in banking, and it’s unlikely that banks can restore it. It’s always difficult to regain trust; it’s easier to start anew.

Luckily, starting anew is exactly what’s happening in the banking sector, with the launch of several start-ups with innovative ideas. They range from new ways to insure mortgages to new models of lending to reliable consumers by bypassing the current banking system. Many others, such as Lending Club and Prosper, are popping up on the Internet, letting investors, rather than credit officers, decide who is creditworthy. It’s too early to tell if these attempts will succeed, but it’s vital that they occur. Through trial and error, a new world of banking will rise from the ashes of the old one.

Should the government subsidize these efforts? In a recent New York Times column, Tom Friedman said yes, suggesting that it should dedicate a fraction of the Troubled Asset Relief Program (TARP) money to promote innovation. Fortunately, several venture capitalists have rejected the idea online, and with good reason: the government’s record as a venture capitalist is rather poor. Nevertheless, the government can foster the new and innovative in a crucial way: by ceasing to subsidize the banking dinosaurs. The evidence shows that subsidies to failing companies not only waste resources in keeping obsolete and inefficient firms alive, but also delay the entry of new and more efficient organizational models.

TARP was sold as a way to keep credit flowing. It failed miserably at that task, and it has also delayed the success of new ventures that could help revive credit in the economy. For finance to begin allocating resources efficiently again, the government must stop propping up Wall Street.

Paola Sapienza is an associate professor of finance and the Zell Center Faculty Fellow at Northwestern University. Luigi Zingales is the Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business and the author of Saving Capitalism from Capitalists.