The New York Times



**August 3, 2009**

**OP-ED COLUMNIST**

# Rewarding Bad Actors

**By PAUL KRUGMAN**

Americans are angry at Wall Street, and rightly so. First the financial industry plunged us into economic crisis, then it was bailed out at taxpayer expense. And now, with the economy still deeply depressed, the industry is paying itself gigantic bonuses. If you aren't outraged, you haven't been paying attention.

But crashing the economy and fleecing the taxpayer aren't Wall Street's only sins. Even before the crisis and the bailouts, many financial-industry high-fliers made fortunes through activities that were worthless if not destructive from a social point of view.

And they're still at it. Consider two recent news stories.

One involves the rise of high-speed trading: some institutions, including Goldman Sachs, have been using superfast computers to get the jump on other investors, buying or selling stocks a tiny fraction of a second before anyone else can react. Profits from high-frequency trading are one reason Goldman is earning record profits and likely to pay record bonuses.

On a seemingly different front, Sunday's Times reported on the case of Andrew J. Hall, who leads an arm of Citigroup that speculates on oil and other commodities. His operation has made a lot of money recently, and according to his contract Mr. Hall is owed $100 million.

What do these stories have in common?

The politically salient answer, for now at least, is that in both cases we're looking at huge payouts by firms that were major recipients of federal aid. Citi has received around $45 billion from taxpayers; Goldman has repaid the $10 billion it received in direct aid, but it has benefited enormously both from federal guarantees and from bailouts of other financial institutions. What are taxpayers supposed to think when these welfare cases cut nine-figure paychecks?

But suppose we grant that both Goldman and Mr. Hall are very good at what they do, and might have earned huge profits even without all that aid. Even so, what they do is bad for America.

Just to be clear: financial speculation can serve a useful purpose. It's good, for example, that futures markets provide an incentive to stockpile heating oil before the weather gets cold and stockpile gasoline ahead of the summer driving season.

But speculation based on information not available to the public at large is a very different matter. As the U.C.L.A. economist Jack Hirshleifer showed back in 1971, such speculation often combines "private profitability” with “social uselessness.”

It’s hard to imagine a better illustration than high-frequency trading. The stock market is supposed to allocate capital to its most productive uses, for example by helping companies with good ideas raise money. But it’s hard to see how traders who place their orders one-thirtieth of a second faster than anyone else do anything to improve that social function.

What about Mr. Hall? The Times report suggests that he makes money mainly by outsmarting other investors, rather than by directing resources to where they’re needed. Again, it’s hard to see the social value of what he does.

And there’s a good case that such activities are actually harmful. For example, high-frequency trading probably degrades the stock market’s function, because it’s a kind of tax on investors who lack access to those superfast computers — which means that the money Goldman spends on those computers has a negative effect on national wealth. As the great Stanford economist Kenneth Arrow put it in 1973, speculation based on private information imposes a “double social loss”: it uses up resources and undermines markets.

Now, you might be tempted to dismiss destructive speculation as a minor issue — and 30 years ago you would have been right. Since then, however, high finance — securities and commodity trading, as opposed to run-of-the-mill banking — has become a vastly more important part of our economy, increasing its share of G.D.P. by a factor of six. And soaring incomes in the financial industry have played a large role in sharply rising income inequality.

What should be done? Last week the House passed a bill setting rules for pay packages at a wide range of financial institutions. That would be a step in the right direction. But it really should be accompanied by much broader regulation of financial practices — and, I would argue, by higher tax rates on supersized incomes.

Unfortunately, the House measure is opposed by the Obama administration, which still seems to operate on the principle that what’s good for Wall Street is good for America.

Neither the administration, nor our political system in general, is ready to face up to the fact that we’ve become a society in which the big bucks go to bad actors, a society that lavishly rewards those who make us poorer.