IN REVIEW

# Feeling Poverty but Not Understanding It

REVIEW BY JOHN F. EARLY

Princeton sociology professor Matthew Desmond has spent his academic career studying American poverty and public policy. In his latest book, *Poverty, by America*, he explicitly states his purpose as answering the question, "Why is there so much poverty in America?" This is an important question, and it can be answered—at least in part—by careful analysis of the data, so I was eager to read what he found.

***Who is poor?*** / One would expect the analysis to begin with some clarity around just how much poverty is "so much"? The official American definition of poverty, underlying the Federal Poverty Level (FPL), is a family lacking the resources required to satisfy its minimum economic needs. That accords well with the meaning of "poverty" in everyday speech. Desmond seems to agree with that measure, but never gives his reader the number of people that he believes is "so much." At the time he was completing his book in 2022, 37.9 million people (11.6 percent of the population in 2021) fell below the FPL, but he never says that 37.9 million people is his "so much."

His only explicit answer to the question is a claim that America has more poverty than any other advanced democracy, based on data from the Organisation for Economic Co-operation and Development (OECD). But the OECD definition of poverty is different from the American definition, which Desmond adopts throughout the book except when he is justifying his "so much" claim. The OECD defines the poor in a country as families with incomes below one-half the median income in their country, but this measure describes poverty in terms of income distribution, not material condition. Consider that Americans whom the OECD deems poor have between 40 percent and 100 percent more income than people it identifies as poor in other advanced OECD countries. This relative measure leads to the paradox that a family in the United States with an income of $30,685 would be counted as poor, while families with income of only $14,141 in Italy or $21,904 in France would *not* be counted as poor. Using the same income standard for all countries shows the United States has at least 60 percent less poverty than other developed democracies.

After citing the deceptive OECD data to justify "so much" poverty, Desmond returns to using the FPL and a "supplemental" measure of poverty from the Census Bureau, neither of which shows any significant change over the last 50 years. He ignores at least two major research studies that show substantial declines in U.S. poverty over the last 50 years, with recent poverty rates between 1.1 percent and 4.0 percent, compared with the official 11.6 percent. These research studies argue that official American measures of poverty are overstated primarily because the Census Bureau does not count 88 percent of government transfer payments (subsidies) given to poor families. The book's failure to even mention these two studies looks like an intentional exclusion to avoid the uncomfortable possibility that most of Desmond's claims are wrong. (The author's endnotes reference a journal article that demonstrates the superiority of one of these consumption-based measures, but he never even acknowledges the existence of that measure in the body of the book.)

***Why is there poverty?*** / The book promises to identify the causes of poverty, but its "evidence" consists of anecdotes about individuals who were substance abusers, or sought jobs in the underground economy where they avoided Social Security taxes and thus were not eligible for disability benefits when injured, or lost their free housing because they physically threw their neighbors out of windows. These are the types of cases that constitute the 2–4 million people who are identified as poor by the improved methods that Desmond ignores. But his cases do not explain most of the 37.9 million who implicitly constitute his "so much" poverty.

The book offers several causes for why "so much" poverty exists. First, it claims poor people are distracted by scarcity, so they make bad decisions. This claim flies in the face of history. In 1949, 35 percent of Americans were poor, but before Lyndon Johnson's War on Poverty started spending any money (1965), more than half of them had earned their way out of poverty. How is it that folks in the mid-20th century were not too distracted to raise their families out of poverty, but in the 21st century they are?

Next, he claims that working Americans look down on the poor as lazy and that somehow causes their poverty. He ignores the real evidence that government transfer payments to low-income households increased by 369 percent in constant dollars from 1967 to 2017, which enticed more

**About Our Reviewers:**
ART CARDEN is professor of economics at Samford University's Brock School of Business.

JAMES A. DEEKEN is a partner in the international law firm Akin Gump Strauss Hauer & Feld and an adjunct faculty member at Southern Methodist University Law School.

JOHN F. EARLY is a mathematical economist, president of the consultancy Vital Few, and an adjunct scholar of the Cato Institute. He has twice served as an assistant commissioner at the U.S. Bureau of Labor Statistics.

THOMAS GRENNES is professor of economics emeritus and professor of agricultural and resource economics emeritus at North Carolina State University.

GEORGE LEEF is director of external relations for the James G. Martin Center for Academic Renewal.

PIERRE LEMIEUX is an economist affiliated with the Department of Management Sciences of the Université du Québec en Outaouais.

VERN MCKINLEY is the coauthor, with James Freeman, of *Borrowed Time: Two Centuries of Booms, Busts and Bailouts at Citi* (HarperCollins, 2018).

PHIL R. MURRAY is professor of economics at Webber International University.

than twice the proportion of low-income prime-working-age adults to choose the increased government subsidies rather than work. Almost half of the poor in Desmond's universe are prime-working-age adults and 55 percent of them did not work at any time during the year. Those who did hold a job worked, on average, only 24 hours per week. This withdrawal from the labor force is about incentives, not labels.


***Poverty, by America***
**By Matthew Desmond**
**304 pp.; Crown (Penguin Random House), 2023**

Desmond objects to proposals that would ask poor individuals to behave differently, such as adopting the "success sequence" of (1) graduating from high school, (2) taking a full-time job, and (3) marrying before having children. Only 2 percent of people who observed all three elements experienced poverty, while 76 percent of those who violated all three were poor. He correctly points to some debate in the literature over the exact magnitudes involved, but there is no serious dispute about the importance of high school graduation and full-time employment in avoiding poverty. Desmond's objection is not fact-based; it is metaphysical. He says that expecting a person to observe productive behaviors is extreme and "asking the person to just get a different life." But millions of people have made the decision to "get a different life" and do what it takes to rise from poverty. Those who haven't are the exceptions.

Another claim is that discrimination against Black people causes "so much poverty." Discrimination is an important social issue, but it is largely irrelevant in the context of poverty. White people account for 67 percent of the poor, while Black people account for 23 percent. The White poverty rate has not declined over the last 50 years, while the Black poverty rate has systematically declined by almost half over the same period. If the most accurate measures of poverty are used, the difference between the Black and White poverty rates is now less than 1 percent.

Another proposed cause is that only one-third of applications for federal Disability Insurance under Social Security are approved, compared with one-half 20 years ago. But that ignores the full set of facts. Many more applications are being submitted for review today because the Social Security Administration loosened its standards and promoted the program. The net result is that, since 1972, the number of people receiving Social Security Disability payments has grown five times faster than the workforce that is paying the bills, causing the proportion of working-age people receiving disability subsidies to be five times *greater*, thereby reducing poverty.

Another putative cause of poverty is that rents have risen "too much," consuming half of poor households' spending. That is factually wrong; the reliable data show it is only about 25 percent. But even if true, his argument is irrelevant for explaining the amount of poverty defined, as he does, by income, not spending.

One final villain in the author's list of causes is the decline in union membership. He argues that union discrimination against Black workers caused the union movement to lose its momentum and not enlist all the oppressed workers in the country. He then makes an unsupported leap to conclude that businesses sensed this weakness and removed worker protections. Yet Desmond fails to list a single protection that was removed. He merely imagines that union membership could have fallen only because government was not *forcing* workers to join unions.

He completely ignores two characteristics of labor economics. First, inefficiencies that unions forced on employers often led to economic failure or offshoring of work. At the same time, more workers voted against unionizing in free and open elections. Desmond tries to avoid that discussion by citing the factoid that, between 2016 and 2017, "the National Labor Relations Board (NLRB) charged 42 percent of employers with violating federal law during union campaigns." There are three misleading components to this claim:

- The wording sounds like a huge number of violations, but it was not 42 percent of the 10 million employers in America, but 42 percent of union organizing elections, of which there were fewer than 3,000.
- The 42 percent figure is almost exactly the proportion of elections that unions lost. The standard operating procedure for unions is to file an unfair labor practice complaint in every lost election, and the NLRB in those years routinely converted each complaint into a charge.
- The figure concerns *charges*, not proven *violations*. More than 90 percent of NLRB charges are "settled" without a finding. For the remaining less-than-10 percent without a negotiated settlement, the Board does not publish how many were proven to be in violation.

The book summarizes its kitchen sink full of causal theories by claiming that poverty springs from systemic exploitation of workers. It claims that all "privileged" people—which seems to be everybody who is not poor or near-poor—are guilty of exploiting workers and must adopt "poverty abolitionist" policies and behaviors. The rhetoric and sweeping generalization of this theory place it firmly in the company of other grand schemes that cannot be described rigorously or proven with data: systemic racism, existential climate change, and so forth.

***Combating poverty*** / Desmond praises Johnson's War on Poverty, writing, "Ten years after the first of these programs rolled out in 1964, the share of Americans living in poverty was half what it was in 1960." But that is a distortion of history. Between 1960 and 1974, the poverty rate did decline from 22.2 percent to 11.2 percent, a drop of 11.0 percentage points. But during the

IN REVIEW

previous 11 years, from 1949 to 1960, it had declined by 12.6 percentage points without any increases in government transfer payments, just normal healthy economic growth. Even within Desmond's selected time period, poverty declined by 0.80 percent per year from 1960 to 1964 and by only 0.78 per year from 1964 to 1974 during the War on Poverty. Had poverty merely maintained its pre-1964 trend, it would have been 9.2 percent in 1974, not 11.2 percent. Furthermore, 1972 and 1973 were the low points for poverty during the entire 57 years after the War on Poverty was announced. Since 1973, poverty rates have simply oscillated with the business cycle, between 11.1 and 15.2 percent.

The official poverty rate failed to fall after the 1960s because government failed to count as income all the new money it gave to poor families and used upwardly biased price indexes to calculate poverty thresholds. If those data failures had been fixed, the measure of poverty would have fallen to a mere 1.1 percent. Desmond ignores those facts, so he then proceeds to claim that far more money needs to be transferred to low-income households. We can be reasonably sure that, like the extra money transferred in the last 50 years, these additional transfer payments will also not be counted by the Census Bureau, and Desmond and his progeny will continue to bewail "so much poverty."

In addition to increased transfer payments, Desmond's proposals constitute a patchwork of traditional progressive policies.

One proposal is to increase the minimum wage and index it to inflation. That is a complete misunderstanding of the facts. Some 40 percent of minimum-wage earners live with their parents. The median income for households with minimum-wage earners is almost the same as the median income for all households. The minimum wage is an entry to the job market, with two out of three minimum-wage workers getting a raise within their first year. The current federal minimum wage of $7.25 would create $15,080 in annual income if one worked full time. That is more than the $14,580 federal poverty level for a single individual, so the *existing* federal minimum wage is not a poverty wage. The principal cause of poverty is the choice *not* to work, not the pay from working. Among prime work-age adults in poor families, 55 percent choose not to work any hours during a year, and among those who do work, they work only 24 hours per week. Those workers earn $11.25 per hour, well above the minimum wage. Instead of making a fact-based case for why the minimum wage should exist at all, not to mention be raised, Desmond simply engages in an emotional tantrum, claiming, "Congress should outlaw undignified, even dangerous, poverty wages." Where are the data?

The book also recommends using government to force employees to accept unionization by empowering the secretary of labor to compel sector-wide collective bargaining. Antitrust laws prevent companies in the same industry from colluding to set their prices, so why should it be okay for monopoly unions backed by bureaucrats to do the same? But the perversity of this proposal runs even deeper, abridging the equal rights of workers. Why should workers in a large New York plant be able to force conditions on workers in a smaller Texas plant in the same industry who do not wish to pay union dues or support union political positions?

One of Desmond's solutions concerns housing. Here, he is onto something. Although none of these proposals would reduce poverty, one could improve the poor's quality of life by eliminating many of the exclusionary zoning and building ordinances that limit the ability of property owners to build the housing of their choice, especially housing for low- and middle-income families. Unfortunately, Desmond takes this good idea and transforms it into a terrible one by proposing "inclusionary zoning"—that is, new housing legally mandated to go to low-income households. He claims, "While exclusionary zoning makes it illegal to develop affordable housing, inclusionary zoning makes it illegal not to." His argument here is internally contradictory. When arguing for the value of removing regulatory barriers to affordable housing, he points out, "Once those plans [for affordable housing] are inked, it doesn't take long for developers to bid on the job because they can make more money on multifamily complexes than stand-alone homes, even when they rent out a share of their units to low-income families." If removing the barriers is so effective on one page, why does it fail on the next page?

