In Review

Moving Beyond Ideology

REVIEWED BY PETER VAN DOREN

Misunderstanding Financial Crises: Why We Don't See Them Coming
By Gary B. Gorton
278 pages; Oxford University Press, 2012

The political left and right have offered many explanations for what caused the financial crisis of 2007–2008. Among the "accused":

- affordable housing requirements imposed by the Community Reinvestment Act and/or imposed on the government-created housing finance giants Fannie Mae and Freddie Mac, resulting in lending to uncreditworthy borrowers
- changes in law exempting various asset repurchase agreements ("repos") from the normal freeze on all assets held by companies in bankruptcy, which gave the impression that repos were low-risk
- excessive leverage in financial institutions' portfolios, allowing them to borrow and then lend and invest in housing finance
- elimination of the separation between commercial and investment banking
- "predatory lending" practices, which duped homebuyers into costly and risky mortgages
- the originate-to-distribute mortgage model, which obscured the quality of the underlying loans
- "exotic" non-amortizing mortgages, which also duped homebuyers
- badly designed compensation plans for financial executives, which incentivized risk-taking

Peter Van Doren is editor of *Regulation* and senior fellow at the Cato Institute.

There are numerous papers and books devoted to supporting and refuting each of those hypotheses. I've reviewed many of them in my "Working Papers" columns in this journal (see Summer 2011, Summer 2012, Fall 2012, Spring 2013).

Gary Gorton, professor of management and finance at Yale, says we should ignore all this chatter because it misses the essentials. In his new book *Misunderstanding Financial Crises*, he explains, "The cause of financial crises is the vulnerability of transactions media, the privately created debt of financial institutions." By "transactions media" he refers to debt obligations that are often traded back and forth as de facto money. They are created by financial institutions to facilitate transactions, but the institutions cannot create riskless debt. For Gorton the history of financial crises is the repeated attempt by private institutions to create transactions media—in effect, creating private money—that trades at par even though it is backed by loans of uncertain value.

The History of Private Money Creation

Initially banks were unable to create transactions media that traded at par. During the Free Banking Era (1837–1863), bank notes for transactions were issued by around 1,500 different banks. The banks invested in state debt in an attempt to create riskless collateral for the notes, but the banknotes did not trade at par. A $10 bill issued by a bank in New Haven, for example, would be worth only $9.90 in New York City. "Today, we take it for granted that when we offer a ten-dollar bill in payment, it is accepted as being worth ten dollars," Gorton writes. "Private banknotes attempted to achieve that and failed."

The National Bank Acts of 1863 and 1864 taxed private bank notes out of existence and collateralized national banknotes with U.S. Treasuries. The Bank Acts were enacted to finance the Civil War rather than create an efficient medium of exchange, but contemporaries recognized (Gorton quotes from publications of the time) that money needs to be backed by collateral that is safe. According to Gorton, only government can provide riskless collateral.

But after the introduction of national banknotes, financial innovation still produced private money that was subject to panic: checks and demand deposits. People feared that during recessions checks would trade at a discount. Thus, during economic contractions, they demanded cash, which resulted in bank runs and jeopardized banks' solvency.

This did not end until the creation of deposit insurance, first by states and then the federal government. In 1911 the U.S. Supreme Court found the mandatory Oklahoma deposit insurance system and fee to be constitutional, ruling that the purpose of the system was to allow checks to trade at par. Writes Gorton, "The advent of federal deposit insurance in the United States [in 1933–1934] was the start of a long period in which effective regulation eliminated the threat of systemic financial crises—the Quiet Period."

For Gorton financial crises are normal in market economies. Only during the Quiet Period (1934–2007) did the public, politicians, and economists come to believe that quiet was normal. The Quiet Period lasted a long time, and memories of financial panics faded and crises were viewed as a thing of the past. Because modern macroeconomics developed during the Quiet Period, almost all economists tended to ignore the crucial role played by efficient financial intermediation in determining economic outcomes and came to believe

that financial crises were a thing of the past. Thus when the panic of 2007–2008 occurred, professional economists were at a loss to understand what was happening.

Why did the Quiet Period end? For Gorton the Quiet Period was the product of the combination of deposit insurance, interest rate controls, and the lack of interest on commercial checking accounts that reduced competition and created economic rents for banks with charters. Banks didn't innovate because they were earning rents from the status quo and were protected from competition that normally would erode the rents.

Innovation did take place outside the official banking system, however, and those developments increased payments to depositors and decreased interest rates for borrowers. Money market funds competed with traditional banks on the liability side, while junk bonds, commercial paper, and—later—securitized loans substituted for bank loans on the asset side. Borrowers interacted directly with investors through processes that bypassed banks.

The net result of this competition was higher costs, fewer deposits, and an erosion of charter rents for banks. Interest expenses were 5.48 percentage points below Treasury 10-year rates in 1979. By 1986 the same measure was only 1.32 percentage points below Treasury 10-year rates. Because of pressure from non-banking competitors, banks had to pay more on deposits, and they were allowed to because of deregulation during the savings-and-loan crisis of the 1980s.

Banks not only faced more competition, but corporations also had more cash to invest. From 1980 to 2006, the ratio of cash to assets of corporations more than doubled from 10.5 percent to 23.2 percent. Commercial checking accounts at traditional banks did not pay interest. Since the early 1980s, corporate treasurers gradually invested all this cash in asset-backed securities, repos, and money market funds, which earned interest income. This "shadow" banking system was collateralized with assets thought to be safe and liquid. But these financial instruments were not insured and thus were vulnerable to panic when investors grew uncertain about the wisdom of trading them for cash at par. Frightened investors could rush to redeem the instruments, causing investment banks and other financial institutions to become insolvent. In essence, the shadow banking system was susceptible to bank runs just as the traditional banking system once had been.

The Panic of 2007–2008

The deterioration of house prices and defaults in subprime mortgages were not enough by themselves to cause a systemic crisis. A 2011 Yale doctoral dissertation by Sunyoung Park examined $1.9 trillion in AAA-rated subprime bonds issued between 2004 and 2007. The realized principal losses as of February 2011 were only 17 basis points (0.17 percent). The Financial Crisis Inquiry Commission, created by Congress to probe the causes of the financial crisis, noted that only 4 percent of subprime mortgages and 10 percent of "Alt-A" mortgages (mortgages to borrowers with good credit scores, but that involve more aggressive underwriting than traditional conforming or "jumbo" loans) had been "materially impaired," meaning that losses were imminent or already had occurred by 2009. So the shock itself wasn't very large. How, then, did we get a crisis?

Gorton argues that the asset-backed securities repo market at its peak had $10 trillion in assets, about the same size as the traditional commercial banking sector. Normally $100 million "deposited" in a repo agreement would be collateralized by $100 million in bonds backed by pools of mortgage, car and student loans, or credit card receivables. Once investors got nervous about the uninsured nature of repo in August 2007, they demanded more in face value of collateral than they deposited. These so-called "haircuts" increased the most on mortgage-related assets, but they also increased on car loans, student loans, and credit card receivables, which had none of the characteristics of the suspect mortgage instruments at the heart of the crisis.

When investors demanded such "haircuts," financial institutions were forced to sell assets (the bundles of securitized loans). The simultaneous selling of similar assets led to severe discounting from face value. By September 2009, Gorton reports that repo transactions had fallen by 50 percent from their pre-Lehman bankruptcy levels. The runs on repos spread to commercial paper and prime brokerage markets as well. This was "a breakdown of the central nervous system of the economy—financial firms." The privately created debt outside the deposit insurance system did not trade at par.

The Common Characteristics of Financial Panics

What unites the panics across nearly two centuries? Gorton argues that in financial crises depositors seek to exit money that is risky (bank deposits) and obtain money that is safe and remains acceptable as a means of payment at par valuation (cash). The particular forms of bank debt vary over time from private bank notes in the 1840s, to checking accounts in the 1870s, to overnight asset repurchase agreements in the 2000s. The demands for cash are on such a scale that they cannot be met.

During crises, according to Gorton, financial institutions have only three options:

- Suspend the contractual right of convertibility of deposits to cash.
- Sell assets to raise cash to satisfy the demands of depositors (but the simultaneous sale of similar assets by financial institutions raises much less cash than face value, and the result is the liquidation of the banking system).
- Receive support from the government or from central bank purchase of assets.

Historically, before deposit insurance, financial crises were always handled through suspension of normal banking rules about access to bank deposits. The suspension of the rules has always troubled those who care about the rule of law. In 1837 John Quincy Adams commented on the suspension of convert-

ibility by saying, "We are now told that all the banks in the United States have suspended specie payments—and what is the suspension of specie payments but setting the laws of property at defiance?" Adams was asking whether suspension was fraud. Shouldn't the banks then lose their charters?

