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It's the Economy, Stupid: Rudy Giuliani, the Wall Street Prosecutions, and the Recession of 1990–91

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Almost anyone who was of age and living in the United States during the 1980s will remember that it was given the moniker of "Decade of Greed." As the story went, Ronald Reagan was president of the United States, the Republicans controlled the U.S. Senate for six years, and a "pro-business" administration permitted businesses—and especially Wall Street—to run roughshod over the regulatory process and engage in financial excesses that amounted to, as Stein (1992) put it, an attempt to "bilk the nation." In the post-Enron era, federal prosecutors seem bent on criminalizing business failures; during the 1980s, however, the business successes were the target of criminal investigations and charges.

Ehrenreich (1990) declared the 1980s to be the "worst years of our lives," and politicians denounced the frenzied atmosphere that accompanied the wave of mergers, startups, restructuring and the like that served as the symbol of that time. As the conventional wisdom tells us, the "Decade of Greed" was severely weakened by the stock market crash of October, 1987, and finally collapsed with the recession and anemic recovery that followed, sweeping Bill Clinton into the presidency in 1992 under the slogan, "It's the economy, stupid."

Ironically, the symbol of that era was not a Republican at all, but a liberal Democrat named Michael Milken, the star trader for the investment banking firm Drexel Burnham Lambert. Writes Scott (2002):

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> Drexel Burnham Lambert was the most successful Wall-Street investment bank in the 1980s. It earned the highest annual profits of any Wall-Street firm: $545.5 million in 1986, a record that stands today. In 1987 its star trader Michael Milken earned a whopping $550 million, a feat only rivaled a decade later by the dot-com millionaires of the 1990s. (p. 2)

Indeed, when then-U.S. Attorney Rudolph Giuliani secured a criminal indictment against Milken in 1989, he made sure that Milken's earnings of 1987 were prominently displayed. What was considered to be success in 1987 was considered an act of criminality two years later, if a federal grand jury is to be believed. In 1990, Milken pled guilty to six felony charges, none of the acts with which he was charged having been considered criminal in the past, according to Fischel (1995). He originally was sentenced to 10 years in prison, but the sentence subsequently was shortened to about two years. In the public eye, it seemed to be an open-and-shut case: the crusading federal prosecutor who wanted to "clean up" Wall Street was able to bring down a "financial crook" and establish honest markets again, and while Milken had his defenders in George Gilder (1989), Fischel, Jesse Kornbluth (1992), Gordon Crovitz of the *Wall Street Journal* editorial page, and Murray Rothbard (1995), the consensus seems to be that Milken was the villain and Giuliani was the hero who was able to ride the wave of popularity from the Milken prosecutions into the mayor's office of New York City and perhaps beyond to higher political office.

The supposed excesses of the "Decade of Greed" and the economic downturn that characterized the early 1990s are not linked in the literature. Indeed, if there is any linkage at all, it has been made by writers like Stein who blame Milken for the collapse of numerous savings and loan institutions and other businesses, describing it as "the devastation left in the path of Hurricane Michael" (Stein 1992, p. 19). Likewise, Stewart (1992) attempts to pin the high unemployment and business failures of the early 1990s on Milken and his operations with Drexel Burnham Lambert. The federal government alleged many of the same things in a series of lawsuits following the S&L debacle.

Likewise, there is literature on the recession that began in July 1990, according to the National Bureau of Economic Research, and continued until March 1991. The sluggish economy, however, lasted well past the 1992 elections. Only Fischel has tried to link Giuliani's attacks on Wall Street and Milken to the recession and anemic recovery beyond. Certainly, no one can point either to Milken or to Giuliani as being the *cause* of the economic downturn; the Austrian theory of the business cycle (ATBC) would not mesh

with a Milken-Giuliani measure of causality, and we hold that the ATBC suffices in explaining the cause of the *original recession*.

However, it also is clear that the U.S. economy failed to recover quickly after the initial downturn, and we hold that the Wall Street prosecutions and their aftermath played a role in that economic failure. What we try to establish in this paper is that the financial wreckage that occurred in the wake of these unjustified prosecutions had the effect of helping to create and sustain an economic crisis in the U.S., and that includes at least some (but not all) of the Savings and Loan crises. To put it another way, Giuliani, his fellow prosecutors, and the horde of politicians and journalists who served as cheerleaders for the prosecution received their share of awards and accolades, and (for some) a financial windfall; millions of other people who depended upon a smooth functioning financial system for their livelihoods found themselves in unemployment lines.