The underlying structure of Desmond's proposals is more government spending and higher taxes because he believes that income is a zero-sum game. He explicitly claims that the poor are poor because they have been oppressed by other people who are rising up the income distribution to become middle or upper class. He says, "Those who have amassed the most power and capital bear the most responsibility for America's vast poverty: … corporate bosses who have spent and schemed to prioritize profits over people." But economic prosperity is not a zero-sum game. Economic prosperity comes from hard work and innovation to create value for which people are willing to pay. The only part of income that is not earned by work or saving is the money that government forces us to disgorge through taxes for the benefit of government's favored redistribution groups.

Despite his wide-ranging search to blame almost everybody for poverty, Desmond devotes but a single sentence to one powerful opportunity to help not only the poor but other low-income households as well: removing excessive government occupational licensing. In the 1950s, only one in 20 jobs required a license, but today it is more than one in four. There should be a clear call to repeal most licensing requirements, but his single sentence on the issue is tepid, and it seems to blame the businesses that hire licensed people rather than the government that created the licensing barriers in the first place.

***Conclusion*** / Desmond promises his readers an answer to one question: "Why is there so much poverty in America?" He fails to do this on three counts. He provides no data for how much is "so much." His theories of poverty's cause are mostly warmed-over statist recitations of blame, with no supporting empirical evidence. And he demonstrates no understanding of the broad and significant research that has been done to answer these important questions. If he does not agree with that research, he should have offered evidence and logic to the contrary, but he simply ignores it.

In the end, his case is strictly emotional. Two pages from the close of the main text, Desmond sums up his whole approach: "We can feel it, the emotional violence we inflict on ourselves, knowing that our abundance causes others' misery." That is not helpful in addressing an issue for which we have large amounts of objective evidence, most of which he has ignored.

# Securities For All?

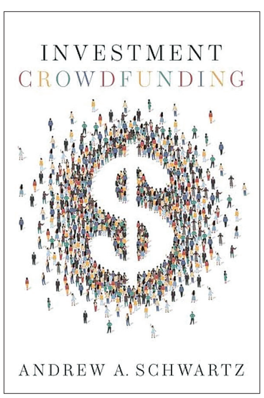
**REVIEW BY JAMES A. DEEKEN**

Crowdfunding is an overlooked portion of the securities markets. Its relatively nascent nature and limited offering amounts have kept it off the radar of most finance and legal professionals. As a counter to that, University of Colorado law professor Andrew A. Schwartz has written *Investment Crowdfunding*, an in-depth analysis of crowdfunding laws and regulations, largely focusing on the United States but also drawing upon comparative international legal analysis from Canada, the European Union, the United Kingdom, Australia, and New Zealand. In the book, Schwartz summarizes current laws and provides analysis of the pitfalls and benefits of various crowdfunding legal regimes.

The U.S. crowdfunding market, which allows the general populace to fund companies outside of the normal strictures of securities law, was created by the JOBS Act in 2012. It was put into place formally by Securities and Exchange Commission regulations that became effective in 2016 and were further amended in 2020 to increase the issuance limit to $5 million.

In Schwartz's view, liberalized laws that allowed the creation of crowdfunding have democratized the market for startup funding, allowing traditionally excluded groups to have both access to new investment opportunities and new sources of capital. More traditional securities law has high barriers that largely foreclose retail participation in private company securities offerings. This requires entrepreneurs to rely on high-net-worth personal connections or relationships with institutional investors for fundraising.

If the book's usefulness were confined to the relatively small world of crowdfunding, its import would be limited. However, Schwartz's analysis has implications that reach toward the broader securities markets. A general thesis of his centers around the concept of "private ordering," where market participants create their own rules independent of government regulation to develop a system of market exchange based on trust and confidence in counterparties.




***Investment Crowdfunding***
**By Andrew A. Schwartz**
**208 pp.; Oxford University Press, 2023**

***Private ordering and regulation*** / Schwartz's main example of private ordering is in how crowdfunding platforms have an incentive to protect their reputations by acting as gatekeepers, independent of any regulatory requirements, listing only a small percentage of companies that apply to participate on their platforms. He further argues that the most likely best way to keep costs down and yet maintain investor protection is for governments to focus their regulatory attention on crowdfunding platforms rather than on individual companies or investors.

His enthusiasm for private ordering dovetails with an at-times skeptical view of government regulation. In particular, he eschews most U.S. crowdfunding regulations except for the $5 million per-issuer limit, which he believes limits the potential for fraud, and a requirement that crowdfunding platforms be licensed by the Securities and Exchange Commission.

However, he does believe that some "market failures" can be addressed with government regulation. He advocates regulation to help avoid fundraisers "gaming" the system by setting artificially low targets that allow them to close under a U.S. rule that a crowdfunding offering cannot close until the target is successfully met. He also advocates for U.S. regulations that would impose time limits on crowdfunding offerings so dormant ones don't linger, following what other international regulators have done.

Finally, he argues for and defends regulations that require companies raising money through crowdfunding to make available periodic financial statements. He finds it ironic that some international jurisdictions' crowdfunding regulations require disclosure when a company is fundraising when its incentive to voluntarily disclose information is already high, but those jurisdictions do not require disclosure after a company has raised money and has less incentive to provide disclosure.

His analysis of the multiple jurisdictions across the world suggests the evolution of a market for regulation. For example, New Zealand, which adopted some of the most liberalized crowdfunding laws and which was one of the first jurisdictions to adopt laws allowing crowdfunding, had one of the greatest needs for private

IN REVIEW

company capital. Schwartz views New Zealand's model as a success because it has kept costs low, encouraged capital formation, and empowered private ordering to protect investors, while having only one violation for fraud after nearly a decade. A second example that he points as evidence of the success of liberalized law is the United Kingdom, which similarly took a light-handed private-ordering regulatory approach to address a need for capital, with results that he views as being successful in encouraging capital formation and minimizing cases of fraud.

Schwartz's critical analysis of the effectiveness of government regulation and his willingness to consider private ordering as means whereby markets can redress at least some market failings on their own make him a unique voice among law school academics. At a time when government regulation is expanding, it would be helpful for people like Schwartz to cross-examine the regulatory state. His willingness to temper his criticism of several government regulations by accepting some current regulations and his advocacy for some regulatory restraints indicates that his views are influenced more by careful analysis than by rigid ideology.

Part of his premise for constraining government regulation in the crowdfunding world is based on the limited amount of capital that investors can put at risk in crowdfunding and the fact that there has not been widespread fraud in the crowdfunding world. It is not clear to what extent his views would carry over to the broader securities markets where fraud is rifer, the amounts at risk are larger, and there is no gatekeeper such as a registered platform. However, it would be interesting to consider whether an opportunity for private ordering exists in the broader markets.

Schwartz should expand on his ideas through more books and consider expanding his securities law scholarship beyond crowdfunding. His insights into private ordering and his analytical approach to evaluating regulations represent views that need to be heard in the broader securities law landscape. R

# A Fashionable Appeal to a Benevolent State

**REVIEW BY PIERRE LEMIEUX**

In *Power and Progress*, Massachusetts Institute of Technology economists Daron Acemoglu and Simon Johnson argue that for technology to be beneficial to society and create no unemployment, inequality, or poverty, it needs to be controlled by social power (especially trade unions) and government regulation. "Progress is never automatic," they say; it must be directed.

According to them, the first phase of the industrial revolution impoverished workers, and we are now facing a similar threat. But, they assure readers, the trajectory of technology is a choice, and it does not have to be left to the market. The shift of power to government regulation and organized labor starting in the late 19th and early 20th century translated into fast growth after World War II and a better sharing of the "rent" of technology between capital and labor. This shared prosperity crashed in the 1980s with the new information technology, automation, and free-market doctrines like Milton Friedman's. Today's advances in artificial intelligence threaten to make the situation worse. Moreover, social media works against democracy. We need to reorient technology to a "socially beneficial trajectory."

The book's economic and historical scope is wide and ambitious. One finds a few good points in its 500 pages—for example, the danger of technology used for government surveillance. However, many of the authors' claims are doubtful and often puzzling.

Acemoglu and Johnson give a very wide definition of power as "the ability of an individual or group to achieve explicit or implicit objectives." They tell us that Lord Acton's aphorism about government's coercive power—*Power tends to corrupt and absolute power corrupts absolutely*—"applies just as aptly to persuasion power, including the power to persuade oneself." They don't seem to think that there is a significant difference between a government command imposed by force and a private choice reached by an individual or a voluntary group of individuals. This fuzzy notion of power is everywhere in the book.

***Industrialization*** / The authors review the history of the Industrial Revolution in the United Kingdon, where it started around the middle of the 18th century. During the first hundred years or so, they claim, it was detrimental to ordinary workers. From then on, they admit that conditions improved, a reversal ascribed to the workers' new political power. The authors' stance on the exploitation of powerless workers for a hundred years or so does fit well in their ideological narrative.

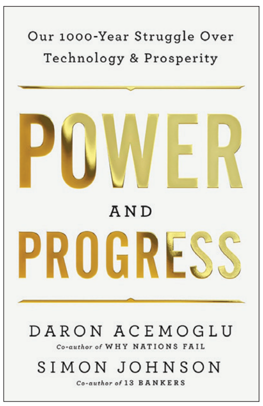
However, their view is hotly debated among historians. Emma Griffin of Queen Mary University argues that ordinary workers benefited very early in the Industrial Revolution from the opportunities offered by steady jobs. As a result of increasing incomes, for example, the urban age of marriage started declining by the end of the 18th century. More generally, she writes:

> Yet even with a government that did nothing, there is an uncomfortable truth that we should confront: industrialisation had remarkable power to put food on the table. And for the first generation, that generation which had expected the hunger of their own childhood to be experienced once more by their children and their grandchil-

> dren, food on the table was all that really mattered. … Critics will argue that the material gains for most families were small. But they were just enough to drag wage-earners out of the servile submission that poverty had forced upon them since time immemorial.

***Progressivism*** / Acemoglu and Johnson laud the Progressive movement in America's late 19th and early 20th century. They admit that the movement had "unappealing elements, including the overt and covert racism of some of its leading lights (including Woodrow Wilson), ideas of eugenics …, and Prohibition." Well, it was not only *ideas* of eugenics that should be mentioned, but the 65,000 women who were forcibly sterilized in America between 1907 and 1980. The main weapon of government intervention is not roses.

"Narrow vision and selfish interests" were challenged. Our authors praise "Nordic choices" and the "Scandinavian social democratic system" and its "corporatist model," which already worked better than the American economy. They have remained fans of the Scandinavian and German models. They even quote Rexford Guy Tugwell, a member of Franklin D. Roosevelt's "Brain Trust," who advocated "a strong government with an executive amply empowered by legislative delegation." They don't mention that Tugwell also thought that new industries should not "just happen" without government permission. (See "Total Regulation for the Greater Whole," Fall 2014.) That Johnson teaches "entrepreneurship" at MIT is somewhat intriguing.




***Power and Progress: Our 1,000-Year Struggle Over Technology and Prosperity***

**By Daron Acemoglu and Simon Johnson**

**560 pp.; PublicAffairs, 2023**

*Power and Progress* lauds Roosevelt for recognizing "the right of workers to collectively organize," helped by special coercive power granted by government. And they seem surprised that Fr. Charles Coughlin, a former populist, New Dealer, and creator of the National Union for Social Justice, later became a supporter of Mussolini and Hitler.

To be clear, I don't criticize Acemoglu and Johnson for sympathizing with workers' voluntary associations. I do, too. But coercive bargaining power and compulsory membership are another matter. The coercive formula prevents a market test of the unions' efficiency.

***Losing our way*** / After World War II, the authors note, union power grew and technology became labor friendly. In the 1960s, President Lyndon Johnson launched the War on Poverty and boosted the welfare state. The authors of *Power and Progress* ignore some inconvenient facts, such as that welfare-state assistance decoupled the bottom income-distribution quintile from the labor market. In this quintile in 1967, about two-thirds of able-bodied working-age persons who were not full-time students worked, but that figure fell to about one-third by 2017. *Power and Progress* also seems to accept uncritically the misleading ideas that circulate about inequality. (See "Is Inequality Bad, Large, and Increasing?" p. 53.)

The reader will find many economically intriguing statements in the book. Acemoglu and Johnson argue that, after 1980, "we lost our way" and abandoned worker-friendly technology and "the shared-prosperity model of the early postwar decades." That was a bad choice: "the bias of technology was very much of a choice—and a socially constructed one." A bit of postmodern jargon cannot hurt. We find many such catchy statements in *Power and Progress*; for example, "By the 1980s, many American managers came to see labor as a cost, not as a resource." What about a resource that has a cost—strange, eh?