The New York state legislature legalized suspension of specie payment (the termination of the right to exchange banknotes for gold) for one year in 1837. In 1846 New York enacted a constitutional amendment that supposedly prohibited the legislature from repeating that policy. But during the 1857 panic, convertibility was suspended again. And the New York Supreme Court ruled in 1857 in *Livingston v. Bank of New York* that suspension of convertibility during crises would not trigger liquidation, even though the state constitutional amendment was designed to prevent time-inconsistent behavior. In 1896 Yale professor William Graham Sumner described the *Livingston* decision as a coup d'état—but he believed that the time-inconsistent behavior of the law was probably a better alternative than liquidation of the banking system.

In 2007–2008 this same logical conundrum repeated itself. Ben Bernanke used language in the Federal Reserve Act to offer lines of credit to financial institutions that were not banks and he offered financial support to the commercial paper and asset-backed securities markets. Critics charged this violated the rule of law just like John Quincy Adams did 170 years earlier.

In the absence of deposit insurance, bailouts and contract suspension are the only means of preventing liquidation of the banking system during financial crises. In the current crisis, bailouts were chosen rather than contract suspension, but the popular reaction, as well as the reaction of Bernanke himself, was similar to John Quincy Adams' reaction to contract suspension. (From Bernanke's March 15, 2009 *60 Minutes* interview: "I slammed the phone more than a few times on discussing AIG. I understand why the American people are angry. It's absolutely unfair that taxpayer dollars are going to prop up a company that made these terrible bets—that was operating out of the sight of regulators, but which we have no choice but to stabilize, or else risk enormous impact, not just in the financial system, but on the whole U.S. economy.") Both bailouts and contract suspension would seem to violate the rule of law and the public's general sensibilities about how markets should work.

Narrow Banking, Free Banking, or Deposit Insurance?

Analyses of the financial crisis by authors other than Gorton focus on the details of the current private money debacle and recommend changes in those details: e.g., eliminating housing affordability goals; increasing capital requirements; pushing homebuyers toward traditional, rather than exotic, mortgage instruments; re-separating commercial and investment banking (adopting the "Volcker Rule"); changing the bankruptcy status of repos. Gorton argues that private-sector innovations in debt contracts arise spontaneously as memories of previous financial crises fade, and so cracking down on the last wave of private debt innovation is akin to generals fighting the last war. Privately created debt is inherently susceptible to economic and informational shocks because it cannot be riskless, he argues. None of the changes enacted in the 2010 Dodd-Frank Act and the recommendations of academics (with the exception of bankruptcy changes) address the fundamental problem as Gorton sees it: the inherent instability of privately created debt. So what regime changes could tackle this problem?

Narrow banking | Some libertarian analysts agree with Gorton's characterization of the inherent instability of privately created debt. They conclude that the costs of banking exceed its benefits and propose that conventional banking (the private creation of debt that trades at par) be banned and replaced with "narrow banking," where the payment system is fully backed by truly risk-free investments—cash and treasuries. Narrow banking is an attempt to carefully demarcate the difference between the transactions media of the payments system (checking accounts, passbook savings, and other demand deposits like repo) and all other investment, which would be at-risk.

An important problem with narrow banking is the time-inconsistency of government policy as described by Gorton. Defining the demarcation line between transactions media that are fully backed with safe collateral and at-risk investments seems to be subject to change. Fannie Mae and Freddie Mac were not legally backed by the government and their liabilities were not covered by deposit insurance, nor were money market funds, nor overnight repos. But when the financial system came under severe stress, the government changed the policy and backed that debt. Likewise, if future stress were to hit at-risk, privately created transactions media, placing the broader economy in jeopardy, the White House and Congress would surely ride to the rescue again. This is what Gorton describes as the paradox of financial crises: the necessity of time-inconsistent behavior.

A second problem with narrow banking is that it would require the legal suppression of what most people now call banking, i.e., financial intermediation in which short-term deposits support longer-term investment through privately created debt. Banks arise naturally in a free society, as Gorton's history documents, and the narrow banking regime would require the use of the power of the state to suppress the transformation of demand deposits into investment.

Free banking | Another libertarian proposal is a return to "free banking." Unlike narrow banking, free banking allows fractional reserves. But unlike the pre–Civil War era of free banking described by Gorton, in which branch banks were largely forbidden, branching would also be allowed. This would strengthen the banks: some (maybe much) of the discounting of private banknotes during the pre–Civil War era was the result of the geographically undiversified nature of the loan portfolios of those banks rather than the state debt used as collateral.

In addition to geographic diversification, truly free banks would include convertibility suspension clauses as part of their initial deposit contract, a feature

of free Scottish banks in the 1700s as described by George Selgin. That way, currency convertibility suspensions would not violate the rule of law. The problem is that in a world in which currency convertibility suspensions were possible, depositors would certainly have incentive to withdraw deposits before the suspension was announced. And given fractional banking, those who withdraw sooner are more likely to succeed than those who wait, which puts banks at risk of runs. So the essential game-theoretic logic of financial crises is thus not altered even if contractual suspension replaces the time-inconsistent paradox described by Gorton.

Selgin positively describes the role that discounting of the notes could play in preventing *random* runs on financial institutions. That is, those banks with loan portfolios thought to be troubled by the market would have notes that traded at greater discount than those that did not. But, for Gorton, once privately created transactions media begin to trade at less than par, and the discounting is volatile rather than constant, then they no longer function as effective transactions media. If energy and effort must be exerted to ascertain their price relative to par, then little difference exists between using privately created currency with time-varying discounts relative to par and stocks and bonds as transactions media. Such transactions media would be efficient but filled with transaction costs.

Deposit insurance | The response favored by Gorton would extend to all demand deposits the current safety net of deposit insurance and access to the Fed. He also would limit the repo exception to bankruptcy's "automatic stay" rule, which halts most creditors' efforts to collect on debts. Limiting the repo exception would reduce the risk of runs on troubled financial firms' assets. (This is the one exception to my claim that Gorton is uninterested in the details of the recent crisis.) This proposal would bring the shadow banking system into the regulated system, extending deposit insurance to special banks that invest in asset-backed securities. Money market funds would be covered indirectly through their purchase of debt of these special repo banks. The bankruptcy privileges (the exemption of repos from the automatic stay provisions of bankruptcy) would be eliminated for repos outside the approved venues. As a consequence, Gorton believes all repos outside the approved venues would disappear.

But even he recognizes that the logic of his historical inquiry suggests the impossibility of any particular solution:

> To design a bank regulatory environment that addresses the vulnerability of bank debt and fosters economic growth is possible in principle. But because of the paradox of financial crises, it might not be possible in practice. …This suggests that the idea that any one policy, such as deposit insurance, would forever solve the problem of crises is naive.

A second essential component of Gorton's solution is central bank discretion:

> Because of the paradox of financial crises, central bankers must be independent so that they can take unpopular actions to keep the banking system from being liquidated.… During noncrisis times most economists think that the central bank should focus on fighting inflation based on rules rather than discretion. But in crisis times it is the opposite.

The classic rule of Walter Bagehot provides some guidance: during a crisis a central bank should lend freely to solvent firms, against good collateral and at high rates. But, Gorton writes, "It is hard to see how the answers to these questions could be pre-specified as rules. And if they could, these rules would likely not be followed in the next crisis."

So what would stop financial institutions from taking on higher-than-appropriate risk if they know Washington stands ready with bailout money? Gorton argues that such concerns did not enter into the recent crisis:

> At least at the outset of the crisis, the run was not contaminated by expectations about the government's crisis responses. It is hard to understand how policies of too-big-to-fail and moral-hazard-related incentives emanating from government regulation could have affected the dealer banks. The government did not know of the existence of the shadow banking system. Further, in light of the testimony of dealer bank CEOs before the Financial Crisis Inquiry Commission, it is doubtful if even the dealer banks understood the changes to the financial system.

Rene Stulz and his colleagues provide empirical support for the Gorton perspective. They attempted to determine why the holdings of highly rated securitization tranches differed so much across banks before the financial crisis. The median was 0.2 percent and the mean 1.4 percent. Citibank had the largest amount at 10.7 percent. Observers commonly argue that investing in these assets was a form of excessive risk-taking. Stulz et al. argue against the logic of bad outcomes as conclusive evidence: "ex post adverse outcomes are not evidence of risk management failures.… [I]t does not logically follow from the poor performance of highly-rated tranches that risk management failed." Instead Stulz and his colleagues examine whether the variation in risk management practices before the crisis was related to holdings of highly rated securitized tranches controlling for other bank characteristics. Using an index that measures the centrality and independence of risk management to a bank, Stulz found no relationship with larger holdings of highly rated tranches.