Perhaps it is ironic that the economic damage that the Bush administration helped to create through its politically-popular attacks on Wall Street firms was not confined to the business firms that were destroyed and the junk bond market. In the end, it also helped to give the White House back to Bill Clinton and the Democrats.

Milken, Giuliani, and the Wall Street Prosecutions

In this section we summarize the actions that Giuliani and his associates took against major players in the financial markets ostensibly to bolster "confidence" in the "fairness" of those markets. Obviously, we cannot recreate the detailed works by Scott and Fischel and others who have covered this particular subject. We agree with both authors, however, that these legal attacks were unjustified, especially when one examines how these situations were handled in the past.

One of the ironies of the Rudy Giuliani prosecutions is that Giuliani himself had decried the emphasis on "white collar crime" from the U.S. Department of Justice during the Jimmy Carter years. Writes Fischel (1995):

> While serving as associate attorney general under President Reagan, Giuliani was a probusiness Republican who criticized the white-collar prosecutions by his Democratic predecessors. He felt such prosecutions were a waste of time that diverted scarce resources and attention away from going after organized crime, drug dealers, and other hard-core criminals. He had no use for prosecutors who were "chasing rainbows, spending two or three years chasing a white-collar case they can never make." "The previous administration had one priority, and that was white-collar crime," Giuliani complained in 1982. "I think there was almost a

> McCarthyism to it. It had gotten to the point where these people had become zealots rather than prosecutors." Giuliani's critics would later use almost the exact same words to describe the U.S. attorney's office during his tenure. (p. 99)

Yet in the six years that Giuliani was the U.S. attorney for the Southern District of New York, he became best known for his assaults on Wall Street firms, with Milken being the biggest (but not the only) prize. The political benefits to Giuliani were enormous, as he was able to use his reputation as someone who "cleaned up Wall Street" as a vehicle to be elected mayor of New York City in 1993, and still is considered to be a "star" in the Republican fold.

Giuliani's foray into white-collar prosecutions began somewhat quietly in 1986 with the arrest of Dennis Levine, a Merrill Lynch trader who was engaging in insider trading. As Fischel points out, most of the investigative work was done by the Securities and Exchange Commission and Merrill Lynch itself, but Giuliani saw an opening and claimed full credit for the arrest and investigation. Fischel notes:

> The press conference [where he announced the arrest] was vintage Giuliani. He had nothing to do with cracking the Levine case. In fact, for all the fanfare surrounding the war on insider trading, Levine's trading activities had gone undetected for almost six years. (p. 101)

However, the politically ambitious Giuliani was able to take that arrest and announce that his office would further investigate what it called Wall Street corruption. Furthermore, notes Fischel, he was able to do it following a politically-popular formula:

> Giuliani's genius was his insight that the unholy alliance between the threatened establishment business community and the "decade of greed" rich-haters would support his high-profile assault on Wall Street, no matter how unprincipled. Conventional wisdom is that the rich have an advantage in the criminal justice system because of their influence and ability to hire the best lawyers. But this advantage becomes a disadvantage when the fact of being wealthy and successful is what makes you a target. And the most talented lawyers in the world can do little when the government decides to criminalize routine business practices and declare them to be major felonies. (ibid., p. 102)

In August 1988, Giuliani raised the Wall Street stakes to their highest levels when he secured a Racketeer Influenced and Corrupt Organizations Act indictment against five officers of Princeton/Newport Trading Partners, a securities firm that did extensive business with Drexel. This was after the infamous December 17, 1987, "raid" by 50 federal marshals on Princeton/Newport in which the

machine-gun toting law officers burst into the offices screaming at the stunned (and unarmed) employees and seizing records, files, and tapes of telephone conversations.

The use of RICO was important because its onerous provisions allowed prosecutors to freeze the company's assets upon indictment and, essentially, put the firm out of business. Fischel writes:

> Giuliani saw RICO's amorphous language as a potent weapon to rubberhose and coerce guilty pleas and punish those who refused to cooperate. He had already pioneered the criminalization of such standardless offenses as insider trading, stock parking, and manipulation. Now the government could claim that the same underlying conduct that supposedly provided the basis for these standardless offenses also constituted a "pattern of racketeering activity" that justified a RICO prosecution. By this bootstrapping logic, Giuliani was able to drop the equivalent of a nuclear bomb on any target, at any time, no matter how trivial or harmless the underlying conduct. (p. 123)

Giuliani was successful, at least in the short run. The Princeton/Newport officers were convicted in federal court and their securities firm destroyed. That the U.S. Second Circuit Court of Appeals in 1991 overturned those convictions would provide some vindication to those Giuliani prosecuted, but the successful appeal of the Princeton/Newport officers came only after Milken pled guilty.