It is difficult to imagine that robots could destroy 50 percent of the jobs and the incomes that go with them, as the authors seem to suggest. Statistically, the number of jobs simply grows with the working-age population as new entrants in the labor market find ways to satisfy the unlimited desires of their fellow humans. Our authors paraphrase economist Wassily Leontief who, in 1983, worried that "human labor would go the way of the horses and become unnecessary for modern production." These fears don't have better foundations than the similar scares that have popped up regularly since the birth of modern technology.

***Magical society*** / Back to the notion of choice, which is another fuzzy matter in *Power and Progress*. The authors insist that machines must be useful "to human objectives." But since human objectives are not identical across individuals, that's not saying much. Although the book does mention Nobel economist Friedrich Hayek (once, but strangely with no bibliographical citation), its authors don't seem familiar with his view that a free society is one where each individual is allowed "to use his own knowledge for his own purposes"—which means for his or her own objectives.

The authors also want to put machines "at the service of people." But the way to make basically anything useful to diversified human purposes is to let private choices be made on free markets and allow demand to determine production. Collective choices will at best be uniform; at worst tyrannical. Private choices on markets are more efficient to determine "where exactly society has the greatest need"—assuming that this way of expression can be interpreted in any other way than social anthropomorphism.

The authors often repeat that technological arrangements and developments are choices. So, who gets to make those choices, political rulers with commands or individuals through contracts? For Acemoglu and Johnson, there seems to be no difference between a "choice" as the unintended result of multiple decentralized private choices or as a decision imposed by political authority, provided the latter acts on behalf of 50 percent + 1 of some group. The only distinction they seem to make is that the former are bad and the latter good.

Contrary to the impression they give, we can't hide behind words like "social." *Power and Progress* uses it as what Hayek called a "weasel word" or what should perhaps be a laundering word. Except for social sins and other negative substantives, everything with "social" appended is supposed good. (See the chapter on "Our Poisoned Language" in Hayek's *The Fatal Conceit*.) In *Power and Progress*, similarly, a mythical "civil society" is called for whenever a deus ex machina is needed. In another book by Acemoglu with James Robinson, *The Narrow Corridor*, the state becomes more and more powerful but is kept in check by a more and more powerful "civil society" in a manner that seems magical. (See "A Shackled Leviathan That Keeps Roaming and Growing," Fall 2021.) In a few places in both books, the magical "social" mutates into "societal," which only has the look and feel of something more scientific.

**The government that the authors hope will follow their advice is not a government in the real world, but an ideal government, not of this world.**

A major rule of standard economic analysis is to carefully distinguish between, on the one hand, positive analysis—that is, explanations of *what is*—and, on the other hand, *what should be*, or the normative values that underlie policy proposals. Acemoglu and Johnson ignore that distinction.

For example, they write that "when there are major decisions about the direction of technology, there is no guarantee that the market-based innovation process will select areas that are more beneficial for society as a whole or for workers." They also write that some technologies profitable for businesses may "not contribute to or may even reduce social welfare." This raises so many questions: Who says so? Who calculates what is more beneficial for "society as a whole"? Who is "society as a whole"? How do our authors measure "social welfare," if only in theory? Perhaps they would answer that they are following some sort of utilitarian cost–benefit analysis, but they would then contradict themselves when they oppose any cost–benefit tradeoffs in the regulation of children's working conditions.

To be clear, I am not arguing for cost–benefit analysis and interpersonal comparisons of utility. I believe that the moderate classical-liberal principles of a free society are more along the lines of Hayek and James Buchanan's theories. (See "An Enlightenment Thinker," Spring 2022.) It would be useful for the reader to know what exactly is Acemoglu and Johnson's political philosophy.

***Angelic democracy*** / To these critiques, the authors of *Power and Progress* may invoke a standard objection: democracy will determine what's good and what's bad. But what is democracy? The closest they come to defining it is when they write that "democracy, above all else, is about a multitude of voices, critically including those of ordinary people, being heard and becoming significant in public policy decisions." But how are these voices aggregated? This is a standard economic problem that Acemoglu and Johnson ignore. What about the opinion of Hayek and many classical liberals that democracy is merely a way to assure peaceful transfers of power? (See "Populist Choices Are Meaningless," Spring 2021.)

In short, it seems to me that Acemoglu and Johnson espouse a simple and angelic conception of democracy, which may be synonymous with "good" and "social." I suggest they would greatly benefit from studying the public-choice explanations of how collective choices are made in different forms of democracies—majoritarian versus constitutionally limited, for example.

The government that Acemoglu and Johnson hope will follow their advice is not a government found in the real world, but their ideal government, not of this world. Consider, for example, their discussion of the 2007–2009 Great Recession, for which they blame greedy corporations. The only blame they assign to the federal government is to not have regulated enough. Remember that the crisis started in the market for mortgage-backed securities (MBS). It was Ginnie Mae, a government sponsored enterprise (GSE) created by Congress in 1968, that pioneered the issuance of MBSs in 1970. Up to the MBS crash, numerous politicians were on record claiming the desirability of *more* mortgages for poorer households. For example, then-congressman Barney Frank wanted to "roll the dice" and "get Fannie and Freddie [two other federal mortgage GSEs] more deeply into helping low-income housing." As for a lack of government supervision, Stanford economist John B. Taylor noted that hundreds of regulating bureaucrats were working on the premises of large banks *before* the crash.

Still, Acemoglu and Johnson maintain that a benevolent, powerful, and effective government would lead society to nirvana: "We must find ways of countering power with alternative sources of power and resisting selfishness with a more inclusive vision." But nirvana is a dangerous mirage.

To be fair to the authors, they do mention the constraint of the rule of law once, and constitutional constraints a couple of times. But they don't explain how the vast new powers they want to grant to the state are consistent with such constraints.

They notably propose to "redirect technological change," remake digital technologies, and create broader-based trade unions. They want "worker-friendly technologies," government-funded worker training programs, data ownership regulations, the break-up of tech giants (Google, Facebook, Amazon), and digital advertisement taxes. Mentioning Sens. Bernie Sanders and Elizabeth Warren, they long for wealth taxes. It nearly goes without saying that "society should strengthen its existing social safety net."

Perhaps more worrisome is what

seems to be the theoretical foundation of the redistribution they are after. They consider any technological innovation and probably any advancement of any sort as creating a sort of "rent" to be shared between "labor" and "capital" under the diktats of some political authority. They don't seem to realize that there is no such floating rent belonging to nobody and waiting to be politically apportioned. Everything belongs to the actors without whom it wouldn't otherwise exist, and free markets are the only known mechanism to distribute these rewards so that opportunities and production are maximized. A state with the power to redistribute the alleged floating rent from social cooperation—including the work of academics, no doubt—would have to be a totalitarian state. Leviathan's monitoring and surveillance would certainly increase, not decrease.

Despite its authors' good intentions, *Power and Progress* looks like the work of philosopher-kings à la Plato. German poet and philosopher Friedrich Hölderlin had an answer when he wrote (as quoted by Hayek) that "what has always made the state a hell on earth has been precisely that man has tried to make it his heaven." *R*

*READINGS*


- *Law, Legislation, and Liberty (1973–1978)*, by F.A. Hayek, edited by Jeremy Shearmur. University of Chicago Press, 2021.
- *Liberty's Dawn: A People's History of the Industrial Revolution*, by Emma Griffin. Yale University Press, 2013.
- *The Fatal Conceit: The Errors of Socialism*, by F.A. Hayek. University of Chicago Press, 1989.
- *Three Generations, No Imbeciles: Eugenics, the Supreme Court, and* Buck v. Bell, by Paul Lombardo. John Hopkins University Press, 2008.
- *Why I, Too, Am Not a Conservative: The Normative Vision of Classical Liberalism*, by James M. Buchanan. Edward Elgar Publishers, 2006.


# Sowell vs. the Social Justice Warriors

**REVIEW BY ART CARDEN**

In his new book *Social Justice Fallacies*, Thomas Sowell returns at age 93 to remind us once again that there is nothing new under the sun. In this case, the "nothing new" are "social justice warriors," who offer allegedly brilliant insights, bold proposals, and emphasis on "root causes." But their ideas really are sour wine in old wineskins.

*Social Justice Fallacies*'s five chapters present a lot of material that Sowell fans and scholars will find familiar. For instance, a chapter on "'Equal Chances' Fallacies" takes on the standard lament that little differentiates people who ultimately find economic success from those who don't. Supposedly, most people have roughly the same innate potential, holding everything else constant. But Sowell points out, little has been held constant across the ages, so people differ substantially in their developed capabilities—and in their prospects for developing economically valued capabilities.

***Proportional representation?*** / It is remarkable, Sowell thinks, that proportional representation by race, ethnicity, gender, and so on is used as a benchmark for social justice. Such equality characterizes hardly any society that has ever existed. We see disproportionate representation in many endeavors. Germans are "over-represented" in brewing beer, Scots in distilling whisky, and the French in winemaking. Sowell points out that players in the National Hockey League are disproportionately Canadian despite the United States' much larger population.

Sowell argues that we don't need invidious discrimination to explain disproportionate representation that accidents of geography, history, culture, and biology can readily explain. As he puts it concerning gender differences across space and time:

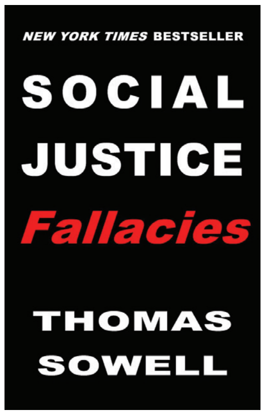
> Human double standards of sexual behavior for women and men have been a pale reflection of nature's more fundamental double standards. No matter how reckless, selfish, stupid or irresponsible a man may be, he will never become pregnant. The plain and simple fact that women have babies has meant that they may not have equal chances in many other aspects of life, even when some human societies offer equal opportunity for people with the same developed capabilities.

Or consider birth order of siblings, which matters a lot. Since first-borns start life with their parents' undivided attention while their siblings do not, firstborns as a group go on to greater academic and commercial success. If we cannot expect equal outcomes among people born and raised in the same household, Sowell asks, on what grounds do we expect equal outcomes among people born and raised in widely differing circumstances?

Sowell explains that innate potential only translates readily into developed capabilities with important co-requisites. The poverty rate among Black households headed by two married parents is usually about 10 percent. Children of parents with professional degrees and professional occupations have an advantage insofar as they

> hear more than three times as many words per hour as children raised in families on welfare. Moreover, these are far more often positive and encouraging words when the parents are professionals, and more often negative and discouraging words when the family is on welfare.

In his chapter "Racial Fallacies," Sowell repeats claims and evidence that readers of his other work will find familiar. Despite the well-known emphasis on the Black–White income gap, he notes that the Asian–Mexican gap is even larger, and the Asian–White gap is considerable. Why, he wonders, do people point to "systemic racism" to explain the first gap but neither of the latter? Racism exists and racism is blameworthy, but Sowell does not believe it has as much explanatory power as other factors. He writes of Appalachian Whites: "People in low-income American hillbilly counties already face zero racism, because these people are virtually all white. Yet they have lower incomes than blacks."




***Social Justice Fallacies***
**By Thomas Sowell**
**224 pp.; Basic Books, 2023**

***Compelling equality*** / In the next chapter, he discusses "Chess Pieces Fallacies," referring to some social planners' assumption that they can manipulate human beings as easily as game pieces on a chess board. He used this idea to great effect in his 2008 book *Economic Facts and Fallacies*. The prose is vintage Sowell, as he writes of discussions about how "we" should "arrange" society to achieve this or that beautiful goal: "Interior decorators *arrange*. Governments *compel*." Compel they do, but frequently compulsion has the opposite of its intended effects. Higher tax rates do not necessarily translate into higher tax revenue, and "tax cuts for the rich" do not necessarily translate into lower tax revenue. Price ceilings create shortages and price floors create surpluses. He argues that Black teenagers' poor job prospects are in no small part due to rules making it illegal for them to take jobs with wages and benefits that third-party observers do not like.

***Knowledge problem*** / If these policies are pathological, why do they persist? And why don't politicians learn that their standard interventionist toolkit has little salutary effect? My students ask these questions regularly. On the latter, Sowell writes: "Politicians *do* learn. They learn what is politically effective, and what they do is *not* a mistake politically, despite how disastrous such policies may turn out to be for the country." Shortly before this passage, he quotes Richard Nixon responding to Milton Friedman's criticisms of wage and price controls: "I don't give a good goddamn what Milton Friedman says. He's not running for re-election."