Some argue too-big-to-fail explains why large banks held these assets. Large banks (assets greater than $50 billion) did hold more than small banks, but among large banks (36 banks have assets greater than $30 billion as of the end of 2012) holdings of highly rated tranches as a percent of assets did not increase with bank size.

Even though Gorton may be correct that the moral hazard created by the paradox of financial crises did not enter into the current crisis, it may affect behavior going forward. Empirical evidence suggests that after the start of the recent crisis, large financial institutions paid lower interest for deposits because the market perceived them to be too big to fail. According to the *New York Times*, in the last quarter of 2006, before the crisis, banks in all size categories

paid 3.6 percent to 3.65 percent on deposits—a very narrow range. In contrast, in the fourth quarter of 2009, institutions with more than $100 billion of assets paid an average of 0.77 percent annual interest on deposits, while institutions with less than $10 billion in assets paid an average of 1.73 percent. The 10 largest banks hold about $3.2 trillion of America's $7.7 trillion of domestic deposits. Apply the differential in deposit interest rates, and those 10 banks appear to be saving nearly $30 billion a year thanks to their size.

Conclusion

So banks present a dilemma for libertarians. The asset transformations that banks can achieve (the provision of liquid transactions media that trade at par) while investing in longer-term loan portfolios enhance economic growth. But those very characteristics periodically result in systemic events in which contract suspension or bailouts are used to prevent the liquidation of the financial system. Deposit insurance and the Quiet Period lulled us all into thinking that systemic events were just interesting historical events. But how wrong we were!

Unlike other scholars, Gorton argues there are no solutions, just patches on the current system of deposit insurance that will also fail in the future in ways that we cannot now predict, combined with clean-up lender-of-last-resort activities by the Fed. Even though libertarians will have a predictably negative reaction to Gorton's book, his analysis and views merit serious consideration. R

READINGS

- "An Interview with George Selgin." *Region Focus* (Federal Reserve Bank of Richmond), Winter 2009.
- "Another Advantage for the Biggest Banks," by Rob Cox and Lauren Silva Laughlin. *New York Times*, March 29, 2010.
- "In Praise of More Primitive Finance," by Amar Bhidé. *The Economists' Voice*, Vol. 6, No. 3 (February 2009).
- "Limited Purpose Banking—Putting an End to Financial Crises," by Christophe Chamley and Laurence J. Kotlikoff. *Financial Times*, January 27, 2009.
- "Rethinking the Roles of Banks: A Call for Narrow Banking," by Oz Shy and Rune Stenbacka. *The Economists' Voice*, Vol. 5, No. 2 (February 2008).
- "Why Did Holdings of Highly Rated Securitization Tranches Differ So Much Across Banks?" by Eril Isil, Taylor Nadauld, and Rene Stulz. SSRN #2186174, December 2012.

Behave!

REVIEWED BY DAVID R. HENDERSON

Insurance and Behavioral Economics: Improving Decisions in the Most Misunderstood Industry
By Howard C. Kunreuther, Mark V. Pauly, and Stacey McMorrow
329 pages; Cambridge University Press, 2013

A friend recently told me that his mother-in-law had been looking back at her and her husband's financial decisions, identifying the good ones and the bad ones. What, in her view, was one of their worst decisions? "We bought too much insurance," she said.

Now, it *is* possible to buy too much insurance. If you buy a $40 item at Best Buy and pay $3 to insure it, you probably bought too much insurance. But that's not what my friend's mother-in-law meant. Instead, she was talking about the various insurances on their house and their lives that they had never collected on. That, to her, meant that they had overinsured.

In *Insurance and Behavioral Economics*, Wharton School economics professors Howard Kunreuther and Mark Pauly and Urban Institute research associate Stacey McMorrow tell similar stories—not from random anecdotes but from market behavior—that show that the sentiment of my friend's mother-in-law is not unusual. The authors also lay out how insurance markets should work when insurance buyers are trying to maximize their utility and insurance sellers are trying to maximize profits. In many cases, they note, insurance markets work well. In one of the best sections of the book, they put to rest the idea that there is rampant adverse selection in the market for health insurance; this mistaken belief seems to have been behind many health insurance economists' support of the Patient Protection and Affordable Care Act, better known as Obamacare. But they also find anomalies. On the buyers' side, they find systematic overinsurance and underinsurance. On the sellers' side, they find for-profit insurance companies failing to maximize profits. They attribute many of those problems to the systematic mistakes people make in their thinking, mistakes that have been detailed by so-called "behavioral economists." Adding to the problems, in many cases, are insurance regulators, mainly at the state level, but increasingly—especially with Obamacare—at the federal level.

The authors, I hasten to add, are not as strongly pro-free-market as I am. But they are sharp, well-informed economists who are experts on insurance markets. So, while in some ways I was disappointed by the lack of a clear bottom line in many of their discussions, their book is full of nuggets of economic wisdom.

Adverse selection problems? | Consider, first, the issue of adverse selection in health insurance. A standard argument by economists is that when insurance companies do not know nearly as much about the health of people they insure as the insured themselves know, they will charge premiums that fail to reflect risk. What's wrong with that? This asymmetry in information means that premiums for high-risk people are too low and premiums for low-risk people are too high, with the result that high-risk people overinsure and many low-risk people drop out of—or never get into—the market.

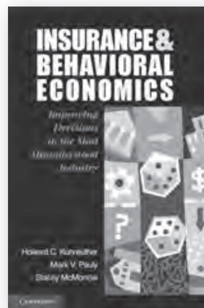
But Kunreuther, Pauly, and McMorrow show that when insurance regulators themselves don't cause adverse selection, it tends not to happen. They write:

David R. Henderson is a research fellow with the Hoover Institution and an associate professor of economics at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, Calif. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

> Where adverse selection does potentially occur, and to a serious degree, is in markets where regulation prevents insurers from taking into account risk information they surely could have. This "artificial" or "non-essential" adverse selection seems to be most characteristic of health insurance and property insurance markets where "risk rating" is prohibited by law (as in some states in the United States and in all group health insurance) or regulators depress premiums for high-risk exposures for political reasons (as in hurricane insurance in Florida).

In an article I wrote in 1994, I called this "adverse selection by law." By contrast, they note, "in individual health insurance markets in the United States where risk rating is permitted, adverse selection is *absent*." [Emphasis mine.]

Another nugget in their book is their discussion of guaranteed renewability of health insurance. It makes sense that there would be consumer demand for health insurance policies that are renewable at a price that reflects the buyer's risk profile going in. That way, if something unfortunate happens during the first year of being insured—getting diabetes, for example—that person's rate does not increase simply to reflect his new circumstances. Where there's consumer demand, one would expect in a well-functioning market that producer supply will follow—at a price. And it does. The authors point out that individual health insurance "was sold for many years with guaranteed renewability protection, even before being required by law."



Real market failures | The authors note, though, some systematic anomalies in buyers' purchase of disaster insurance. Shortly after a disaster, they report, the demand for disaster insurance increases. They give the example of Californians after the 1989 Loma Prieta earthquake. Before the earthquake, 22.4 percent of homeowners in the affected counties had earthquake coverage. Four years later, 36.6 percent had coverage. According to the authors, seismologists say that the probability of another severe quake actually falls after a big earthquake because the stress on the fault has been relieved. So if buyers are informed and rational, the percentage of homeowners with earthquake coverage after the 1989 quake should have been *lower,* not higher.

Related to this anomaly is the fact that many buyers of flood insurance cancel their insurance after they have gone a few years without a flood. The authors suggest two possible reasons: (1) the longer homeowners go without experiencing a flood, the lower they estimate the probability of a flood, or (2) they think (like my friend's mother-in-law) that the money they spent on flood insurance during dry years was wasted.

The authors also find that sometimes people overinsure. They point out the case of Aflac's cancer-only policy, which pays $300 for every day the cancer patient is in the hospital. Using the probability of getting cancer, the authors estimate that, in return for an annual premium of $408, people receive an expected payout of only $77. That's expensive insurance, and I'll never again look so fondly on that duck.

Insurance companies are supposed to maximize profits, so you'd think they would make good decisions based on probabilities and the size of payouts. That's certainly what I thought before reading this book, and it's true in many, and probably most, cases. But what is striking are the anomalies and how extreme some of them are. Exhibit A is the price of terrorism insurance after the September 11, 2001 terrorist attacks. Before the attacks, for example, Chicago's O'Hare Airport paid an annual premium of $125,000 for $750 million of terrorism insurance. But after the attacks, the best deal the airport could get was $150 million in coverage for a whopping annual premium of $6.9 million. Even if the loading fee (transactions costs and costs for advertising, employees, building, etc.) was a relatively large 50 percent of the premium, the implied probability of an attack in a year was 1 in 43. And who believed it would be that high? It seems as if insurance sellers, like insurance buyers, can be subject to panic and bad thinking. Of course, if O'Hare actually bought that high-price policy—and neither the authors nor the source they cite make clear whether the airport did buy—the insurance company would have made lots of money, so the transaction doesn't necessarily reflect panic on the selling company's side. But the fact that that was the best deal O'Hare could get does suggest that competing insurers were panicked.