As for Milken's 1989 guilty plea on six felony counts, we write (Anderson and Jackson 2004, p. 94):

> The Milken case has received a great deal of attention, and we cannot do it justice here. Fischel, however, strongly disputes the government's contention that Milken's guilty pleas—made under extreme duress after government prosecutors threatened to indict members of his family—proved that, in the words of Securities and Exchange Commission chairman Richard Breeden, "he stood at the center of a network of manipulation, fraud, and deceit." Fischel writes: "Breeden's statement could not have been more wrong. None of the six felonies that Milken pled guilty to demonstrated that he was 'at the center of a network of manipulation, fraud, and deceit.' Breeden would have been closer to the truth if he had said that there was still no basis for concluding Milken committed any crimes, using the common understanding of what it means to commit a crime."
>
> Fischel is not the only critic of Giuliani's RICO prosecutions. Although *Wall Street Journal* news reporters such as James Stewart and Laurie Cohen served as virtual mouthpieces for Giuliani and his assistants, the editorial page staff of that same newspaper defended many of the Wall Street traders who found themselves in the government's crosshairs. George Gilder compared Milken to

> the fictitious Tom Smith in R. W. Grant's "The Incredible Bread Machine," who goes to prison for inventing a machine that makes bread for a penny a loaf. L. Gordon Crovitz said that Giuliani's targeting of Milken was a case in which "prosecutors indicted first, asked questions later." He added, "As Justice Robert Jackson [warned], few things are as dangerous as a prosecutor who finds a target, then looks for crimes to pin on him."

Fischel and Scott look carefully into the charges against Milken and others and declare them to be baseless, at least when one attempts to use a historic definition of what constitutes criminal behavior. Of course, the question arises as to why Giuliani, who was critical of the white-collar prosecutions made by the DOJ of the Carter administration, would focus his energies upon Wall Street securities firms. As we already have pointed out, Giuliani personally benefited from those actions. However, as Rothbard (1995) writes, there is much more to the story. Rothbard viewed the Wall Street prosecutions mainly as something that *served* to protect the established brokerage firms and banks that were being forced to compete head-to-head with the upstart Drexel. Rothbard (1987) writes:

> During the 1960s, the existing corporate power elite, often running their corporations inefficiently—an elite virtually headed by David Rockefeller—saw their positions threatened by takeover bids, in which outside financial interests bid for stockholder support against their own inept managerial elites.
>
> The exiting corporate elites turned—as usual—for aid and bailout to the federal government, which obligingly passed the Williams Act (named for the New Jersey Senator who was later sent to jail in the Abscam affair) in 1967. Before the Williams Act, takeover bids could occur quickly and silently, with little hassle. The 1967 Act, however, gravely crippled takeover bids by decreeing that if a financial group amassed more than 5% of the stock of a corporation, it would have to stop, publicly announce its intent to arrange a takeover bid, and then wait for a certain time period before it could proceed on its plans. What Milken did was to resurrect and make flourish the takeover bid concept through the issue of high-yield bonds (the "leveraged buy-out").
>
> The new takeover process enraged the Rockefeller-type corporate elite, and enriched both Mr. Milken and his employers, who had the sound business sense to hire Milken on commission, and to keep the commission going despite the wrath of the establishment. In the process Drexel Burnham grew from a small, third-tier investment firm to one of the giants of Wall Street. (pp. 178–79)

He continues:

> The establishment was bitter for many reasons. The big banks who were tied in with the existing, inefficient corporate elites, found that

the upstart takeover groups could make an end run around the banks by floating high-yield bonds on the open market. The competition also proved inconvenient for firms who issue and trade in blue-chip, but low-yield, bonds; these firms soon persuaded their allies in the establishment media to sneeringly refer to their high-yield competition as "junk" bonds.

People like Michael Milken perform a vitally important economic function for the economy and for consumers, in addition to profiting themselves. One would think that economists and writers allegedly in favor of the free market would readily grasp this fact. In this case, such entrepreneurs aid the process of shifting the ownership and control of capital from inefficient to more efficient and productive hands—a process which is great for everyone, except, of course, for the inefficient Old Guard elites whose proclaimed devotion to the free markets does not stop them from using the coercion of the federal government to try to resist or crush their efficient competitors. (p. 179)

Fischel makes similar points:

The 1980s were years of tremendous innovation in financial markets and wealth creation. The much maligned wave of hostile takeovers, leveraged buyout transactions, recapitalizations, divestitures, etc., dramatically increased the profitability and efficiency of corporate America. Many of these transactions were made possible by another innovation, high-yield bonds, which also provided a valuable financing alternative to new companies in growing industries. The investment banking firm of Drexel Burnham Lambert and its star employee, Michael Milken, were at the center of the financial innovations and corporate restructurings that dominated the decade.