Sowell's penultimate chapter explains "Knowledge Fallacies." Much of it will be familiar to those who have read his books *Knowledge and Decisions* (1980) and *A Conflict of Visions* (1987). It will—or should be—revelatory to people who are not. As he does in his earlier work, Sowell builds on Friedrich Hayek's insights to distinguish the kinds of knowledge intellectuals have from the *consequential* local knowledge dispersed throughout society. One can know much about navigation and how to operate oceangoing vessels, but on one fateful night in 1912 the consequential knowledge most relevant to passengers on the *Titanic* was of where the icebergs were.

People unacquainted with Sowell might be surprised to learn that he has little use for intellectuals' and experts' pronouncements, plans, and visions. After all, he is an intellectual and an expert himself. However, he does not think himself fit to serve as a surrogate decision maker for others who do not know as much as he does about economics and intellectual history but might have more consequential local knowledge about what Hayek called "the particular circumstances of time and place."

This tension came into high relief during and after the COVID-19 pandemic, and we will be discovering unintended consequences of expert contempt for consequential local knowledge for years to come. Mask mandates, for example, substitute experts' knowledge about transmission probabilities for speech therapists' consequential local knowledge about the importance of seeing people's faces and, importantly, how particular conditions vary from patient to patient.

For politicians, this all boils down to what President George H.W. Bush called "the vision thing." But these visions are not *just* visions; politicians try to turn them into reality, often with poor results. Sowell describes the consequences memorably:

> Stupid people can create problems, but it often takes brilliant people to create a real catastrophe. They have already done that enough times–and in enough different ways—for us to reconsider, before joining their latest stampedes, led by self-congratulatory elites, deaf to argument and immune to evidence.

He elaborates on this in his final chapter, "Words, Deeds, and Dangers." Many things done in the name of social justice visions decades ago have created problems that social justice warriors feel called upon to "solve" today.

One will search the book in vain for mention of present-day "woke" leaders of the social justice movement. Their omission is both a weakness and a strength of the book. It is a weakness in that the world would benefit from direct, line-by-line refutations of these warriors' claims by a scholar of Sowell's distinction and stature. It is a strength, however, in that Sowell explains how the social justice vision is not some new thing, but has been around for a long time.

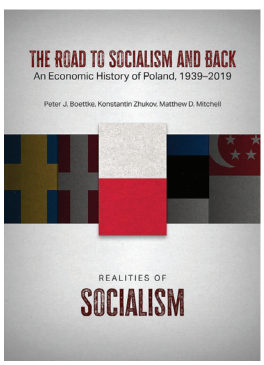
If this turns out to be Sowell's final book, it is a fitting summary and statement concluding a long, distinguished career of following the facts and logic wherever they may lead. It does not contain much that will be new to people already well-marinated in his other work. It will be, however, a revelation to the fair-minded observer wondering whether today's crusades for social justice are as new—or as likely to be effective—as the crusaders claim. R

# Poland's Hard Road

**REVIEW BY THOMAS GRENNES**

The new book *The Road to Socialism and Back*, by George Mason University economist and philosopher Peter J. Boettke, his graduate student Konstantin Zhukov, and Fraser Institute senior fellow Matthew Mitchell, deals with the four-decade period after World War II when Poland experimented with socialism and the subsequent four decades when it has somewhat moved toward liberalism. The title reminds readers of Friedrich Hayek's *The Road to Serfdom*, and the book frequently cites him on economic and political freedom. More appropriately, it underscores how, like serfdom, socialism reduces people to mere factors of production.

***Gap between promises and realizations*** / One of the book's main conclusions is that there is a deep gap between the lofty stated goals of socialist ideology and the realized results in socialist Poland. Economic growth was less than promised, and socialism did not bring about the promised greater economic equality among Polish citizens. In its attempt to eliminate capitalism, the socialist experiment created a set of privileged insiders who were able to use their power to enrich themselves and their elite associates. Socialism lowered average income and increased inequality while it favored a set of privileged insiders called *nomenklatura*.




***The Road to Socialism and Back: An Economic History of Poland, 1939–2019***

**By Peter J. Boettke, Konstantin Zhukov, and Matthew Mitchell**

**Fraser Institute, 2023**

The failure of Poland's experiment to demonstrate the superiority of socialism was much like the results of related 20th century experiments in Russia and other Eastern European countries. The book effectively analyzes specific policies that contributed to the failure, such as rigid central planning, top-down decisions, and ending private property. Fixing prices independent of supply and demand created a shortage economy and black markets.

Socialism was not chosen freely by the Polish people. It was imposed on them a few years after World War II by the Soviet Union and was enforced by the threat of invasion if liberal reforms were made that Soviet leaders opposed—a threat that Leonid Brezhnev made official doctrine in 1968. Ultimately, poor economic and political performance led to Poland's revolt against socialism that began in 1980 with the rise of the independent trade union Solidarity, led by Lech Walesa. Reductions in real gross domestic product for three consecutive years contributed to opposition to the socialist government. Lack of economic growth, a shortage economy, and a pathology of privilege among the elites contributed to the revolt.

***Reform and its results*** / Polish reformers such as Walesa initiated change, but foreign countries played an important role. The USSR's decision to refrain from using its military to stop the reform was crucial. It had intervened in East Germany in 1953, Hungary 1956, and Czechoslovakia in 1968. The rise of Gorbachev and the end of the Brezhnev Doctrine were helpful to Polish reformers.

In 1989, Solidarity leader Tadeusz Mazowiecki became the first non-communist prime minister of Poland since 1946. He formed a government in which finance minister Leszek Balcerowicz played a prominent role in reforming the economy. Balcerowicz's swift and comprehensive reform plan has been described as "shock therapy." Later, with Balcerowicz as head of the central bank (Narodowy Bank Polski), Poland got inflation under control. The need for reform and the specific reforms proposed by Balcerowicz were initially supported by a broad section of the Polish population. According to Polish economic historian Piotr Korys, the transformation model was not criticized by any of the country's mainstream political groups.

Western governments also contributed to Poland's move away from socialism. The new Polish government followed the Ten Points of the Washington consensus, which included fiscal discipline, liberalization of trade, privatization of state enterprises, legal security of property rights, and elimination of anti-competitive regulations. The United States, the Paris Club of Western governments, and the London club of private Western banks all forgave Polish debt.

Among Polish political factions, initial agreement on the proposed reforms included both Solidarity leaders and the brothers Lech and Jarosław Kaczyński, founders of the Law and Justice Party (PiS). In his 2018 study of Poland's post-reform growth, Kozminski University economist Marcin Piatkowski refers to the reform as a "miracle" and the post-reform period as a "Golden Age." Poland also opened its economy to the world by reducing barriers to trade and joining NATO and the European Union.

Following the transition from socialism to a more market-oriented economy, Polish real GDP grew for 28 consecutive years. Australia was the only other country that achieved this consistency of growth. Consumption grew and Polish life expectancy increased. Economic movement away from socialism produced favorable economic growth, but it also produced greater income equality as measured by the Gini coefficient. Prior to 2004, inequality was greater in Poland than in the average country in the Organisation for Economic Co-operation and Development (OECD), but from 2008 to 2019, Polish inequality has been lower than in the average OECD country.

Extreme inflation was a problem during the transition period away from socialism. In 1989, the inflation rate was 251 percent, and it reached its peak of 586 percent in 1990. The next year, it fell to 70 percent, and then to 28 percent by 1995. Eventually, it fell below the average for OECD countries. Later, after Balcerowicz became head of the central bank, the inflation rate fell to the bank's target rate of 2 percent. Unsurprisingly, the decline followed a slowing of the growth of the broad money supply.

***From reform to populism*** / However, in recent years, Poland's road away from socialism has taken a detour to populism. Over time, PiS gravitated toward populism and illiberal democracy. The party gained control of the Polish parliament in 2015 and began opposing domestic reformers like Balcerowicz. PiS leaders also came to oppose basic positions of Poland's Western allies, such as the European Union. They rejected the application of various EU rules as encroaching on the sovereignty of Poland. In a recent *Atlantic* article, "Poland's Imperiled Democracy," Johns Hopkins University political scientist Yascha Mounck reported that when PiS gained control of the government, it immediately began to undermine the rule of law. (Interestingly, though PiS and reformers disagree on many issues today, one exception is they both support Ukraine in its defense against Russia.)

Boettke et al. use the Fraser Index of Economic Freedom to identify Poland's retreat from liberalism and economic reform. Poland's Total Freedom Index peaked in 2014–2015 and then declined through 2018. Defense of property rights was one of the worst components of Poland's Total Freedom Index. In 2018, it ranked 35th out of 38 reporting OECD countries. Boettke et al. observe that Polish regulators still suffer "from a milder version of the pathologies that plagued socialist economies."

The Fraser Index provides a quantitative measure of decline, but the authors provide no information about the role of specific people or institutions. The book acknowledges Donald Tusk, leader of the major opposition party Civic Platform, for his efforts to lower income tax rates. However, it does not mention the Kaczyński brothers or PiS, even though Poland's Freedom Index score declined as soon as PiS took power.

Although Boettke et al. provide empirical evidence of Poland's retreat from reform after 2015, they offer no explanation for why its economic freedom declined. Critics, including Balcerowicz and other reformers within Poland, point out that the retreat followed the rise of PiS and its populist economic policies, especially its monetary and judicial policies.

Differences between PiS and reformers became more extreme after the period covered by the book. In 2023 a group of 12 former Polish central bankers issued an open letter criticizing the Polish Central bank under the PiS. Among Poland's allies, the EU has criticized Polish policies under PiS and fined Poland for violating EU rules.

***Why the retreat?*** / Could Poland's retreat from reform be related to its history of being dominated by foreign powers? It has had few opportunities to create its own economic and political institutions. Foreign control of Poland began long before 1939; Free Poland ceased to exist in 1795 when it was partitioned by Russia, Prussia, and Austria, and that occupation lasted until 1918.

The only period when Poland was free of foreign control was the brief interwar period, 1918–1939. And for much of that period, the country was plagued by illiberalism. A military coup by General Józef Piłsudski in 1926 imposed an autocratic government. A group of economists from the Kraków School, led by Adam Krzyzanowski of Jagiellonian University, opposed the autocratic policies of Piłsudski, but Polish independence was ended by the 1939 invasion by Nazi Germany, the Slovak Republic, and the Soviet Union.

Foreign domination for long periods has made it difficult for Poland to develop its own institutions that are conducive to economic and political freedom. In addition, the pathology of privilege granted to elites under Polish socialism led to resentment of elites that added to the appeal of populism.

***Threats to freedom*** / In recent decades, Poland has achieved impressive gains in economic and political freedom relative to the socialist period, despite the retreat since 2015. However, the durability of these achievements faces threats from both foreign and domestic sources. The foreign threat is partly geographical, given the country is in a dangerous neighborhood as underscored by Russia's invasion of Ukraine.

Following the fall of the Iron Curtain, Poland sought to protect itself from Russian aggression by connecting with the West via NATO and the EU. This deterrence depends on how Russian leaders perceive the strength of commitment of Poland's allies, a commitment that has been tested in Ukraine. This has reinvigorated NATO members and prompted the additions of Finland and (probably soon) Sweden. In America, the Biden administration has strongly supported Ukraine, though Trump Republicans are reluctant to challenge Putin.

Given the threat from expansionist Russia, Poland's connections with NATO and the EU are crucial. If NATO partners are viewed by Russian leaders as firm and reliable defenders of Poland, that commitment should deter Russian aggression. However, if NATO members demonstrate disunity and reluctance to support Poland, that would encourage Russian aggression. The influence of American populists is a key factor in confronting Russia in Eastern Europe. Developments in NATO's support for Ukraine will provide some evidence on this issue.

The populist turn of PiS is a second threat to economic freedom. Led by Jarosław Kaczyński, it offered populist policies and autocratic government as soon as it rose to power in 2015. Its government has been described by many critics as an "illiberal democracy." Encouragingly, this past fall's elections may reverse this illiberal slide. Though PiS won a plurality in the Polish Parliament's lower house, the opposition parties, led by Tusk's Civic Coalition, appear poised to assemble a coalition government while the upper house is under the control of the opposition Senate Pact 2023 alliance.