Deregulating principles | In a chapter titled "Design Principles for Insurance," the authors lay out three principles for insurance regulation. Interestingly, although they never come out and say it, all three principles, if followed, would lead to less regulation. The principles are:

- Avoid premium averaging.
- Do not mandate insurance benefits not worth their cost.
- Examine the impacts of crowding-out effects on behavior.

The first principle, if followed, would end one of the key features of Obamacare: its prohibition of insurance companies pricing for risk. That means, in essence, that Obamacare prohibits *insurance*, and replaces it with socialized financing of health costs that uses private companies as intermediaries.

The second principle, if followed, would mean getting rid of Obamacare's requirement that health insurance companies pay for various tests—mammograms, Pap smears, and prostate PSA tests, for example—without charging a co-payment to beneficiaries. The authors do not point out either of those two implications of their principles. That's a disappointment because the book was published almost three years after Obamacare was passed. It seems as if the authors decided to pull their punches in precisely the area where their work could have had one of its biggest effects.

The third principle, "examine impacts of crowding-out effects on behavior," is not really a principle, but it is a good idea. The authors cite a 2007 paper by Jeffrey Brown, Norma Coe, and Amy Finkelstein that shows that Medicaid's coverage of long-

term care crowds out private purchase of such coverage.

Suggestions | Although it comes out implicitly in the book, it would have been nice if the authors had, upfront, made explicit the three factors that make something an "insurable event." Those three factors are:

- The event has a high cost.
- The event has a low probability.
- Having insurance does not much influence the probability of the event.

Had they made those three factors explicit, it would have helped not only the reader, but also the authors, identify insurance anomalies. Consider, for example, the Medicare drug plan initiated by President George W. Bush. The authors point out that Medicare's website "supplies an online decision tool that will tell the beneficiary how much out-of-pocket expense to expect under each of the Medicare drug plans, given information the beneficiary inputs about the drugs he or she is now taking." I expected the authors to then inform the reader that this certainty of collecting means that the drug benefit is not insurance. The essence of insurance, as I noted, is that it pays for items that people have a small probability of using. But the authors don't even mention that this is not really insurance. Their exposition is accurate, but what it shows is that the Medicare drug benefit is largely pre-payment for drugs with a large dose of taxpayer funding thrown in.

Probably reflecting the fact that one of the authors, Mark Pauly, earned his doctorate under James Buchanan, one section of the book attempts to put insurance regulation into a "quasi-constitutional" framework. But the attempt is half-hearted. The authors' plea seems to be more of a plea for "good government" than for any hard-nosed constitutional limits on insurance regulators.

I'm not sure, even after reading the book thoroughly, what the authors' main goal with the book is. What does come across, though, is the ways in which insurance regulation alters incentives and distorts the economy. R

Prejudice and Public Choice

REVIEWED BY GEORGE LEEF

The Declining Importance of Race and Gender in the Labor Market: The Role of Employment Discrimination Policies
By June O'Neill and David M. O'Neill
294 pages; American Enterprise Institute, 2012

Beginning with the Civil Rights Act of 1964, the federal government undertook to eliminate labor market discrimination. The original idea was that no worker should be rejected from consideration for a job on account of his or her immutable characteristics. Over time, however, zealous officials backed by equally zealous interest groups have changed that mission, expanding it to a general quest for overall "fairness" in the labor market. Employers now have to worry about attacks from federal agencies if any employment decision might have a "disparate impact" on a protected group, if they haven't done enough to recruit a sufficiently diverse workforce, or if they have employee preferences that government officials regard as somehow being inequitable.

Given the expanded mission of the anti-discrimination regulators, you might think that labor market discrimination must have grown worse since 1964, but this book shows that not to be the case. June and David O'Neill (both of whom teach at Baruch College) demonstrate in their heavily researched book that employer prejudice against minority workers and women has not just declined, but has almost disappeared.

The authors' careful statistical analysis shows that the difference in average earnings for various groups is explained by their differences in productivity and the choices of individual workers. Moreover, they show that labor market discrimination was fading rapidly *before* the government got involved in its eradication and that the gains made by minority groups actually slowed after the federal campaign began.

Thus, the large and costly federal crusade against discrimination in the labor market seems unnecessary. It imposes substantial dead-weight losses on taxpayers as well as on firms, which have to devote resources to placating government officials. Yet the crusade continues and even shows signs of growing, giving us a perfect example of the Public Choice observation that bureaucracies will do all they can to remain in existence long after the problems they were supposed to address have diminished or even disappeared.

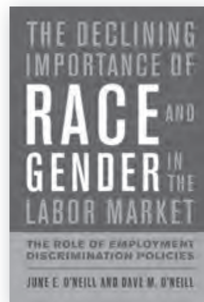
Pre–Civil Rights Era | The O'Neills begin by tracing the relevant history, focusing first on the fortunes of black workers after the Civil War. There was, of course, a huge gap between the average earnings of whites and blacks for decades, but that began to narrow substantially early in the 20th century as many blacks migrated from the agricultural South, where racial antagonism was strongest, to the rapidly industrializing North, where they encountered less prejudice and more opportunities for good employment. Improving education for blacks was also important in their advancement.

World War II further broke down racial barriers and by 1960 the black–white earnings gap was much smaller than it had been in 1940. In 1940, the average earnings for black men who were full-time labor force participants had been only 45 percent of average white earnings, but by 1960 that figure had risen to 61 percent. For black women, the gains were even greater, increasing from 40.5 percent in 1940 to 66 percent in 1960.

Another important datum is the high degree of black labor force participation

George Leef is director of research for the John W. Pope Center for Higher Education Policy.

that formerly prevailed. In 1940, 92 percent of black men ages 25 to 54 were working, compared with 95 percent of white men. That statistic shows that although black workers may have found some employment opportunities were denied them due to bias, they could and did find work in businesses that did not discriminate against them. Since 1940, black labor force participation has decreased, but that cannot be attributed to increasing racial discrimination.



Those data strongly suggest that economists are correct when they argue that labor market discrimination should be rare. Competition for good workers punishes employers who make their hiring and promotion decisions on factors other than productivity.

Civil Rights Act of 1964 | Throughout the 20th century, free market competition had been wiping away the vestiges of slavery and Jim Crow. Without government intervention, blacks had made steady progress, but there were still remnants of labor market discrimination in 1964 and many people regarded it as a national problem. Led by President Lyndon Johnson, Congress passed the Civil Rights Act of 1964. The act's Title VII provided that employment discrimination was illegal and established a new agency, the Equal Employment Opportunity Commission, to enforce it.

Significantly, however, the law did not require employers to fulfill group quotas in their workforces. In fact, the statutory language was written carefully to prohibit "preferential treatment to any individual or groups because of race, color, sex, or national origin." The law was meant to attack the perceived problem of discrimination against *individuals,* not to bring about equal results for *groups.* At that time, the law only reached to those few employers who still insisted on keeping black or other minority workers out; the great majority of employers that did not discriminate had nothing to fear.

The law did not stay that way for long.

In 1965, Johnson signed Executive Order 11246, which imposed a far more onerous hiring regime on firms that contracted with the federal government. That order created the Office of Federal Contract Compliance—now known as the Office of Federal Contract Compliance Programs (OFCCP)—and empowered it to ensure that firms holding contracts with the federal government comply with its nondiscrimination rules. Companies wishing to become or remain eligible for federal contracts had to follow OFCCP regulations aimed at what federal officials regarded as "fairness." The result was de facto racial quotas.

Also, Congress has amended the Civil Rights Act several times, first in 1972, in ways that liberated the EEOC to pursue its own vision of what nondiscrimination requires of employers. Not content merely to go after the small and dwindling number of employers that held to bias against some groups, EEOC officials have kept expanding their mission to the point of absurdity, as the authors show with numerous cases.

Disparate impact | Finally, the courts have gotten into the act. The leading case is the Supreme Court's 1971 decision in *Griggs v. Duke Power*, which turned occupational testing and standards into a legal minefield by ruling that facially neutral tests or standards can nevertheless violate the law if they might have a disparate impact on protected minority groups. That decision was manna from heaven for the EEOC, which began to bring numerous cases based on the theory that various firms' employment rules resulted in some alleged disparate impact.