But these innovations and corporate restructurings produced powerful dislocations. Old-line Wall Street investment banks were losers, as they ceded their previously dominant position to Drexel, which rose from nothing to become the most profitable investment bank in the country. The corporate establishment were also big losers. Many executives of Fortune 500 companies lost their jobs in corporate restructurings, and those who didn't were forced to downsize and streamline their operations.

Drexel and Milken upset the status quo and made phenomenal amounts of money in the process. The establishment losers in the marketplace, desperate for revenge and to restore their lost positions of dominance, turned to the government for help. There the losers found ambitious but unscrupulous prosecutors like Rudolph Giuliani, who were willing to help because they saw opportunities to further their own careers by capitalizing on the public's historic distrust and envy of financiers. (p. 7)

Rothbard also recognized the dangers of criminalizing the financial exchanges that characterized the famed "junk bond" market that Milken dominated:

> this whole Milken affair, in fact, the entire reign of terror that the Department of Justice and the Securities and Exchange Commission have been conducting for the last several years in Wall Street, raises a lot of questions about the workings of our political as well as our financial system. It raises grave questions about the imbalance of political power enjoyed by our existing financial and corporate elites, power that can persuade the coercive arm of the federal government to repress, cripple, and even jail people whose only "crime" is to make money by facilitating the transfer of capital from less to more efficient hands. When creative and productive businessmen are harassed and jailed while rapists, muggers, and murderers go free, there is something very wrong indeed. (p. 180)

Scott continues this same line of analysis:

> Junk bonds were attacked by a managerial class interested in protecting its employment. For executives who patiently spent decades climbing up corporate ranks with their eyes on senior-management positions, Milken was their worst nightmare. The turning point for Milken was 1985 when he became a superstar and junk bonds were labeled a scourge. The initial denunciation of the high-yield bond came from the lawyers and press releases of companies targeted by the LBO movement. The attempt by T. Boone Pickens to take control of Unocal in 1985 inspired an intense lobbying campaign. The American Petroleum Institute and the Business Roundtable (representing the Fortune 200) opposed Pickens. They found ideological soul mates in Senate Majority leader Howard Baker and future Treasury Secretary Nicholas Brady. Brady worked his way up to chairmanship of Dillon Read, an old investment bank which had a relationship with Unocal going back thirty years.
>
> On the LBO question the Reagan administration was split ideologically, though it eventually began to decisively oppose takeovers, junk bonds, and ultimately Milken and Drexel. Even Federal Reserve Chairman Paul Volcker joined the anti-LBO fray, telling the Bank of Montreal not to loan money to the likes of Pickens. In 1985, thirty-one bills on capital laws were introduced, including one with the earnest title The Junk Bond Control Bill. Chronic inanity aside, Congress proved to be less pliable than state legislatures. At this time thirty-seven states had passed laws against the use of junk bonds in merger-and-acquisition activity (p. 189). This shameless attack, more successful at the state rather than the federal level, reached its high-water mark when Congress passed the S&L bailout which required thrifts to dump their holdings of junk bonds, which comprised only 7 percent of the roughly $200 billion in such bonds outstanding in September 1988. For "Decade-of-Greed" conspiracy

> theorists, this was a milestone since the bailout conspicuously linked the disparate issues of the S&L debacle and junk bonds in the American public consciousness. The scapegoating of Milken for the nation's real and imagined financial troubles was now codified in federal law.
>
> In general, established business interests do not like innovations that undermine their competitive position. It is well documented that the exaggerated charges against junk bond-financed takeovers had a basis in self-serving motives. One can only grimace in disbelief at the inconsistencies of top U.S. companies who rationalize mergers when big buys small but inveigh against LBOs (small buying big). There is precious little to defend in the federal and state legislative wars against junk and takeovers. The legislative case at the federal level against takeovers was razor thin: no studies were done, no reasons were offered, and no public comments were solicited. At the state level, the case can be summed up by a quote from an Arizona representative describing a special session called in July 1987. Greyhound Lines, an Arizona company, feared a takeover. "Greyhound said 'Jump' and we said, 'How high,'" said the representative. (pp. 43–44)

Furthermore, points out Scott, those who found themselves having to compete with Drexel were able to marshal powerful forces both in Congress and in the regulatory agencies of the executive branch:

> The whole argument concerning junk-bond viability had its origin in paid lobbyists of the oil industry, who exploited a recklessly controlling Congress and compliant administration. Recalling the atmosphere in Washington, University of Chicago Professor John Lott (then employed at the newly formed U.S. Federal Sentencing Commission) remarked in 1993 that intense pressure flowed from Congress to do something as the number of mergers accumulated. Though other banks were hopping on the LBO bandwagon, Drexel Burnham Lambert was singled out not only because of growing fear and suspicion about junk bonds but also because they had virtually no regulatory connections like other investment banks. Also, 40 percent of Drexel's ownership (the Belgian-based Lambert) lived in France. Within a short time the goals of regulators and prosecutors were aligned with what lobbyists were telling Congress, namely that the market in junk bonds was a swindle of epic proportions. Over time, the federal government, including the Securities and Exchange Commission, the U.S. Attorney's office in New York, and the FDIC/FSLIC went after the person who unleashed the power of the high-yield bond.
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> From 1986 on, there were many groups aligned against Milken, some overtly working together with others adding their voices to the building chorus. Those who were opposed to Milken, with

> varying degrees of political power and influence—as previously mentioned—included the Business Roundtable and the American Petroleum Institute (including Fred Hartley of Unocal who aggressively organized against Milken). Even the investment-banking community joined the fray. John Gutfreund of Salomon Brothers was incensed that Drexel corralled some of his firm's largest clients such as Beatrice and Wickes. Salomon had a deep personal and professional rivalry with Drexel. Nicholas Brady, "first friend" and fellow patrician of George Bush, was hostile to Drexel from the beginning. He was driven by both moral indignation against Drexel's "gamblers and hustlers" and Dillon Read's failure to compete in the new environment. The Congress naturally responded to constituent interests, newspaper editorials, and large contributors. State legislators tended to work to protect constituent corporations and they had no means of going after Milken, Drexel, and other Wall-Street investment banks directly. That burden fell mostly on the federal level. (pp. 44–45)

The allegations that the Wall Street prosecutions might have involved something different than the "official" story of the crusading prosecutor wanting to "clean up" Wall Street in order to "send a message to small investors" that they could have "confidence" in the markets certainly do not surprise anyone who hails from an Austrian or Public Choice School of thought. The list of individuals and organizations engaged in the demonization of Milken and the other "rogue" financiers during the 1980s also coincides with a "list" that one might create to see who might *benefit* from bringing down Milken.

Indeed, there was something for everyone. Ideological journalists from the *New York Times* could rail against capitalism and its "excesses," leftist politicians could use Milken as a whipping boy to call for more regulation of financial markets, the principals of established financial firms could use the public outcry to demand protection from their more nimble competitors, and Giuliani was able to take advantage of the publicity he received and further his political career.

However, as we point out in the rest of the paper, not everyone benefited. Certainly, one can say that many people who were in Giuliani's crosshairs did not benefit. As Roberts and Stratton (2000) point out, Milken

> had the law on his side, but that wasn't enough. To this day, no evidence exists that Milken ever committed any crimes or engaged in any conduct that had ever before been considered criminal. Giuliani's assistant U.S. attorney John Carroll admitted as much. At Seton Hall Law School in April 1992, Carroll said that in the Milken case "we're guilty of criminalizing technical offenses. . . . Many of

> the prosecution theories we used were novel. Many of the statutes that we charged under . . . hadn't been charged as crimes before. . . . We're looking to find the next areas of conduct that meets any sort of statutory definition of what criminal conduct is." (p. 96)

Obviously, some people and groups benefited from the Wall Street prosecutions, while others were harmed. The questions that have not been asked—and the ones we are trying to answer—are these: (1) What was the financial "collateral damage" from the destruction of Drexel and the Wall Street prosecutions, and (2) How far did the harm spread?