**Conclusion** / *The Road to Socialism and Back* is effective in summarizing and analyzing developments in Poland during 1939–2019. Good works on Poland in English are hard to find, and this one is a welcome addition to the literature. It explains the rise of socialism, the reasons for its failure, and describes the all-too-brief period of successful reform. However, it only touches on the worrisome prospect that Poland's road away from socialism might not lead to greater economic and political freedom. *R*

*READINGS*

- *Europe's Growth Champion: Insights from the Rise of Poland*, by Marcin Piatkowski. Oxford University Press, 2018.
- *Poland from Partition to EU Access: A Modern Economic History, 1772–2004*, by Piotr Korys. Palgrave Macmillan, 2018.
- "Poland's Imperiled Democracy," by Yascha Mounck. *The Atlantic,* June 8, 2023.

# Is Economic Inequality Bad, Large, and Increasing?

**REVIEW BY PIERRE LEMIEUX**

As I prepared to read these two books, I had different expectations. I thought Branko Milanovic's *Capitalism, Alone* would contain some interesting defenses of capitalism, while *The Myth of American Inequality* by Phil Gramm, Robert Ekelund, and John Early would offer an easy and perhaps banal defense of existing inequality. After all, what should I expect from a politician like the ex-senator Gramm, even if he pursued some good policy ideas during and after Ronald Reagan's presidency (when the Texan switched to the Republican side of the Senate aisle)?

To my surprise, I found Milanovic's ideas rather banal and too uncritical of the zeitgeist of our times. Gramm et al., on the contrary, present deep and interesting statistical and economic analyses of the trumpeted inequality of American society.

**Milanovic's capitalism** / Milanovic, a former World Bank economist, is now a senior scholar at the City University of New York's Stone Center on Socio-Economic Inequality. His book argues that capitalism stands alone in today's world because all successful regimes are variations of the same basic system. He uses the term "liberal meritocratic capitalism" to describe the political-economic system found in advanced Western countries as well as Japan and South Korea. It combines capitalism with legal equality and democracy, the latter two attenuating the market's harsh meritocratic feature. "Social-democratic capitalism" is another form, which is supposed to have fleetingly existed between the end of World War II and the early 1980s in Western Europe and North America. Milanovic thinks that this form of capitalism tried to redistribute income more seriously. "Political capitalism," represented by the Chinese model, is based on decentralized enterprises with "wide latitude" but under a powerful authoritarian state guaranteeing stability.

"Classical capitalism" is an obsolete form of capitalism that prevailed under Adam Smith and the Industrial Revolution. Milanovic believes that it was not ethical or consistent with today's globalized world—nor presumably with our progressive elites.

The book contains some good ideas. Take the discussion of the "unfounded fear of technological progress." Milanovic shows that there is no reason to fear that technological progress will reduce employment and cause social dislocation. We have experienced 200 years of technological progress, "and every time, after the shock is past, it turns out that [these fears] have been exaggerated." When resources became scarcer, their prices increased, they were economized, and other resources were substituted for them (synthetic rubber is just one example). New resources and production methods were discovered or improved (beet sugar or fracking, for example).

Milanovic tells the instructive story of Stanley Jevons, a prominent 19th-century British economist, who believed that the supply of trees would run out, paper would become scarcer, and paper prices would go through the roof. He thus hoarded a large stock of paper. But new technologies reduced the cost of manufacturing paper as well as the cost of harvesting and replanting forests. Fifty years after Jevons' death, his children had yet to use up his paper stockpile. "We are no smarter than Jevons," Milanovic complains. "We, too, cannot imagine what might replace fuel oil or magnesium or iron ore. But we should be able to understand the process whereby substitutions come about and to reason by analogy."

**Shaky claims** / The main thread of the book's argument, however, is very shaky. Despite what he said about technological progress and reasoning by analogy, Milanovic is suspicious of Adam Smith and Friedrich Hayek's autoregulated economic order. He sees capitalism as a regime that promotes the interests of capitalists instead of a set of free markets that satisfy consumers' demand. It's barely exaggerated to say that in his vision of capitalism there are no consumers with diversified preferences, just a mass of people who want "economic growth," whatever that is! Consequently, it is only an empirical question which system produces more economic growth, liberal meritocratic capitalism or (if corruption is kept at a reasonable level) political capitalism, and which regime will come out the winner in the evolution of social institutions.

For Milanovic, it seems, capitalism

is always crony capitalism, except if the political system dominates. He does not seem to realize that, between the capitalists' special interests controlling the state on the one hand and, on the other hand, a state that controls capitalists and everybody else, there is a third alternative. The third alternative we may call "free markets" if the label "capitalist" is unavailable. In a free-market society, capitalists only have *veto power* against expropriation and state control. Besides that, consumers rule. That, contra Milanovic, should be the ideal.

Milanovic thinks the current system of globalized "capitalism" is naturally amoral, by which he seems to mean *immoral*. Except perhaps for his summary references to John Rawls, I would argue that it is Milanovic's own approach that suffers from amorality if not immorality. Democracy, conceived as the mere rule of the majority and yearning for material equality, appears to be his only moral foundation. Nowhere in the book does he mention or cite James Buchanan or raise the question of whether individual liberty can foster, or be supported by, an ethics of responsibility and reciprocity. (See "An Enlightenment Thinker," Spring 2022.)

The neglect of spontaneous economic order and a sketchy ethics mean that *Capitalism, Alone* leaves no room for limits on political power. The author seems to imagine a Brave New World made of economic growth—the production of as much as possible of *something*—and submission to some numerical majority or other benevolent ruler. He is blind to the danger of tyranny.

The Chinese model looms large in Milanovic's scenarios and in his attraction to political capitalism. He is not the only one to think this way. It is strange that so many economists have not realized that the Chinese economy can only provide meaningful economic growth—that is, growth that responds to market demand—to the extent that it gets closer and closer to real, non-political capitalism. Through international trade, it is now easy to start an industrial revolution; maintaining its momentum is another matter. It is strange that we could ever believe that more economic dirigisme and more industrial policy would make the Chinese model more attractive instead of compromising its economic success. But it is now becoming obvious. (See "Getting Rich Is Glorious," Winter 2012–2013.) It is also obvious that the Chinese government does not need the ill-advised cooperation of the protectionist U.S. government to undermine the enrichment of Chinese citizens (or subjects).

**Egalitarianism** / Milosevic more-or-less assumes that economic inequality is bad, large, and increasing. If it continues to grow, liberal meritocratic capitalism will have to move toward a more advanced and egalitarian stage. "We must set ourselves an entirely new objective: *We should aim for an egalitarian capitalism based on approximately equal endowments of both capital and skills across the population*" (emphasis in original).

His proposed policies include:

- tax advantages for the middle class;
- higher taxes on the rich, including higher inheritance or wealth taxes that could finance a "capital grant" for every young adult;
- employee stock ownership plans;
- better public schools; and
- forbidding private contributions to political campaigns, which he expresses as "strictly limited and exclusively public funding of political campaigns."

This last mantra seems to always pop up in progressive wishes, as if Donald Trump would not have been elected under a populist election financing system!

Otherwise, we are warned, liberal meritocratic capitalism is likely to evolve toward a plutocratic regime and eventually into political capitalism. The majority will want to drop democracy in favor of equality, stability, and growth. The good state will intervene to control all that. But, he should realize, the equalizers will be less equal than the equalized.

**Gramm et al.'s very different book** / *The Myth of American Equality* is a very different book: more focused, more critical, and better grounded in the values underlying the ideal of a free society. It challenges the accepted idea or assumption that large and increasing inequality is a huge problem under the sort of capitalism that we know in America (even if it is far from classical capitalism). The authors are three economists: Gramm, who at the beginning of his career taught economics at Texas A&M University; Ekelund, a professor emeritus at Auburn University who passed away as I was putting the finishing touches on this review; and Early, a mathematical economist and consultant who, interestingly, was once a legislative assistant of the late Democratic senator George McGovern.

As announced in the title of the book, the authors argue that the problem of large and growing inequality in America is a myth. Whatever inequality exists in earned income (market income) largely results from individual choices in pursuit of economic opportunities. Besides, it is much attenuated by the welfare state's transfers and taxes. These transfers, however, have generated a worrisome "decoupling of low-income households from the workforce" and created a whole class of dependent people with reduced opportunities.

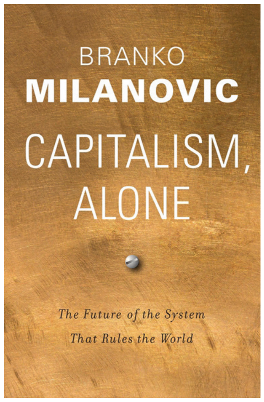
The authors carefully document how income inequality is exaggerated in many published statistics from the Census Bureau and the Bureau of Labor Statistics (BLS) because real income is inaccurately measured. The required correctives are well-known and have been documented and published elsewhere by these or other government agencies.

**Earned-income inequality** / I will first consider the measurement of earned income—that is, household income before taxes and transfers. The taxes considered in Gramm et al. include federal and state personal income taxes, payroll taxes including Social Security and Medicare taxes, sales taxes, and property taxes at all levels of government, and all "other" taxes.

A measurement problem that is well-known and has been researched for several decades is that the ordinary Consumer Price Index (CPI), as opposed to the "chained" CPI (C-CPI) or to the Personal Consumption Expenditure Price Index, overstates inflation by something like 1 percentage point every year. One reason is that the CPI does not timely recognize the substitutions that consumers make by moving away from more expensive goods toward less expensive ones when relative prices change—for example, by substituting chicken for beef if the price of the former decreases or the price of the latter increases. Technically, the quantities used to weigh prices in the index lag (by up to three years) the decisions consumers make to maximize their utility. That difference matters. If we use C-CPI, which includes this corrective, instead of the ordinary CPI, we obtain an increase of 31.8 percent in real wages from 1967 to 2017, or more than three times the official 8.7 percent published by the BLS.

A reminder might be useful: a price index is meant to extract from money income the general depreciation of the currency's purchasing power. Having more money does not help if prices have generally increased by the same percentage. As Gramm et al. point out, the federal government is hypocritical (my expression) on this because it does use the C-CPI to adjust tax brackets, which reduces the inflation offset and thus increases the tax grab!

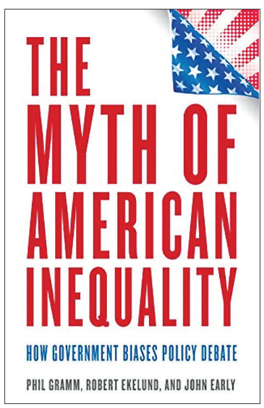
Another reason why the ordinary CPI overestimates inflation is that the BLS takes many years to correct for price increases stemming from improved or new goods (say, cars with navigation systems) or services (in medical care, for example). Part of such price increases comes from improvements that consumers are happy to pay for, not from a general depreciation of the currency. Including both the substitution effect and the effect of improved products reduces by close to half the measured inflation between 1967 and 2017. As a consequence, we observe that real wages increased not by 8.7 percent, not by 31.7 percent, but by 74 percent during that period. And the real median household income nearly doubled, instead of increasing by the reported 33.5 percent.




***Capitalism, Alone: The Future of the System That Rules the World***

**By Branko Milanovic**

**304 pp.; Harvard University Press, 2019**




***The Myth of American Inequality: How Government Biases Policy Debates***

**By Phil Gramm, Robert Ekelund, and John Early**

**264 pp.; Roman & Littlefield, 2022**

I wouldn't say, like the authors of *The Myth of American Inequality*, that "as a nation, we need to get our facts straight," because that holist phrase is meaningless. A nation cannot get its facts straight any more than it can read Adam Smith or eat at McDonald's. Nobody can act "as a nation," as if he were 334 million individuals. But *the federal government* should certainly correct highly misleading statistics that only help politicians increase their power and bureaucrats boost the importance of their bureaus.

The Gini coefficient is a measure of income equality that varies between 0 for perfect equality and 1 if only one household received all income. Between 1967 and 2017, the Gini for earned income increased by 27 percent to 0.561. Many factors contributed to this. As we will see, the proportion of poor people who don't work doubled, thereby earning lower incomes than they would have otherwise. The market incomes of the most qualified workers increased faster than those of the less qualified. Those who pursued more education got larger remuneration increases. Not only education choices but also marriage choices have played an important role: more educated women entered the labor market, married higher-income men (a phenomenon called homogamy), and thus increased the relative incomes of richer households.

It is important to understand that real earned incomes increased all over the distribution ladder. In 2017, 44 percent of households even earned real market incomes that, 50 years before, were only earned by those in the top quintile.