The O'Neills devote many pages to OFCCP and EEOC cases where the employer found itself in the bureaucratic cross hairs for actions that would seem entirely reasonable to most people. Many of the cases apparently have no more basis than a desire for government officials to look busy. For example, one firm was hauled into court because it hired mostly white workers over a mere three-month time span, ignoring the company's long-run record, which was faultless. Eventually, the OFCCP lost in court (and one heartening thing we learn from the book is that judges often slap down these "we're suing just because we can" cases), but the costs of needless litigation are irretrievable.

Government officials, the authors note, benefit from favorable publicity when they institute proceedings against a company, with press releases depicting themselves as knights in shining armor battling the dark forces of corporate discrimination. If they manage to force a settlement (as often happens), that is another occasion to crow. If they should happen to lose, that news will reach hardly anyone and the public will never contemplate the unseen costs.

When they win, not only do the bureaucrats trumpet their glory, they're inclined to impose Treaty of Versailles–like conditions on the vanquished firm. In one case, the EEOC went after the clothing retailer Abercrombie & Fitch over "image discrimination" that manifested itself in it penchant for hiring young, attractive, white kids who fit the image the company projected through its advertising. Instead of fighting an expensive legal battle, the company capitulated and accepted a consent decree. That decree mandated, among other things, that the firm hire a "vice president for diversity," employ up to 25 "diversity recruiters," and ensure that its marketing materials "reflect diversity."

In a recent initiative named E-RACE (Eradicating Racism and Colorism from Employment), the EEOC plans to investigate through a five-year program of data collection what it suspects is the problem of "colorism": preferences for lighter-skinned over darker-skinned people within the same racial group. The authors write that this "suggests that the agency sees a world still drenched with racism." Probably so, but it also suggests an agency that wants to look like it's busy solving deep social maladies as a means of guarding against budget cuts.

Education | Equal employment enforcement is worse than just a costly program to solve a diminishing labor market problem. It also impedes progress attacking the real problem, which is providing young people, especially black males, with the skills they need to succeed. The O'Neills write,

> We find that it is not employment discrimination that is holding back groups with lower earnings. When lack of skill is the problem, it is counterproductive to compel employers to hire or promote workers they view as unsuitable for the job.... Moreover, the requirement of racial and gender preferences ... that are the basis of affirmative action and disparate impact rulings can have undesirable effects. They reduce the incentive to obtain the human capital needed and they reduce the significance of the accomplishments of those minorities who did not require special standards to compete.

In other words, the crusade for ideal fairness in the labor market (as viewed by EEOC and OFCCP bureaucrats) is a distraction from real problems. The authors don't indict our horrible public primary and secondary school system directly, but fixing basic education so that most young Americans leave high school with respectable skills and work habits would do infinitely more good than the witch hunt for race and gender discrimination. The O'Neills evidently didn't want to expand their book by getting into education, but that indictment is present between the lines.

Our authors do not, however, call for abolishing the government agencies and even write that the EEOC has "important work to do." On that point, I disagree. Their work shows that capable workers will be able to find employment that pays them according to their productivity, no matter their race or sex.

Even if companies sometimes have preferences for people with certain characteristics, the market is an ocean of opportunities. When Abercrombie & Fitch hires only perky white kids, that means there are fewer perky white kids competing for other jobs in retail sales. When Joe's Stone Crabs hires only male waiters to carry their heavy trays (another protracted battle covered in the book), that means there are fewer men competing with women for other restaurant jobs.

If it were politically possible to do so, we should get rid of the EEOC and OFCCP, thus saving the country a great deal of useless regulatory cost. Reining them in would, however, be a good first step and this book helps mightily in paving the way. R

Energy Follies

REVIEWED BY RICHARD L. GORDON

U.S. Energy Policy and the Pursuit of Failure
By Peter Z. Grossman
397 pages; Cambridge University Press, 2012

For at least five decades, economists have provided essential insights into the severe defects of government intervention in energy. Yet, policy reform has been spotty and critical myths remain impervious to criticism—just as the economics of government failure would predict. Butler University economist Peter Z. Grossman offers a splendid, clearly written, masterly, wide-ranging analysis of these policy failures. His book is must reading for anyone concerned with energy policy and worth the attention of those with broader concerns about expansive government.

Richard L. Gordon is professor emeritus of mineral economics at Pennsylvania State University.

The crux of every policy evaluation is getting the economics right. Grossman excels at this. His basic propositions are that recognition of the underlying economics should govern energy policy, policymakers systematically fail to use sound economics, and they make the repeated error of backing a slowly changing suite of "magic potions" that they expect to quickly and cheaply replace oil and natural gas.

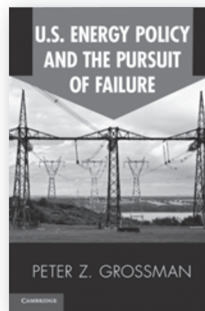
The book is nicely designed to demonstrate the persistence of this folly. Grossman adds an interesting further proposition that the political process encourages some political response to events that induce wide concern. He uses the shorthand of popular outcry, but experience with policy furors suggests that the impressions among politicians often are formed by limited but loud complaints.

These concerns are applied to a largely chronological review of energy policy, which in the United States includes the claim that conventional energy use somehow poses a national security threat. Advocates of government intervention invariably employ spurious analogies to the Apollo space program and the Manhattan Project nuclear bomb program, saying that the proposed government policy measures will quickly induce a "moon shot" breakthrough. Grossman pays more concentrated attention to the defects of the Apollo analogy than to the underlying national security justification for action. The latter is addressed by descriptions throughout the book of the concerns expressed at different times about national security, culminating in the last chapter with a good summary statement of why the fears are ill-founded and clearly insufficient to justify the policies adopted. The cumulative effect is to indicate that the national security concept has changing, but always-vacuous, meanings. Overall, the book demonstrates how numerous economic fallacies were perpetually and often disastrously employed in energy proposals and actions. His historical discussion focuses on highlighting arguments and action that illustrate these errors.

Grossman cleverly encapsulates the contents of his chapters with terse titles. The chronology starts with a chapter ("Crisis") on Richard Nixon's responses to the 1973 oil shock and broader implications critical to the book. Then it treats basic conceptual questions about whether sound economic bases exist for energy intervention ("Failure"). Grossman next backtracks ("Fuels") to review energy policy prior to the 1973 disruption; he starts with sections on the individual fuels pre-Nixon and turns to a review of actions from John F. Kennedy to Nixon. A Gerald Ford chapter ("EIA") and a Jimmy Carter chapter ("Morality") follow. Given Carter's particular overreach, the next chapter ("Apollo") is devoted to skewering the man-on-the-moon analogy. A chapter ("Collapse") on

developments from Ronald Reagan to Bill Clinton follows. The next chapter ("Crisis 2.0") examines energy policy under George W. Bush and Barack Obama. A chapter of policy suggestions ("Modesty") ensues, and the book ends with an appendix on the compulsion of politicians to act in the face of frightening events. Each chapter covers many subjects, and only the most important are noted here.

The effort has a peculiarity that greatly affects the exposition. Grossman relies heavily on archival material: presidential papers and newspaper reports. This has the advantage of uncovering an enormous amount of nonsense now forgotten because so many of the exhaustively formulated policies ultimately weren't adopted or were quickly diluted and quietly withdrawn. For example, he reports frequent calls for energy price controls and expressions of fears of lines at gas stations (a product, as he notes, of price controls). The main disadvantage of this approach is the neglect of important parts of the relevant formal literature and reliance on newspaper reports about other material. In particular, Grossman neglects most of the scholarly attacks on the national security justification. A related problem is lack of references for many statements. In fairness, he also unearths much useful, less familiar scholarly work.



Beyond market failure | The initial "Crisis" chapter serves as both an overview of the book and a survey of post-disruption policy in the Nixon administration. The chapter orients the book by introducing several central themes. The primary points are that in 1974, as in later years, the implicit economics behind policy proposals made no sense, the inherently vague term "crisis" was employed by government officials and special interests to rationalize ill-defined concerns that inspired a desire to intervene, and ultimately the resulting proposals provided the impossible offer of vast supply increases without price increases. Grossman further indicates the pernicious effects of price controls in theory and in Nixonian practice. Here and in several later chapters, he makes effective use of simple supply-demand diagrams to skewer the tacit economics of the policies adopted.

His "Failure" chapter nicely epitomizes standard free-market arguments about market failure. He begins by reviewing various faltering efforts by the U.S. government to ensure that a market-failure justification for a policy exists. He turns to noting the conventional litany of market-failure types. He next recalls that valid policy analysis should begin with recognition that the concept of perfect competition is a pedagogical device that can never be realized in practice. Departures from the ideal may have justifications that at worst produce problems too small to justify the expense that actual intervention inevitably requires. Moreover, as he then discusses, the competence and motivation of governments are far less than tacitly assumed by proponents of correcting for departures from the assumptions of perfect competition. As illustrated by the never-ending socialist-calculation debate, the government cannot secure—at least at a cost that is less than the benefits produced—the information to determine the optimum level of correction. Moreover, an enormous literature arose from Chicago, public choice, and mainstream economics discussing why, given the windfalls arising from regulating markets, government often designs intervention to aid some politically powerful group in a fashion that actually decreases efficiency.