THE RECESSION OF 1990–91 AND THE ANEMIC "RECOVERY"

In the summer of 1990, a long-running boom of approximately 92 months came to a halt, and the U.S. economy settled into a recession that lasted officially (from the National Bureau of Economic Research 1992) until March 1991.[1] As recessions go, it was not nearly as severe as the one that lasted from July 1981 to December 1982, a downturn in which the rate of unemployment rose to about 10 percent.[2] The 1990–91 recession saw the rate of unemployment rise to 7.7 percent, but the bust was especially traumatic after the previous boom.[3]

Butos (1993) agrees, writing:

> Compared with the previous post-World War II recessions, the recession of 1990–1991 was not especially virulent. The standard array of macroeconomic data suggests a downturn substantially less severe than advertised. Yet the recovery has, by historical standards, been sluggish. (p. 277)

Both Butos and Rothbard argue that the recession followed the path explained by the Austrian theory of the business cycle (ATBC), which emphasizes monetary expansion by the banking system that creates an unsustainable boom which then ends in a bust or economic downturn (Mises 1980, 1998; Rothbard 1993, 2000). Since other works have explained the ATBC in detail, we see no point in reproducing them here; suffice it to say that both Butos and Rothbard see the ATBC patterns as matching the boom of the 1980s and the bust of 1990–91. Writing about that particular downturn, Rothbard says: "The culprit then is and was, not taxes or greed, but above all inflationary credit expansion generated by the Fed" (p. 108).

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[1] "NBER Business Cycle Dating Committee Determines that Recession Ended in March 1991."

[2] "Business Cycle Contractions and Expansions."

[3] "Job market slid in early 1991, then struggled to find footing."

Butos (1993) agrees, saying that "the ATBC does indeed add to our understanding of the boom of the 1980s and the recession from which we are still recovering" (p. 298). Yet, both Butos and Rothbard also note that other factors played a role in the severity of the recession, and especially its length. Both writers look to changes in the real estate market, and especially how the Tax Reform Act of 1986 brought about transformations in the value of property—and in the value of the loan portfolios held by the nation's savings and loans.

According to Rothbard (1995):

> Every year after 1981, the Reagan administration agreed to continuing tax *increases*. . . . The topper was the bipartisan Jacobinical Tax Reform Act of 1986, which lowered upper income rates some more, but again clobbered the middle class by wiping out a large number of tax deductions, in the name of "closing the loopholes."
>
> One of those "loopholes" was the real estate market, which lost most of its tax deductions for mortgages and tax shelters, and which helped put real estate a few years later into perhaps its deepest depression since the 1930s. (p. 107)

The idea that other factors contribute to what occurs in a recession is not a refutation of the ATBC. Rothbard (1972) explains that the economic calamity known as the Great Depression began as a classic ATBC case, but then turned into a full-blown depression only after President Herbert Hoover and Congress proceeded to make things worse by imposing the Smoot-Hawley Tariff, demanding that businesses enact "voluntary" floors on wages and prices (ostensibly to increase "purchasing power" of market participants), and a huge tax increase. It was the enactment of those policies after the initial stock market crash and recession that created the outright depression.

Butos further points out that the real estate collapse to which Rothbard refers had its roots in an artificial boom created not only by Federal Reserve policies, but also from tax laws. He writes:

> the 1981 Economic Recovery Tax Act (ERTA) significantly stimulated the commercial and residential real-estate market. The resulting real-estate boom led to serious overbuilding and price increases in real estate, especially in some geographic areas. The real-estate boom also contributed to the longstanding but deepening difficulties of the S&L industry as it attempted to salvage itself by participating in an increasingly speculative and artificially sustained market. (pp. 296–97)

Concurring with Rothbard, Butos adds:

> In 1986, however, the Tax Reform Act reversed ERTA's provisions by extending the depreciation period for commercial real estate from 15 to almost 32 years and by eliminating the preferential tax

> treatment of capital gains. In addition, the 1986 Act reduced the top marginal tax rate from 50 percent to 33 percent, thus reducing the tax savings per dollar of deduction associated with depreciation costs or real-estate losses. The overall effect of the 1986 legislation was to eliminate the tax incentive to hold commercial real estate. This dramatic change in tax policy was the primary initiating factor in the collapse of the real-estate market that began in 1987. (p. 297)

Since most savings and loans had their portfolios tied up in real estate, it was not surprising that many of them faced insolvency when the real estate values plummeted in the late 1980s. This "doomsday" scenario was made worse by the fact, as Butos points out, that in 1983, "perhaps half of them (S&Ls) had negative net worth" (p. 297). The near-collapse of almost the entire industry by 1990 certainly owed much to the real estate and "tax reform" debacle.

However, we contend that there is a "Giuliani effect" that took a very bad situation and made it worse. To be more specific, Congress unwisely reacted to Giuliani's direct war on Drexel and Milken—and his indirect war on Drexel's high-yield, high-risk "junk bond" that was the firm's bread-and-butter investment. As shall be pointed out in the next section, the fact that Congress decided to make war on the junk bond market through its unwise 1989 legislation under the acronym FIRREA had the dual effect of not only severely damaging one of the most important capital markets that sustained economic growth in the 1980s, but also pushed more S&Ls into insolvency. The result, we maintain, is that these actions helped to exacerbate the so-called credit crunch that slowed economic recovery and ultimately led to electoral losses by Republicans.