***The wealthiest*** / But what about the filthy rich? The first thing to realize is that the super-rich are not very numerous. Sometimes, the supposed super-rich are not all that rich. A household earning $600,000 in pre-tax annual income has already entered the top 1 percent of the income distribution. That is certainly a good income, but not outrageous when one realizes it typically goes to a two-earner household. Moreover, the average one-percenter household pays 40 percent of its income in taxes, more than the average tax rate for any of the five income quintiles. Note also that among households earning $1 million or more a year, only 21 percent received any inheritance.

It is only at the top of the top 0.001 percent of the income distribution that the average tax rate decreases, from 40 percent to about 32 percent for the 400 richest American households. Up to there, the average tax rate increases all along the income ladder, from the first to the fifth quintile. Regarding these superrich households, Gramm et al. calculate that "if government seized all of their after-tax income, it would fund the federal government for less than six days." Note also that the assets of the very rich are taxed at 40 percent upon their death.

According to *Forbes*, the 400 richest American individuals have an average net worth of more than $2.9 billion. It is estimated that almost two-thirds of them came from poor to upper-middle-class families, including 7 percent from poor ones. Only 6.5 percent of the 400 live on merely inherited wealth.

How can economists like Emmanuel Saez, Gabriel Zucman, and Thomas Piketty claim that the very rich pay a lower tax rate than nearly everybody else, an urban legend echoed everywhere? Because their calculations add to the earned incomes of the very rich the returns on their assets (that is, their capital gains) *that have not been realized*, artificially increasing the denominator of the tax rate. The implicit idea is that these people should pay a tax on their capital as well as a tax on the annual income from that capital. It is as if a worker were taxed not only on the annual return of his human capital—taxed on what he earns as wages or salary—but also on the increased value of his human capital. It is as if every year in which one's human capital increases in value (because of education or experience or better health), one has to immediately pay taxes on all future earnings to flow from this new capital.

***Inequality and government transfers*** / Let's now consider the distribution of *total* income, adding to earned income all the assistance that governments provide. Gramm et al. call "transfers" all forms of such assistance, whether in cash (e.g., Social Security) or not (e.g., Medicaid). The problem is that the Census Bureau's income statistics, designed in 1947, count only some government transfers. For example, food stamps, Medicare, Medicaid, and the reimbursable Earned Income Tax Credit and Child Tax Credit are not counted. More than 90 percent of the more than 100 federal transfer programs are not counted. The majority of state and local transfer payments are not counted either. Overall, in 2017 only $0.9 trillion (32 percent) of the $2.8 trillion of government transfers were included in income. Families classified as poor are eligible for more of the excluded transfers and receive higher benefits from them, so Census counts only 12 percent of the transfers that they actually receive.

Counting all transfer payments (federal, state, and local), they add up to 22 percent of all earned household income (before taxes) in 2017. In the average bottom-quintile household, total government transfers amount to $45,489 compared to $4,908 in earned income.

If we recalculate the poverty rate by adding all the transfer payments (net of taxes) and using a proper price index, it falls to 1.1 percent in 2017 compared to the official rate of 12.3 percent. Applying the same adjustments to the whole bottom quintile, we find that the real average family income after transfers and taxes has multiplied nearly eight times since 1947, a faster growth rate than all other quintiles including the top one.

These analyses reveal another remarkable fact: government redistribution through taxes and lifts the average income of households of the first quintile to 89 percent of the second quintile.

These conclusions are not that surprising because, although poverty does exist, casual observation does not often reveal it, except in the marginal phenomenon of homelessness. Of course, any measure of poverty or inequality is an average, and extreme cases exist. Two-thirds of the Census Bureau poor have cable or satellite television, and almost three-quarters have a car or truck. In 2009, according to a Census Bureau study, poor and middle-income children had diets with equivalent amounts of protein, vitamins, and minerals. "Among families defined as poor," the authors of *The Myth of American Inequality* write, "hunger has been virtually eliminated, inadequate housing has all but disappeared, and the amenities of daily life have expanded."

After we correct the Gini coefficient to include all government transfers and correct for some technical changes in its calculation over the years, inequality of total income has decreased by 3 percent between 1947 and 2017, from a Gini of 0.345 to 0.335.

A perverse consequence of the massive transfers to bottom-quintile households has been to incentivize these people to decouple from the labor force. In 1967, in that quintile, those who had a job represented 68 percent of able-bodied, working-age individuals not studying full-time. In 2017, after 50 years of War on Poverty programs, only 36 percent worked. The proportion of the employed increases steadily as we move up the quintiles, until we find that 100.5 percent are working in the top quintile, indicating that even some individuals past the retirement age plus some students are employed. The work factor is the main cause of the increased inequality in earned income over this half-century.

Other numbers illustrate this dependence on the welfare state. For example, 13 percent of the American population now benefits from food stamps. It was not meant to be like that. Franklin D. Roosevelt thought that able-bodied individuals should earn their keep. Similarly, Lyndon Johnson declared: "The War on Poverty is not a struggle simply to support people, to make them dependent on the generosity of others. It is an effort to allow them to develop and use their capacities." The two presidents obviously did not think about the economic logic of a system that rewards the opposite of self-reliance.

**Social mobility** / *The Myth of American Inequality* argues that the American Dream is alive and well. Contrary to accepted wisdom, the country shows a high rate of income mobility despite the government essentially discouraging many individuals from rising above relative poverty. Two sets of numbers stand out.

Consider first *absolute* earned-income mobility, correcting for overestimates of inflation. Gramm et al. find that in 2017, 44 percent of households earned a real income that would have placed them in the top quintile in 1967.

Second, we consider *relative intergenerational* income mobility (income being defined roughly as taxable income plus some government transfers) by following each one of two generations of families with panel data. Three different studies are used to follow the position of adult children across income quintiles during the first or second decades of the 2000s compared with the position of their parents' families. If perfect mobility obtained, the family incomes of the now-adult children would be distributed randomly across the five quintiles; with zero mobility, at the other extreme, the children's family incomes would all fall in the same quintile as their parents' families. The results of the three studies all fall between those extremes, but much closer to the random case—that is, to perfect mobility: "On average…, adult children's income distribution showed that 29.2 percent of adult children stayed in the same quintile as their parents." The rest, 70.8 percent, changed quintile. For example, 63 percent of bottom-quintile children moved up to another quintile with their families, and 62 percent of the top quintile moved down.

With relative mobility, if some unit moves up, another must of course move down. But as we saw, real incomes have generally increased over time. Recall that real wages increased by 74 percent over the past 50 years and the real median household income nearly doubled. Economic growth allows both income mobility and a general increase in real income.

***Solutions and questions*** / Government transfer payments provide a big lift to the incomes of poorer households, but we have also seen that the welfare state's value is ambiguous because it traps first-quintile (and some second-quintile) households into idleness and economic dependence. Another example is that one in eight Americans gets food stamps. This raises fundamental issues about how the state can offer some "income insurance," as James Buchanan and many other classical liberals proposed, without creating a society of dependent wards.

The authors of *The Myth of American Inequality* advance four policy proposals that follow from their analysis:

- The federal government should stop misinforming people with misleading statistics.
- It should also stop incentivizing able-bodied, working-age individuals to stay out of the labor force.
- Elementary and secondary education should be reformed through competition (charter schools, scholarships to private schools, vouchers).
- Abolish government barriers to opportunities, notably occupational licensure, which hit 5 percent of workers in 1950 and 25 percent in 2012.

These proposals would make a good first step. But it is doubtful they would be sufficient, or even possible, without more fundamental changes in the role and power of governments and without a general understanding of the conditions of a free society. Obviously, neither the Republican Party nor the Democratic Party is on the right track. They are going in the opposite direction.

At any event, it is difficult to discuss equality, inequality, prosperity, and the future of our more-or-less free societies without the numbers that Gramm, Ekelund, and Early put before our eyes. R

# AIER Takes On the New Deal

**REVIEW BY GEORGE LEEF**

The conventional wisdom about the New Deal is that it pulled the United States out of the Great Depression. President Franklin D. Roosevelt is credited with saving the country by abandoning the outmoded ideas of laissez-faire and limited government. It hardly occurs to most Americans to question those beliefs or consider objections made by contemporary opponents of the New Deal who had reasonable arguments against it.

The New Deal, as Roosevelt's program came to be known, began 90 years ago, in the spring of 1933. Later that year, one of the Americans who feared that Roosevelt was taking the country in the wrong direction, Col. Edward Harwood, founded the American Institute for Economic Research (AIER) to be a voice for sound economic thinking. So, it is fitting that AIER has now published *New Deal Rebels*, assembled by historian Amity Shlaes, containing a fascinating and diverse array of historical material from critics of the New Deal. The book is arranged chronologically, beginning with a prescient essay by William Graham Sumner written in 1919, continuing with critical commentary published during Roosevelt's four terms, and ending with several post–New Deal writings. There is a wealth of material here for scholars to delve into this little-explored aspect of American history.

***The forgotten man*** / Sumner, a Yale University sociologist, foresaw the philosophy of the New Dealers and, in his essay "The Forgotten Man," he warned of the damage it would do. Who was the forgotten man? Sumner explained:

> He is the man who is never thought of. He is the victim of the reformer, social speculator, and philanthropist, and I hope to show that he deserves your notice both for his character and for the many burdens which are laid upon him.

Sumner's description is deadly accurate, but he couldn't have imagined just how great those burdens would become during the New Deal—or that Roosevelt would adopt the term "the forgotten man" to refer to the people he claimed the New Deal would help.

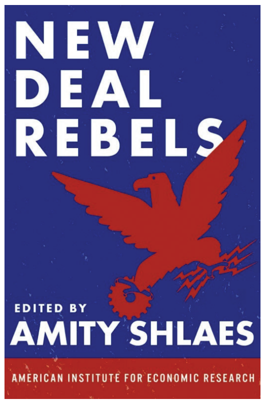
President Calvin Coolidge similarly understood the danger to American liberty and prosperity from government intervention into people's lives. In a 1923 speech that anticipates the concept of spontaneous order, Coolidge said:

> What no government was ever able to do for its subjects, the people have done for themselves. The strength of this whole movement, the virility of this entire principle, is revealed in the fact that it is not imposed upon the people, but

*IN REVIEW*

> results from their own deep and abiding convictions.

Coolidge died in 1933, before he could witness what transpired once Roosevelt and his theorists set out to transform the country.




***New Deal Rebels***
**Edited by Amity Shlaes**
**317 pp.; American Institute for Economic Research, 2023**

Republicans were not the only critics of the New Deal. Some prominent Democrats challenged Roosevelt's agenda, including the party's 1928 presidential candidate, Alfred E. Smith. Prior to the 1932 campaign, Smith could see the looming class warfare that Roosevelt would often resort to. In a 1932 speech, Smith said, "I will take off my coat and fight to the end against any candidate who persists in demagogic appeals to the masses of working people of this country to destroy themselves by setting class against class and rich against poor." Roosevelt shamelessly did exactly that and, ever since, unscrupulous politicians have used divisive class warfare to win elections.

One of the most surprising pieces included in the book is a 1933 letter from British economist John Maynard Keynes to Roosevelt. Keynes wrote politely to say that he thought the president's signature policy, the National Industrial Recovery Act, was impeding economic recovery and the administration's obsession with restoring prices to pre-crash levels was a mistake. Wrote Keynes, "But too much emphasis on the remedial value of a higher price level as an object in itself may lead to serious misapprehension as to the part which prices play in the recovery." Keynes was enough of an economist to grasp that you can't pull an economy up to full employment and prosperity by engineering higher prices for certain goods, but that was a key element in the New Deal plan.

Keynes also advised Roosevelt that prosperity would not be restored by increasing the money supply, writing: "Some people seem to infer that output and income can be raised by increasing the quantity of money. But this is like trying to get fat by buying a larger belt." AIER's Harwood subsequently penned an open letter to Keynes, published in 1934, where he agreed that trying to force up prices arbitrarily would accomplish no good. He observed that the Depression had its origins in inflation from 1922 to 1929, which led to unwise investments. Here we see a glimmer of Austrian theory, locating the roots of economic instability in government policy, not in the market itself.

How did New Deal policies affect American business owners? Many found it extremely damaging, as we read in a 1934 letter by Carl Pharis, owner of Pharis Tire and Rubber Company, to Idaho Sen. William Borah, a critic of Roosevelt's policies. Among Pharis's complaints was the government's insistence that small firms not undercut the price levels dictated by the National Recovery Administration. Referring to the large national tire companies like Firestone, Pharis wrote, "If we are compelled to sell our tires at exactly the same price as they sell their tires, their great national consumer acceptance would soon capture our customers and ruin us." Of course, cartelization and price fixing were a central aspect of Roosevelt's strategy for economic revival.