He then provides examination of the implications for energy policy. He presents a laundry list of possible market failures that might arise in energy. Here, as in the rest of the book, he concentrates on the inability of the adopted policies to eliminate these defects, with mention that in any case the United States cannot isolate itself from the effects of world-oil upheavals.

His key conclusion is that a capital-market-imperfection argument is the only one that, were it valid, justifies government intervention in energy. The stress on expensive alternatives to fossil fuel makes sense only if unfettered markets fail optimally to invest in such alternatives. The core of the supporting interventionist argument is that profitable investments in alternatives are hindered by failure of markets to recognize and respond to the impending exhaustion of fossil fuels. Another investment failure is in recognizing ways to decrease energy use profitably. Grossman throughout the book relentlessly demonstrates the perpetual wastes of government spending on projects their advocates falsely claim are undervalued by private investors.

History of energy policy | The "Fuels" chapter provides first a fuel-by-fuel treatment of earlier 20th-century developments and then a combined discussion of events from the Kennedy administration to the oil-supply disruption of the early 1970s. This nicely covers issues most of which have had book-length treatments. Thus, the oil section well examines the move from exhaustion concerns after World War I, the massive discoveries that produced price reductions leading to state programs to restrict output, and the crass decision of the Eisenhower administration to restrict oil imports to protect the domestic output-restriction policies. The gas section too briefly conveys how a U.S. Supreme Court decision forced the unfortunate Federal Power Commission regulation of field prices of natural gas. (This includes the most egregious example of reliance on secondary sources: Grossman correctly cites Eisenhower saying, while vetoing a 1956 revision of the Natural Gas Act, "In the long run this will limit supplies of gas, which is contrary not only to the national interest but especially to the interest of consumers." Examination of the veto statement indicates the veto, as often noted in the literature on natural gas regulation, was due only to wishing to dispel the taint of unseemly lobbying for the bill. Eisenhower's statement clearly related to the impacts of not passing an unsoiled revision of the Natural Gas Act, and not, as Grossman asserts, a justification of the veto.) The nuclear power section stresses how U.S. guilt over producing

and using a nuclear bomb led to excessive investment in peaceful nuclear power. The chapter concludes with a view of energy policy developments from the Kennedy administration to 1973. The key part of the examination is how the general wage and price controls introduced by Nixon evolved into the insidious crude-oil price controls that persisted through the 1970s.

The "EIA" chapter on the Ford administration traverses through the bitter, convoluted debate between Ford and the Democrats who controlled Congress. The title refers to the Energy Independence Authority that Ford proposed as part of an Energy Independence Act to decontrol oil and gas prices, adopt "conservation" standards, and provide massive government support for research and development. In particular, the Authority would have served as a development-funding agency. The chapter chronicles how Democratic resistance to decontrol led to an energy act that allowed for phased decontrol of prices, automobile efficiency standards, and the creation of a strategic stockpile of crude oil. In the process, Grossman points out the severe defects of all those measures.

The "Morality" chapter emphasizes the posturing that characterized Carter's energy policies. Grossman observes, "In fact, before, during, and after his presidency, Jimmy Carter was primarily a moralist." The chapter develops the case that Carter relied on flawed and quickly refuted premises about the might of the Organization of the Petroleum Exporting Countries (OPEC) cartel, the impending exhaustion of world oil, the promise of new technology, and the alleged ability to finance his efforts by taxing oil companies. The discussion includes examination of the exhaustion fears, Carter's posturing, and the two series of energy legislation in 1978 and 1980.

The "Apollo" chapter starts with the standard points that the Apollo program and Manhattan Project were well-funded programs whose goals were fully attained just by completion of the projects. At best, the energy projects considered in the book would have led to new technologies that then would have to prove themselves commercially. Given other misuses of the Apollo analogy, he might have added that, unlike a cure for cancer (another instance in which government intervention was justified by the Apollo analogy), the Apollo program and Manhattan Project objectives were known to be attainable. The rest of the chapter provides useful discussions of how commercialization occurs, why the defects of government make it an inept promoter of new commercial technology, and the errors made in energy.

The "Collapse" chapter starts with review of the energy-price declines of the 1980s, with note of how OPEC countries had bought into the vision of perpetually rising prices. The Reagan section tries too hard to fault over-optimism about the effects of oil price decontrol, but properly reserves its greater scorn for those predicting disastrous oil price rises. The George H.W. Bush section deals with numerous elements, including yet another unjustified energy panic in the wake of the first Gulf War, the ill-advised 1990 Clean Air Act Amendments that pushed ethanol use in automobiles, and the grab-bag National Energy Policy Act. The Clinton section pays most attention to a failed effort to inspire more energy efficient motor vehicles and the inevitable fiasco of California's ill-designed restructuring of its electric power industry.

> The theme is that President Obama displays great gusto in embracing all the myths skewered in Grossman's earlier chapters.

Today and tomorrow | "Crisis 2.0" deals with the George W. Bush and Obama years. It starts with a description of Bush's outlook on energy and moves to sketching Obama's similar one. The next section reviews the economic literature that tries to determine the extent, if any, that oil price changes affect total economic activity. Grossman doubts the effects are great and argues that monetary policy is more appropriate as a cure than reducing imports. Then the actual policy debates and actions of the Bush years are examined. Particular stress is placed on unjustified enthusiasm for ethanol.

The Obama section is aptly titled "Nothing Learned." The theme is that Obama displays great gusto in embracing all the energy myths skewered in earlier chapters. Particular attention is given to the large "green energy" component in the 2009 stimulus bill and the further energy efforts in the failed Waxman-Markey bill to control greenhouse gas emissions. The chapter concludes with a discussion of the failures of the U.S. Department of Energy (DOE). A key element is a short recollection that supply disruptions have been and are likely to remain brief and manageable. Another point is that the DOE has the classic defects of a large government agency.

Grossman's "Modesty" chapter starts off well by arguing that fears of imports are overblown and should be repudiated and that depletion, if it ever threatens, requires no government intervention. He recognizes that environmental externalities from energy use arise and that the dependence of other nations on Middle Eastern oil precludes U.S. isolation from the effects of disruptions. More questionably, he stresses the need to intervene militarily and diplomatically to help allies in times of crises. A stronger argument is that only total U.S. renunciation of international trade would actually insulate the United States from oil shocks. Grossman correctly concludes that actual policies were inordinately expensive ways to provide a cushion. Another valuable point is that justifying intervention on extraneous bases such as job creation should cease. He next urges increased clarity in lawmaking.

He then suggests that unnamed government actions could facilitate development of needed new institutions such as those required for an electricity "smart

grid." Given the historical record in that realm, I submit the real need is for the government to stop interfering with private institutional development. Grossman urges making explicit the consequences of any proposed intervention.

He then advocates ceasing support of commercialization of energy research and developing a sounder program to support basic research. The latter argument starts with the standard "underinvestment" theoretical case for action and then uses an example of a basic-research program in solar energy that he optimistically argues would have been fruitful if the original goals were continued. However, this seems to ignore his earlier caveats about government actions to cure apparent market failures.

He is too equivocal about what to do with the DOE. He fears a lack of coordination among energy actors if the agency were terminated, even as he recognizes that the DOE is a bloated bureaucracy. Given his sensible suggestions about limiting intervention, he admits that in his ideal world the DOE would have little to do. He should have gone further. As his book shows, the creation and perpetuation of the DOE reflect two fallacies that perpetually plague energy policymaking. The first, central to the book, is belief in the existence of market failures that governments can correct. The other, kept implicit, is that something so widely employed and thus deeply integrated into the economy as energy cannot be neatly isolated. The DOE was assigned responsibility over limited components of government programs affecting energy; much else remained the purview of other agencies. In many cases, such as the Environmental Protection Agency, the Department of Interior, and the Tennessee Valley Authority, they exercise pernicious influence. Rather than worry about losing the DOE, concern over these many other sacred-cow agencies is needed.

His case is not helped by his praise of the Energy Information Administration (EIA) for removing the asserted taint of "industry" data provision. That assertion is nonsense. Before and after the creation of the EIA, data were collected from industry and largely reported by a government agency—the main exception being oil and gas reserve data that previously were generated by an industry committee. The EIA took over the effort and much more expensively, more slowly, less extensively, and less well produced what the private sector had provided.