CONGRESS BRINGS DOWN THE S&LS AND CREATES A CREDIT CRUNCH

The savings and loan crisis of the late 1980s for the most part was made in Congress. Perhaps a better way to put it is to say Congress created the seeds of the crisis through its unwise policies toward the S&Ls in the early 1980s, and then it made the problem worse through legislation that forced lending institutions to unload their "junk" bonds in a fire sale atmosphere, a move that quickly forced down thrift asset values and drove more institutions into insolvency. The resulting "cleanup" that the government enacted through the now-defunct FSLIC (Federal Savings and Loan Insurance Corporation) to pay depositors of the failed thrifts amounted to approximately $150–$200 billion and surely contributed to the length and severity of the 1990–91 recession (Fischel 1995, p. 190).

While this paper is an inappropriate vehicle through which to explain the S&L debacle in its entirety, it is important that readers know just how Congress took a bad situation and made it worse. As Fischel points out, by the early 1980s, most of the nation's savings institutions were in deep financial trouble. Interest rates stood at double digits following a severe bout with inflation, but much of the asset base of the S&Ls was tied up in home mortgages with interest rates well below 10 percent. Writes Fischel:

> The savings and loan crisis occurred because unprecedented high interest rates, advances in computer technology and information processing, and increased worldwide competition in financial markets . . . made the savings and loan industry obsolete. Rather than let the industry fail, the government enacted a series of misguided regulatory policies designed to preserve savings and loans as viable entities even though they no longer served any socially valuable function. (pp. 190–91)

Instead of allowing failure, however, Congress increased deposit insurance to $100,000 per account, allowing thrifts to compete with banks for larger deposits, but also increasing the moral hazard that accompanies deposit insurance. Unfortunately, as Fischel points out, "thrifts were extremely leveraged, so the margin of safety was razor thin. Thrifts typically held only about $5 of assets for every $100 of deposit liabilities" (p. 192).

Furthermore, as Fischel notes, the government encouraged entrepreneurs to purchase the thrifts, and some real estate developers did just that, using their thrifts as captive entities in order to finance their own developments. The best-known entrepreneur was Charles Keating, the chairman of American Continental Corporation of Phoenix, Arizona, who purchased Lincoln Savings and Loan of California in 1984. By following an aggressive policy of financing ACC's developments, direct commercial real estate investment, and high-yield "junk" bonds, Lincoln grew rapidly to where in 1987, *Forbes* rated it the second most profitable S&L in the United States (Fischel 1995, p. 215).

When the Arizona real estate market collapsed in the aftermath of the 1986 tax reform, Lincoln, too, went under in a spectacular fashion.[4] The failure process was repeated again and again as the real estate market went bust and took down a number of thrifts in the process. And while Congress can be blamed in large part for that

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[4]California prosecutors secured a criminal conviction against Keating in 1991, but it was overturned on appeal because prosecutors had convicted him on what was an unconstitutional bill of attainder.

problem, that was not all of the financial damage that the nation's legislative branch of government would attain. As real estate went down, Congress also decided to declare war on the high-yield "junk" bonds.

During the 1980s, a number of large savings and loans, including Lincoln, were regular customers of Drexel, and while they constituted only a small portion of the overall asset base of the thrifts, nonetheless they were profitable, or at least profitable until Giuliani and the U.S. Government declared war on Milken and his bonds. Unfortunately, the triple loss of recession, real-estate failures, and the administered collapse of the "junk" bond market would keep a recovery from taking place in an orderly fashion.

In the late 1980s, it became obvious that Milken was to be a major target of federal investigators, who first went after Milken's company, Drexel, and forced the company into bankruptcy. In December 1988, just after his RICO indictment of Princeton/Newport drove the firm out of business, Giuliani threatened the same kind of indictment for Drexel, and the board caved in, agreeing to pay $650 million in fines and firing both Michael and Lowell Milken. Writes Fischel:

> The post-Milken Drexel was to be run as a quasi government agency. Drexel was forced to hire and pay for "compliance officers," and an SEC-approved accounting firm to monitor its actions, including every high-yield bond trade, to detect any possible wrongdoing.
>
> Drexel's deal with the government guaranteed the firm would never again be a factor on Wall Street. By pleading guilty to six felonies, the firm was disgraced. Few understood that the felony charges were for acts that were, at worst, the same hypertechnical books-and-records offenses alleged in the SEC's civil complaint that nobody had ever thought constituted crimes. . . . During the entire investigation, the government never identified anyone who was harmed by any of Drexel's supposed "crimes." (pp. 138–39)

A few months later, with the indictment of Milken, Congress decided to get into the act and force the S&Ls to dump their "junk" bonds. Ironically, before it passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, Congress heard testimony from Richard Fogel, assistant comptroller of the General Accounting Office, who told a congressional committee that the so-called junk bonds "have been a fairly good investment for thrifts that have had them in their portfolios" (Fischel 1995, p. 201).