What about the effect of the New Deal on Black Americans? In the popular mind, big government activism is assumed to be advantageous to minority populations, but we read that many Blacks found themselves far worse off as a result. John P. Davis was a Black lawyer and activist who wrote an essay, "A Black Inventory of the New Deal," that excoriated Roosevelt's agenda. The New Deal, Davis wrote, led to severe job losses among Black workers who had little seniority and was especially harmful to Black farmers. "For them," Davis wrote, "reduction of acreage for cotton and tobacco, with the quantum of such reduction controlled and regulated by local boards on which they had no representation, has meant drastic reduction in their already low income." Once again, great harm was done to the forgotten man.

***Repugnant scheme*** / The Supreme Court was very busy during the New Deal. A decision rendered in 1935 upheld the government's policy of reneging on contracts obligating it to pay in gold. The Court accepted the idea that, because the country was facing an emergency, the government could stop honoring its contracts. Dissenting, Justice James McReynolds wrote:

> Just men regard repudiation and spoliation of citizens by their sovereign with abhorrence; but we are asked to affirm that the Constitution has granted power to accomplish both. No delegation of such power exists, and we cannot believe the far-seeing framers who labored to establish justice and secure the blessings of liberty intended that the government have authority to annihilate its own obligations.

While the Court bowed to Roosevelt in the gold clause case, it rebuked him in another key case, *Schechter Poultry*. Justice Benjamin Cardozo blasted the National Recovery Act for illegally delegating to bureaucrats the power to dictate commercial rules and obliterating the distinction between interstate and intrastate commerce. To underscore the benefits of reining in federal administrative authority, Shlaes includes an editorial from the *Chicago Defender*, a Black newspaper, applauding the decision. Wrote the editorialist, "The whole scheme represented the ultimate cordiality of campus opinions by men whose ideas of economic and social security found life in a dissembling mirage of old-world viewpoints."

How did the New Deal use the tax money taken from workers? Some was used for blatant propaganda. Writer Garet Garrett blew the whistle on that, excoriating the production of a pro-government play paid for by the federal government. That expense was approved by Roosevelt. As Garrett observes, "What Congress did was to surrender control of the public purse to the President, under a law authorizing him to spend it in his own discretion." The New Deal opened the door to the unconstitutional business of executive branch spending, and it has only opened wider since.

Readers may be surprised at the depth of opposition to the New Deal from some Democrats. Sen. Carter Glass of Virginia, despite co-authoring one of the era's signature banking laws, denounced Roosevelt's Court-packing threat as "frightful" and "a repugnant scheme to disrupt representative government in the nation." Another Democrat who was appalled at the administration's abuse of power was New Mexico Sen. Carl Hatch, who sponsored legislation in 1939 to prevent federal employees from engaging in partisan political activity.

Some of the articles strike a philosophical tone. Garrett, in a 1940 *Saturday Evening Post* column, wondered why most Americans had been so passive as the New Deal trampled upon their rights. He concluded that they had been seduced by government handouts and promises, saying, "Political freedom is heavy, too heavy for soft people." Much in the same vein, Shlaes includes F.A. Hayek's 1940 essay in which he explained how government economic planning leads inevitably to tyranny.

Reading the assembled criticisms of the New Deal, one cannot help but notice the parallels with the situation we face today. Just as Roosevelt's administration relentlessly expanded the powers of unelected bureaucrats, so do today's presidents. Just as reckless spending during the New Deal helped Roosevelt's political allies but damaged the nation as a whole, so do today's politicians spend money with political expediency in mind. And just as judicial independence was threatened in the 1930s, so is it again today. Reading *New Deal Rebels*, it's easy to think, "If only we could have avoided those terrible mistakes. R

# Yet Another Bank Supervision Breakdown

**REVIEW BY VERN MCKINLEY**

Three bank failures made headlines in 2023: Silicon Valley Bank (SVB) and Signature Bank (SB) in March and First Republic Bank (FRB) in May. The failures triggered a great deal of soul searching by the federal regulators primarily responsible for overseeing the institutions, the Federal Reserve and the Federal Deposit Insurance Corporation. Their missteps were the most recent examples of more than a century of banks behaving badly and federal supervisors failing in their most basic oversight responsibilities.

In late April, the two federal overseers released separate reports after the first two failures, assessing what happened and why it happened. The Government Accountability Office, a more independent arbiter than the conflicted federal regulators, also weighed in with a report. The GAO put the blame squarely on breakdowns by the banks' management teams and the supervisors who identified many of the percolating problems but took very few of the critically important follow-through measures to promptly shut down the banks.

New York University's Stern School of Business has now released *SVB and Beyond*, its own review of the three failures. The book is a collaboration of contributions from 13 scholars affiliated with Stern, most prominently economists Viral V. Acharya, a professor and former deputy governor of the Reserve Bank of India, Richard Berner, co-director of NYU's Volatility and Risk Institute and former director of the U.S. Treasury Department's Office of Financial Research, and Lawrence J. White, formerly a board member of the Federal Home Loan Bank Board and Freddie Mac.

I don't often review books of this genre: an academic compilation by numerous authors. For me, these works typically do not have the cohesiveness of a book drafted by one or two authors. This book suffers from that weakness and would have been more focused and effective without a few of the chapters. Still, there is much to recommend it. For this review, I will concentrate on the chapters that I found to be most targeted to the topic. As its title implies, an outsized share of the book is committed to SVB, which was overseen by the Federal Reserve and California banking authority, while SB and FRB were overseen by the FDIC and state authorities.

***Overview and causes*** / The authors present a good summary of what produced the bank failures:

- Bank reliance on volatile, uninsured, on-demand mega-deposits that made the banks vulnerable to a run (for example, the top 10 depositors in SVB held a combined $13 billion), particularly those deposits held by borrowers in speculative, stressed sectors.
- Monetary and fiscal accommodation, resulting in deposit inflows that later reversed during the contractionary phase.
- Bank management teams seemingly incapable of navigating the challenging, Fed-induced interest rate risk environment.

One grating thing about the book is the constant reference to the episode as a "panic." The term "panic" is not defined by the authors, but it implies a lack of rationality on the part of depositors who are draining funds not only from weak banks, but also strong banks. The overview chap-

*IN REVIEW*

ter uses "panic" seven times to describe the circumstances in early 2023, but there isn't any supporting analysis for the characterization that individual, healthy banks were likewise at risk of runs. It was entirely rational for many depositors to withdraw funds from, as the authors describe it, "banks that shared [SVB and SB's] fragilities."

The first line of a chapter dedicated to the supervision of SVB states the obvious: "Supervision clearly failed to avert the failure of Silicon Valley Bank." The chapter goes on to detail what the authors classify as "detective" and "punitive" supervision of SVB: the former involves the scrutiny of larger banks that are undertaking unsafe and unsound practices that may lead to significant losses or insolvency, and the latter involves compelling banks to alter behavior unearthed through detective supervision. The authors rightly call the Fed on the carpet for "the egregious failures of detective and punitive supervision of SVB as documented by the Federal Reserve" in its own report on supervision and regulation of SVB and break down their analysis based on the detective and punitive supervision distinctions. They note the need to "significantly improve the culture and practice of detective and punitive supervision."

***Plans for resolution*** / The authors also delve into a common point of policy disagreement about the failure of SVB: "the 2019 Tailoring." This describes legislative and regulatory reforms led by the Trump administration intended to reduce the burden of select Dodd–Frank Act regulations on banks whose failure would have a limited systemic effect. This was done by tailoring regulations to the individual risk profiles of domestic and foreign banks. Many critics of the Trump administration like to blame the tailoring adjustments and a so-called "cultural shift" during the Trump years that accompanied the tailoring changes for allowing SVB to slip through the regulatory cracks. The authors are skeptical of that criticism, concluding:

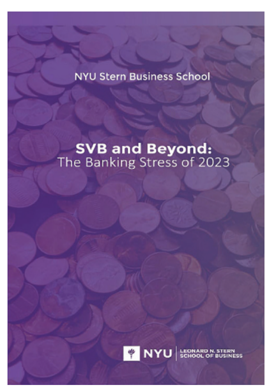
> Allegations of an enervating cultural shift in supervision concurrent with the 2019 Tailoring are hard to assess.… There does not seem to have been any specific rule of the [Dodd–Frank Act] loosened by the 2019 Tailoring that would likely have averted SVB's failure.

The 2019 Tailoring exempted SVB's holding company from a requirement under the Dodd–Frank Act for submitting a resolution plan to the Federal Reserve. There was still a requirement that the bank itself submit a plan to the FDIC. Citing the GAO's analysis that "SVB's plan was deficient in failing to identify potential buyers for either the whole or parts of the bank," the authors note that the FDIC's review of the plan took five to six months. The FDIC staff reviewed the plan in early 2023, but the FDIC Board had not even provided formal feedback before SVB's failure. I would argue that the FDIC, as resolution authority, should draft resolution plans rather than entrusting them to the banks themselves.

Much of the critique by the authors on the policy response to SVB, SB, and FRB is on point and encapsulates the incompetence of the banking authorities:

> The unprecedented speed of the run is not a compelling justification for a lack of preparedness.… The authorities had several months during which they should have assessed SVB's potential losses, identified the lowest-cost means of cleaning up the bank, and begun to identify a list of potential buyers of a "good bank" with the goal of being able to conduct an effective auction on very short notice.

A resolution timeline at the end of the chapter is also helpful. For example, the FDIC and the California agency overseeing state-chartered banks designated FRB as a "problem bank" on April 28, 2023. Problem bank status is supposed to be applied many months before a bank could fail, to prompt measures to allow the bank to recover from its troubled state. Yet FRB failed just three days after the designation, far too late for it to serve any useful purpose.




***SVB and Beyond: The Banking Stress of 2023***
**NYU Stern School of Business**
**262 pp.; Volatility and Risk Institute at NYU Stern, 2023**

Much of the remainder of the assessment of the policy response is wishy-washy and not very well supported:

> The combination of an ongoing panic and the lack of a buyer … probably was sufficient to motivate the authorities' decision to invoke a systemic risk exception to protect all depositors of SVB and SB. In such circumstances, it is doubtful whether any policymakers would risk a broader banking collapse by failing to exercise such discretion when they have the authority to do so.

Unfortunately, the authors evade the obvious question of whether the authorities' chosen path was the right one.

The described systemic risk exception—the agreed resolution option of the Fed, FDIC, and Treasury—moves the decision-making from a technocratic decision of the least-cost resolution option to a political decision left in the hands of political appointees—in this case, mostly Democrats but also a few Republicans. The authors do not identify any specific problems beyond the failure of the three banks to justify this policy change or explain how the change would be helpful. They do note that "the S&P Regional Banks stock index plunged by more than 20% from March 8 to March 13." But this was not a systemic run on the banking sector but rather a run on the business model of a few banks—an event that should have triggered the swift shuttering of all insolvent banks relying on that business model without the bailout of millionaire and billionaire uninsured depositors.

***Deposit insurance*** / At the core of the authorities' response was their strategy to completely ignore the very clear statutory deposit insurance limit: $250,000 per depositor, per insured bank, for each ownership category. Those sympathetic to the response of bailing out all uninsured depositors take the view that $250,000 is simply not a sufficient level of coverage. The authors set out three potential options for FDIC insurance going forward, which they draw from a May 2023 FDIC report:

- Set coverage at $250,000 or some higher, justifiable level below 100 percent coverage.
- Expand the first option through increased coverage for transaction accounts of small and medium enterprises (SMEs).
- Institute 100 percent coverage.

After a lot of hemming and hawing about the pros and cons for each of these options, the authors settle on the second: "The most promising avenue for further exploration is Option B, a targeted increase for SME payments." They really don't convincingly support this conclusion for a potentially massive expansion of the federal financial safety net. The authors seem to throw up their arms, as if to say let's just go with Option B. They highlight the pros of such a move (e.g., SMEs don't have the scale to manage cash like large firms, the risk exposure of payroll of SMEs) and the cons (e.g., targeting deposit insurance coverage and specifying eligibility criteria for SMEs are complex). But there is no serious exploration of how the SMEs could rely on a private sector solution through deposit brokers to address their needs, a notion the authors raise only very briefly in the chapter (with a reference to private insurer Intrafi). This was just a poorly written and reasoned chapter.

***FHLB lending*** / The Federal Home Loan Banks (FHLBs), like Fannie Mae and Freddie Mac, are government-sponsored enterprises that provide funding to financial institutions for targeted purposes and have the implicit backing of the federal government. All have a long history of distorting borrowing markets and risk assessment.