A long subsection lists the main aspects of the global-warming debate. The apt conclusions are that massive interventions à la Waxman-Markey are clear losers, a rush to act is ill-advised, and a carbon tax is preferable to cap-and-trade. He ends with brief warnings that forecasts err, markets can be trusted, and President Obama remains wedded to the view of energy that the book shows is defective.

These are lessons that deserve frequent examination. Having made similar arguments for more than half a century, I am aware that resistance to this wisdom is high. Yet progress is made, and keeping silent is not appropriate for economically literate observers of energy (and the many other realms of ill-informed intervention). The idiocy keeps coming. R

Two Hundred Ways the Tax Code Stinks

REVIEWED BY IKE BRANNON

Taxes in America: What Every American Needs to Know
By Leonard E. Burman and Joel Slemrod
Oxford University Press, 2012

For reasons I cannot fathom, most people do not share my enthusiasm for reading about the intricacies of the "tax loss carryforward." Len Burman and Joel Slemrod aim to fix that, and more generally to make the tax reform discussion that's slowly insinuating itself in newspapers across the country a bit less mystifying for policy geeks and laymen alike. The timing for this primer is impeccable because if reform does occur, it will necessitate some major changes in the tax code that can (and will) be easily demonized. A handy prophylactic that covers all contingencies is just what the times call for.

The subtitle of this book may be "what every American needs to know," but a better one would be "the person who writes the check is not necessarily the person who bears the burden of the tax, you idiots." While it's a message that might seem straight out of Econ 101, in my experience it also happens to be something that most students quickly forget and that politicians feel free to ignore. Disregarding this simple tenant is commonplace among those content with the status quo who reject any radical changes. And radical change is precisely what the tax code deserves, for it is a complete and utter mess: many find it difficult to comply with; it incentivizes dubious actions and discourages other, salutary ones; and it has become an impediment to the type of economic growth the United States needs if it is ever to dig itself out of its current fiscal hole.

Ike Brannon is director of research at the R Street Institute in Washington, D.C.

Simplify | Tax reform involves two separate maneuvers, both of which are politically precarious. The first is the reduction or elimination of various deductions, credits, and exemptions that litter the code. The second involves using those savings to reduce tax rates, reduce the deficit, or (if you are the current president) increase spending elsewhere. Both maneuvers promise to be contentious, but it is simplification that portends the most difficulty. This is where *Taxes in America* is most helpful. Most deductions end up being economically useless to most Americans, but those deductions

convey significant benefits on a relatively small group of "winners"—winners who will fight fiercely to keep the benefits. It is a fight that cuts across party lines, and Burman and Slemrod manage to destroy the various shibboleths that special interests construct to defend their sacred cows.

They deftly tear down the tax deductions for mortgage interest, employer-provided health insurance, and state and local taxes, which are the three costliest deductions and ones that prominent politicians on both sides explicitly defend while saying out of the other corner of their mouths that they are in favor of tax reform. It's rhetoric akin to agreeing to a strict diet as long as pizza and cake are what's for dinner. Proper tax reform entails everyone's ox (or special tax break) getting gored, but with the ancillary benefit of more economic growth and more jobs—and ultimately more revenue.

The authors are very good at explaining the origins and attendant complexities of the alternative minimum tax and give a great explanation of the marriage penalty in light of the mathematical difficulty of avoiding penalizing either single or married workers. It provides a great perspective for how the tax code grew to be so complicated in the first place and it describes the obstacles that stand in the way of giving everyone a post card–sized tax return to file.

Reallocation | When it comes to distributing the gains (the aforementioned second part of tax reform), the authors are a bit more circumspect. There's no one right answer, especially in an economy running trillion-dollar deficits with fierce demographic pressures knocking on the door. But Burman and Slemrod do provide some sage wisdom for those pondering the exercise.

To wit, two competing sentiments among the advocates for tax reform split along conventional political sensibilities: the desire to rearrange the tax code so that it is more conducive to economic growth, and the desire to change the code so it does more to redistribute wealth across the income brackets. Despite the fervent wishes and banal arguments to the contrary, these two generally work in the opposite direction. If we follow the economists Thomas Pikkety and Emmanuel Saez and tax the income of the wealthy at a 70 percent rate, there *will be* a reduction in economic growth; the question is only how much of a reduction.

Liberals love to use the utterings of a few extremists on the right who aver that all tax cuts pay for themselves as proof positive that supply-side economics is the realm of the loony. But holding that people and businesses are largely unresponsive to tax rates (as a recent publication by the Congressional Research Service suggested) is a willful ignorance as wrong as that of the most extreme supply-siders. While tax cuts can rarely be said to "pay for themselves," the fact remains that sustained, solid economic growth is a necessary ingredient in any attempt to boost revenue. The two largest revenue gains in post-war history occurred from 1996 to 2000, when federal revenue went up by 50 percent, and then from 2004 to 2007, when it increased by over one-third. In neither period was tax rates increased. Both spans represent periods of strong and sustained economic growth.

A mathematical truism is that the difference between 2 percent and 3 percent economic growth is not just 1 percentage point—it's 50 percent. In the long run that difference can have a huge impact on standards of living and tax revenue, as anyone familiar with the miracles of compound interest can attest.

Burman and Slemrod demonstrate that taxing the wealthy is never as simple as it may appear. For instance, since most capital gains and dividends go to the wealthy, there is always a strong sentiment within the Democratic Party to increase taxes on those sources of income. However, the end result of higher capital taxes (which includes corporate income taxes) is a reduction in the return to capital, so that we see less investment in the economy. That, in turn, translates to less capital—the tools, machinery, and plants that make workers more productive. Ultimately, a person's income is determined by productivity, which means that higher taxes on capital depress wages—first and foremost the wages of those who work with capital, namely blue collar workers. The notion that labor—and not the owners of capital—bear the brunt of capital taxation is not a radical idea: the Congressional Budget Office and Tax Policy Center assume as much when they create their tax distribution tables.

So while the answer may be that economic growth can fix much of what ails our economy as well as our wretched government balance sheet, how we get there is not so elemental. Fixing the tax code and making it look like it was designed on purpose, to borrow from former treasury secretary William Simon, is not sufficient to do that, but it is certainly necessary.

Berman and Slemrod's implicit plea is for our government to use the tax code first and foremost to raise revenue—and to do so with the least negative effect on economic growth. Incentivizing bigger home mortgages, the purchase of hybrid cars, employer-provided health insurance, and the myriad other things buried in the tax code should be cut back or eliminated wherever possible. This is because there are inherent problems to incentivizing behavior via the tax code: it allows members of Congress to pretend that their favorite subsidies, when run through the tax code, are "tax cuts." The less the government uses the tax code to push and prod us in various ways, the more difficult it is to insert such unproductive policies through the code.

It is an unfortunate fact that the odds against tax reform—like any significant change in government, no matter how worthy—are slim. Burman and Slemrod's primer implies, through the cavalcade of sensible answers to each and every question relevant to the tax code, that it is a battle well worth undertaking. The potential returns to the economy and the citizenry could be significant. It is a shame that this simple fact alone doesn't factor into the political viability of such a change, but a concentrated group of potential losers invariably finds it easier to band together and defeat a diffuse group of potential winners, even if the winnings vastly outweigh the losses. R

Better Mixed Economy

REVIEWED BY DAVID R. HENDERSON

Better Capitalism: Renewing the Entrepreneurial Strength of the American Economy
By Robert E. Litan and Carl J. Schramm
263 pages; Yale University Press, 2012

What should be done to increase the growth rate of the sluggish U.S. economy? This is the main issue that economists Robert Litan and Carl Schramm address in their book, *Better Capitalism*. The book is mistitled. As valuable as many of the authors' proposals are and as tight as a good deal of their reasoning is, they are not proposing better *capitalism*. While they advocate some deregulation—especially of the entrepreneurial sectors of the economy, including the labor market—they also advocate extensive regulation of energy and transportation. What we currently have is not capitalism, but what the 1950s to 1970s economics textbooks accurately called "the mixed economy." The authors don't propose making it less mixed; rather, they want what they regard as a better mix. A more accurate title, therefore, would have been the admittedly less-catchy title *Better Mixed Economy*.

The book is uneven. Some chapters offer provocative ideas that got me thinking in new ways but did not necessarily persuade me. Some chapters, especially the one on immigration policy, are excellent. The chapter on energy policy is weak on economic analysis and proposes new regulations, one of which could, ironically, make the United States even more susceptible to the international oil cartel, OPEC.

Promoting research | The authors' central proposition "on which all of [their] arguments rest" is this: "[F]aster economy-wide growth over the long run rests on the formation and growth of high-growth companies." They define a high-growth company as a start-up whose revenues eventually mature into $1 billion a year. They use some basic arithmetic to show that if an additional 60 such companies started in the United States in a year, the economy's growth rate that year would rise by 1 percentage point. Their calculation is based crucially on a datum from Yale economist William Nordhaus, who found that the innovative entrepreneurs "capture only 4 percent of the total social gains from their innovations." This estimate seems reasonable.