However, as Fischel writes, that was *before* the indictment of Milken in March 1989, which, he notes, "changed everything" (ibid.). Representative Byron Dorgan (who now is Sen. Dorgan, D-North

Dakota) introduced an amendment to FIRREA to demand thrifts divest themselves of "junk" bonds, and while others in Congress argued that such a move would be disastrous, "opponents of the Dorgan amendment could not compete with the anti-Milken/junk bond/takeover fervor sweeping the country" (ibid., p. 203). The result, Fischel writes, was a steep drop in the prices of high-yield bonds, as thrifts sought to unload them into the market.

The consequences went well beyond Milken, Drexel, and even the insolvent savings and loans, according to Fischel, who declares:

> The government's attempted purge of the high-yield debt market created a "credit crunch"—the inability of borrowers to obtain financing for profitable investments—which contributed to the length and severity of this recession. This credit crunch was experienced primarily by non-investment-grade borrowers, the source of America's boom during the 1980s. Between 1989 and 1990, new capital raised in the public high-yield debt market fell by 95 percent, from $28.8 billion to $1.4 billion. During this same period, the size of the investment-grade debt market declined by less than 15 percent. (p. 155)

Fischel hardly was the only one who saw a "credit crunch" in the early 1990s. In a speech December 7, 1992, Federal Reserve Chairman Alan Greenspan told the Tax Foundation audience that the "credit crunch" was "attributable to a number of factors":

> Part of the so-called credit crunch problem reflects deep-seated economic forces which government policy can only tangentially affect. Part is a reflection of the interaction of bank lending policies with those economic forces that government policies can impact somewhat. Finally, part reflects the statutory framework under which banking labors and to which supervision and regulation must adhere. Here, of course, government generally has full control.[5]

A translation of his remarks would include an admission that the recession had cut into the demand for business and real estate loans, but also that the current regulatory atmosphere was playing a role. Others involved in financial markets, while disagreeing as to whether or not a crunch was real, did call for regulatory relief.[6] Fischel concurs, writing:

> In 1990 the insurance industry, fearing passage of a FIRREA-type law applicable to insurance companies, enacted guidelines limiting insurers' ability to invest in high-yield bonds. Several states also

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[5]Remarks were made December 7, 1992, at the 55th Annual Meeting of the Tax Foundation, Washington, D.C.

[6]"Regulation needs to Be Less Burdensome," p. 15.

> enacted laws to the same effect. The regulatory siege on the high-yield debt market also extended to commercial banks, money market funds, and pension funds. . . .
>
> By attacking the high-yield debt market at the end of the 1980s, government regulators again reduced the supply of credit to worthy borrowers at precisely the wrong time. But sound economic policy was not the government's objective. The government was far more interested in appearing responsive to the demagogic attacks against junk bonds, which many viewed as the symbol of what was wrong with America during the "decade of greed." (pp. 155–56)

CONCLUSION

In this paper, we have given a brief history of Rudy Giuliani's assault on some Wall Street investment firms during the 1980s. Furthermore, we have contended that one reason that the recovery following the recession of 1990–91 was anemic was that the financial markets were badly shaken in the aftermath of the destruction of Drexel and other firms that dealt in high-yield, high-risk bonds.

While it is true that Giuliani's attacks were selective—and supported by the Wall Street "establishment" against newcomers like Michael Milken—their effects had repercussions well beyond their intended targets. In the end, the Republicans, who had enthusiastically backed Giuliani's escapades, lost the White House and seats in Congress, as the voting public blamed them for the recession and slow recovery.

One would think that there were lessons to be learned from Giuliani's Wall Street prosecutions, but seeing the reaction of Congress to the fall of Enron and other companies that were highly-leveraged at a very bad time—the beginning of a recession—one realizes that economic and political lessons do not mix. From the passage of the onerous Oxley-Sarbanes Act to the draconian financial provisions in the Patriot Act to the Enron prosecutions, it is clear that Congress and the executive branch believe that increased regulation pays good political dividends—even as that regulation further strangles the economy.

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