According to the authors, in the case of the three bank failures, the FHLBs in San Francisco and New York "played an enabling role in delaying the regulatory reckonings and increasing the costs of the [FDIC] resolutions for [SVB, SB, and FRB]." The three failed banks borrowed modest sums because of their relatively smaller size compared with mega-banks, with SVB's, SB's and FRB's borrowing peaking at $15 billion, $11 billion, and $28 billion respectively (based on available quarterly and annual data). In comparison, during the 2008–2009 financial crisis, Citigroup borrowed upward of $80 billion during its near failure.

The authors show how, in the case of SVB, FHLB borrowings in 2022 essentially replaced an equivalent amount of deposit outflows. The borrowings thus "were critical in keeping the banks afloat.... The banks were gambling for resurrection on the back of mispriced government-sponsored financing." The authors rightly conclude that if the FHLB advances had not been available, all three of the banks "would have experienced financial difficulties earlier." They also conclude that "the FDIC might have become aware earlier that these banks were experiencing difficulties and would have had more time to prepare an orderly (and less costly) resolution process."

***Conclusion*** / *SVB and Beyond* is a good first effort by observers outside of government to develop a thorough assessment of the banking instability of early 2023. It is well-documented, except for those areas highlighted in this review. The one disappointment is the book does not break new ground by uncovering revelatory government documents, avenues that are being pursued by news outlets such as *Bloomberg News* and government watchdogs such as Judicial Watch. *R*

# Vouchers for Health Coverage

**REVIEW BY PHIL R. MURRAY**

Americans have high expectations for healthcare, and sometimes high anxiety over health insurance. Stanford economist Liran Einav and Massachusetts Institute of Technology economist Amy Finkelstein frequently collaborate on research on insurance markets. Last issue, I reviewed their book *Risky Business*, written with Boston University economist Ray Fisman. Now, Einav and Finkelstein are back with *We've Got You Covered*, in which they try to answer a question posed by Finkelstein's father-in-law, "What would you propose doing about health insurance coverage?"

One source of anxiety over health insurance is being uninsured. Einav and Finkelstein state that 30 million Americans were uninsured in 2019. A second source of anxiety is "insurance uncertainty," which the authors characterize as the "risk of losing coverage." Workers who get fired from their jobs or quit to find better ones lose coverage; divorce may cause a loss of coverage; Medicaid recipients may lose coverage when their earnings rise or when they recover from illness. Medical debt is a third source of anxiety; "In early 2020" the authors report, "there was $140 billion in unpaid medical bills held by collection agencies."

***Automatic coverage*** / In the authors' language, problems with the health insurance system are "gaps" and typical solutions are "patches." A patch begins with an individual who attracts considerable sympathy. Take Katie Beckett, born in 1978, who suffered from encephalitis (inflammation of the brain). After her parents' insurance reached a limit of $1 million (presumably late 1970s dollars), Medicaid paid for her treatment so long as she remained hospitalized. But her parents wanted to care for her at home, which they believed would be better for Katie and would cut her care cost. However, her parents still needed public support for her care, but Medicaid didn't allow it. President Ronald Reagan heard of Katie's case and ordered changes in the Medicaid program that enabled Katie and children in similar situations to be treated at home and be covered by Medicaid. The change in legislation that followed is dubbed the "Katie Beckett waiver." This exemplifies a pattern whereby "a particular problem surfaces, generates public outcry, and prompts (limited) policy action."

The problem is, this creates "an endless series of patches." The authors reject this piecemeal approach on grounds that patches "are all inherently flawed." The flaw in the Katie Beckett waiver is that after a disabled child reaches 19 years of age, Medicaid ceases to pay for outpatient care. "History teaches us," the authors observe, "that more patches won't work." They call instead for an overhaul of the health insurance system.

Einav and Finkelstein contend that there is an "unwritten social contract" pertaining to healthcare. To begin, the authors go back to the late 18th century. Early Americans faced the problem of paying for the care of itinerant sailors who became ill or injured. Alexander Hamilton proposed to tax sailors and use the revenue to pay for their care, and Congress implemented the program. More recent evidence of the "social contract" is the Emergency Medical Treatment and Active Labor Act (EMTALA). Passed in 1986, EMTALA mandates that hospitals receiving Medicare funding (which is nearly all of them) provide emergency room services to patients regardless of their ability to pay. Einav and Finkelstein reason that human nature cannot resist providing care to those who deserve it. Thus, they argue, the aim of a health insurance system is to provide "automatic, universal basic coverage."

By "automatic," the authors mean "without an enrollment step" and "as an entitlement." In essence, Einav and Finkelstein would give all Americans a voucher to finance what the authors deem basic care, either by directly purchasing the care or by purchasing basic insurance coverage. Providers would not inquire as to what a patient's income is; health care would be "free for patients" and therefore "taxpayer financed." Politicians on both the right and left point to EMTALA to claim that health care is already universal. "There are a host of government commitments in place," Einav and Finkelstein add, "to provide the uninsured with medical care when they cannot pay for it."

They define "basic coverage" as "all essential medical care for the critically ill" and "primary and preventive care for patients who are not yet critically ill." "Gatekeeping," whereby "the insurer also plays an active role in determining what medical care a patient can get," would be a component. By "basic" they also mean "longer wait times, less patient choice over their doctor and their medical care, and much less comfortable hospital accommodations."

If the reader thinks that providing healthcare at no cost to the patient violates conventional economic wisdom, the reader is correct. Einav and Finkelstein tell the story of a debate from the early 1970s that established the conventional wisdom. Economist Mark Pauly held that the quantity demanded of healthcare varied inversely with the price. Economist Rashi Fein held that the quantity demanded of healthcare did not vary, or varied little, with the price. "We go to the doctor grudgingly," in his view, "and only when we need to." The RAND Corporation eventually tested whether there was a difference between the healthcare consumption of patients who paid for their care versus those who did not and determined that the former consumed less than the latter. Though RAND's determination became "gospel" and Einav and Finkelstein "preached" it, they do not hold to the faith. "In working on this book," they confess, "we realized that it's time to turn our back on the conventional wisdom." Their heresy is based on their observation that wherever governments stipulate cost sharing, they then create so many exceptions that cost sharing becomes meaningless.

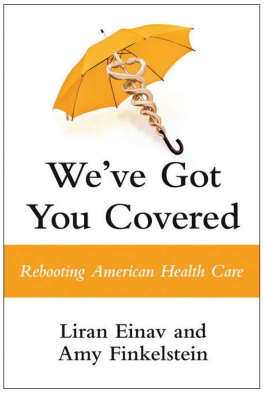
***What is basic coverage?*** / Determining what basic healthcare should cover is difficult. The authors share scenarios involving real people. For instance, a British television program probed the financial tradeoff between covering one person's dialysis versus 50 people's hip surgeries. Oregon officials decided to pay for the primary care of 4,000 children and pregnant women but not a bone marrow transplant for one 7-year-old. Those are tough decisions indeed. Einav and Finkelstein state:

> There are many aspects of medical care that can be excluded from basic coverage while still fulfilling our social contract: infertility treatment, dental care, vision care, physiotherapy, various forms of long-term care, and the list goes on and on.

They decline to say how they would decide what basic coverage would cover. But they tell us how other people decide. British economist Alan Maynard told the above-mentioned television audience that he would decide between dialysis and hip surgery by calculating benefit–cost ratios and performing the procedure that has the higher ratio. Oregonians calculated benefit–cost ratios for over a thousand procedures. Their calculations produced "counterintuitive" outcomes, however. "Tooth capping," Einav and Finkelstein explain, "was estimated to be more cost effective than surgery for an emergency appendectomy or an ectopic pregnancy." If, for illustration, the cost of tooth capping is $1,000 and the benefits are $10,000, and the cost of an appendectomy is $100,000 and the benefits are $900,000, benefit–cost analysis leads to such "unacceptable results." Thus, Oregonians moved beyond benefit–cost analysis. They "used their judgment" instead "to create broad categories of health care that they ranked in order of importance." Their process for prioritizing procedures recognizes benefits, costs, and "moral philosophy."

Einav and Finkelstein tell the story of

the Balanced Budget Act of 1997 as it pertained to Medicare expenditures. Congress intended to limit the increase in Medicare expenditures, but when the legislation called for reducing payments to doctors to achieve that goal, lawmakers failed to follow through, year after year. The authors declare, "We won't accept this." That is a welcome reaction to Congress's fiscal irresponsibility. The authors go on to demand a budget for basic coverage. Their rationale is that a budget induces citizens and politicians to face tradeoffs between healthcare and other goods, helps prioritize procedures under basic coverage, and limits spending. They address the concern that taxes will rise to pay for basic coverage. "It may come as a surprise," they tell us, "that taxpayer-financed healthcare spending in the US is already large enough to pay for universal basic coverage."




***We've Got You Covered: Rebooting American Health Care***

**By Liran Einav and Amy Finkelstein**

**275 pp., Portfolio/ Penguin, 2023**

***Beyond basic coverage*** / One remaining feature of Einav and Finkelstein's plan deserves to be explained: the option to buy supplemental coverage. While vouchers would cover people's basic coverage, they could buy supplemental coverage that provides additional treatments, procedures, and amenities.

The authors provide an example. Suppose basic coverage pays for a drug that needs to be injected and costs $800 per month. Patients who would rather have the same drug that may be taken orally at a cost of $2,000 per month may get $800 from the government and pay an additional $1,200. This feature, the authors say, is like the way Medicare Advantage works.

There are challenges for this idea, however. One is the "selection problem": private insurance companies will try to attract less costly patients and avoid more costly patients, leaving the latter to the government-financed care. The authors propose to deal with that by adjusting the government payments based on the beneficiary's health status and restricting the beneficiary's option to move back and forth between government and private systems.

The authors are not utopian. For instance, they share economist Victor Fuchs' early contribution to healthcare economics. Fuchs wondered why Utahans lived longer than Nevadans despite having so much in common. He decided that lifestyle choices accounted for the difference. Utahans typically abstain from alcohol and tobacco while Nevadans do not. The authors share a recent scholarly contribution as well. Harvard economist Raj Chetty and coauthors sought to explain nationwide differences in longevity. In the words of Einav and Finkelstein:

> The higher-life-expectancy places didn't enjoy a greater quantity or quality of medical care, or higher rates of insurance coverage. Rather, higher-life-expectancy places had populations that smoked less, exercised more, and were less likely to be obese.

Einav and Finkelstein use those findings to warn that no one should expect their plan to make everyone equally healthy. Nor should anyone expect their plan to reduce expenditures on healthcare because they admit that "we don't (yet) have the silver bullet for dramatically lowering healthcare spending while fulfilling the dictate to 'do no harm' to the patient."

***Conclusion*** / Although the authors are not utopian, the frequency with which they use the word "design" shows their confidence. But markets like healthcare put such designs to the test, revealing important flaws. A few potential flaws came to mind as I read the book.

For instance, the authors claim that taxes need not be raised to finance their plan for basic coverage. They are not necessarily wrong, but something seems amiss when they write:

> To be clear, total spending on health care in the US as a share of national income is much larger than it is in any other country—17 percent in the US in 2019, compared with 12 percent in the next highest-spending country that year, and to 9 percent on average across high-income countries. That higher US spending, however, primarily reflects higher *private* spending. Not higher public spending.

The World Health Organization's Global Health Expenditure Database, which they cite, does indeed show that all U.S. spending on healthcare amounted to 17 percent of national income in 2019. But my reading of the data is that U.S. taxpayers paid 14 percent of national income and private individuals contributed 3 percent. That does not refute the authors' argument that taxes are sufficiently high enough to finance their plan for basic coverage (9 percent of total income), but it does conflict with the authors' point about U.S. public vs. private healthcare spending. If spending a lot on healthcare reflects government largess and not consumer choice, perhaps the authors should not dismiss concerns that healthcare expenditures are "unsustainable." Even if taxes need not rise, reallocating taxes to carry out the authors' plan might prove to be difficult.

Free-market supporters will have additional concerns about the book. They will bristle at Einav and Finkelstein's jab that an economist with "libertarian roots" such as James Buchanan typically has "no public policy solution" for healthcare. They will be skeptical of the authors' confidence that their plan will not produce more unintended consequences than they can imagine. But free-market fans should not be deterred from reading the book. *We've Got You Covered* is a good book on healthcare economics and how two leading economists with interventionist roots would redesign health insurance. *R*