With this 60-additional-firm goal as their starting point, Litan and Schramm spend most of the rest of the book considering how to get there. That leads them to discuss research and development policy, how universities could reform their incentives for research, tax policy, immigration policy, and energy policy, among others.

On R&D policy, the authors argue persuasively against more federal government funding of research. They claim that the peer review system for awarding funds creates and cements "a club of well-connected senior researchers" who resist novel thinking. As evidence, they note that the average age at which U.S. Nobel Prize winners made their Nobel-worthy discoveries is 34, but that "the average age of the primary investigators who have been awarded research grants by the National Institutes of Health is over 50, and has been steadily rising." The authors emphasize that they do not advocate a rollback of existing levels of research support. It sounds, therefore, as if they're claiming that the existing level is optimal, but they never say why.

The authors advocate a permanent 8 percent R&D tax credit to replace the current temporary 25 percent tax credit that applies to R&D spending over a particular baseline specified by Congress. They would apply the tax credit to "only those activities aimed at exceeding, expanding, or refining commonly held knowledge." They don't explain, though, how that would be enforced when the incentive would be to claim as much as possible in that category. They also favor ending the corporate income tax in order to end the double taxation of corporate income (once as corporate income and again as paid-out dividends), but they stop short of advocating it.

Litan and Schramm are rightly skeptical about government attempts to support business "incubators" and "clusters." They note that the main examples of companies that succeeded—Microsoft, Apple, Dell, Amazon, etc.—did not do so because of a government plan. They point out that many of the entrepreneurial movers and shakers in high-tech clusters don't know or regularly interact with each other, but surprisingly they advocate that local mayors get such people together so that they *can* interact. If they succeeded without knowing each other, why do the authors think that a government official needs to get them to know each other?

Possibly their most insightful chapter is on the important role of universities in research. One striking fact is that in 1975, private firms accounted for over 70 percent of what *R&D* magazine called the top 100 "most technologically significant new products" and that the university share was only 15 percent. By 2006, the university share was 70 percent and the private-firm share was down to 25 percent.

The authors have clearly thought a lot about how to leverage academics' contributions more effectively. They make a number of suggestions for changes in the contracts between universities and academics so that academics can be freer to push their ideas into the private sector, and universities can still get their cut. This is not exactly a government policy issue because these are contractual matters between often-private universities and their faculties. In one section of this chap-

David R. Henderson is a research fellow with the Hoover Institution and an associate professor of economics at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, Calif. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

ter, though, Litan and Schramm seem to forget their own earlier reference to Nordhaus's finding that innovators get a small fraction of the social gains that their innovations create. The authors present a table showing that for the top 10 universities, licensing income gave a rate of return on research expenditures ranging from a low of 0.3 percent for the University of California system to a high of 4.3 percent for New York University. They call these returns "abysmally low." But if these are the private returns, then aren't the social returns an order of magnitude higher?

Attracting immigrant entrepreneurs | In their chapter on immigration policy, titled "Importing Entrepreneurs," Litan and Schramm point out that between 1995 and 2005, immigrants started or co-founded about one-quarter of "successful firms engaged in technology and engineering," even though immigrants make up only one-eighth of the population. Not surprisingly, therefore, they want to make it easier for entrepreneurial foreigners to immigrate to the United States and stay. On the way to their policy recommendations, the authors give a nice, terse history of U.S. immigration policy. As a U.S. immigrant who had a tough tangle with the Immigration and Naturalization "Service," I thought I understood the ins and outs of immigration law. But the law has changed since I became a permanent resident in 1977, and almost entirely for the worse. The authors note that the number of H-1B visas—visas granted for only six years to high-skilled workers—that Congress allows has fallen from 195,000 a year in 2001–2003 to only 65,000 a year today. Also, to get an EB-5 visa, which is for "immigrant investors," one typically must invest at least $1 million in a business. When I immigrated in 1977, the number was $10,000.

The authors highlight a 2011 proposal by former senators John Kerry and Richard Lugar for a new EB-6 visa for immigrants who want to start a business. Had the law passed, the visas would have been granted to those who invested a minimum amount—well under $1 million—in a business, to those on H-1B visas, or to those who graduated with a science, technology, education, or mathematics degree and met minimum income ($30,000) or asset ($60,000) thresholds. This would have been a major improvement over current law. People who qualified could have gotten permanent-resident status if they had generated three to five jobs for nonfamily members within two years. Litan and Schramm argue that, with these criteria, there should be no quota on the amounts of these visas issued because immigrants who meet the standards would be creating jobs, not reducing them.

Errors on energy | Litan and Schramm's weakest chapter is on energy. One problem is that their history of the energy industry is weak. They claim that John D. Rockefeller's Standard Oil Company engaged in "price-fixing schemes and other anticompetitive practices." In fact, the way Standard Oil was able to capture "upwards of 85 percent" of the oil market was by cutting prices, not raising them. And while they are correct that the Japanese government's "quest for oil security led Japan on an expansionist drive throughout the Pacific that ultimately led to its attack on Pearl Harbor," they leave out the fact that President Franklin D. Roosevelt had tried to cut off Japan's oil supply. While that doesn't make their history wrong, it does make it incomplete and misleading. Also, whereas they correctly date the formation of OPEC to 1960, they don't mention that OPEC's formation was an unintended consequence of President Dwight Eisenhower's discrimination against the Middle East in his assigning of oil import quotas.

Also, the authors don't seem to understand the nature of the world oil market. They write that the "United States is importing oil and will continue to do so, mostly from countries that are autocratically ruled, unfriendly to the United States, or at best, unreliable allies." They see this as a problem. Put aside the fact that between 2006 and 2011, imports from Canada, whose residents are not that unfriendly, grew from 17 percent to 24 percent of total imports. More important, wherever our imports come from, people sell us oil not because they like us, but because they want to make money. We don't really need to worry much about which tyrant controls Iraq, Iran, or Saudi Arabia—they all want to make money. And notice, by the way, that the U.S. and European governments, not the Iranian government, are the ones that restrict oil imports from Iran.

Finally, the authors claim that the U.S. oil industry receives $40 billion in subsidies a year. They footnote an article that they claim makes that case, but I did not find that estimate in the article. It's true that in earlier times the U.S. oil industry was heavily subsidized—if one defines an oil depletion allowance as a subsidy—but most of that special tax treatment is long gone, as the article they cite points out. Their estimate is an order of magnitude too high.

In addition to their weak historical and economic analyses, Litan and Schramm offer some questionable policy proposals for energy. Specifically, they advocate an oil price floor of $60 to $70 per barrel. To maintain that floor, they would have a variable tax on oil, both imported and domestic, equal to the difference between the price and the floor. So, for example, if the floor were $60 and the world price of oil were $50, the tax would be $10. The main advantage they see of such a proposal is that it would protect the investments of "developers and manufacturers of alternative liquid fuels." Their fear seems to be that in the absence of a floor, OPEC would occasionally reduce the price to below $60 per barrel in order to discourage competition.

In two articles in *Energy Journal* in the late 1980s, I showed the perverse effects of a related proposal—an import fee on oil that varies inversely with the price of oil. Their proposal has the same problem: the fee would make the U.S. elasticity of demand artificially lower. If, therefore, OPEC does have monopoly power—as most energy economists believe—such a variable tax would *increase* OPEC's monopoly power.

Conclusion | With the exception of this one weak chapter, the rest of Litan and Schramm's book is quite good. If their book persuades the U.S. government to allow even 20,000 more permanent immigrants into the United States every year, it will have been well worth writing. R

IS THERE HOPE FOR THE DOLLAR?

☐ YES ☐ NO ☑ FIND OUT!

Donate to Atlas's Sound Money Project at AtlasNetwork.org

"...a proven prescription for restoring American prosperity."
-Jim DeMint, U.S. Senator South Carolina

"...Shelton shows exactly how to make the dollar sound again."
-James Grant, Editor of Grant's Interest Rate Observer

"Dr. Shelton offers here a much-needed education...Members of Congress, take note!"
-Larry Kudlow, Host of CNBC's "The Kudlow Report"

"...a must-read for all would-be reformers of our broken monetary system."
-William Kristol, Editor of The Weekly Standard

FIXING THE DOLLAR NOW

JUDY SHELTON

WHY US MONEY LOST ITS INTEGRITY AND HOW WE CAN RESTORE IT

Available on Amazon.com & Kindle!

1201 L Street NW, Washington, DC 20005 • 202.449.8449 • AtlasNetwork.org