IN REVIEW

Freedman's Bank's Failure and Its Familiar Causes

REVIEW BY VERN MCKINLEY

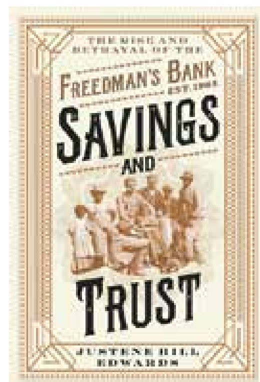
Financial institution failures in the United States have had different impacts on depositors exposed to losses depending on the response of the contemporary financial authorities. The 2023 failure of Silicon Valley Bank was expected to negatively affect tech millionaire and billionaire depositors who were negligent in managing their finances until the federal financial authorities intervened with a depositor bailout. In contrast, the 1930 failure of the Bank of United States caused losses for depositors, many of whom were recently arrived immigrants in New York City. They were likely drawn to deposit their money in the bank because of the safety implicit in its official-sounding name.

Along similar lines, the 1874 failure of Freedman's Savings and Trust (FST) caused heavy losses predominantly for recently freed slaves who were persuaded to deposit their hard-earned greenbacks in an institution named for them and whose deposit funding model revolved around them. In the end, depositors recovered a mere 20 percent of their funds. Justene Hill Edwards's book *Savings and Trust* chronicles this failure. Edwards is an associate professor of history at the University of Virginia and author of the 2021 book *Unfree Markets*, a study of the US slave economy.

Birth of Freedman's / On March 3, 1865, President Abraham Lincoln signed "An Act to Incorporate the Freedman's Savings and Trust Company." The express purpose of the institution was to "receive on deposit such sums of money as may from time to time be offered therefor, by, or on behalf of persons heretofore held in slavery in the United States, or their descendants."

Edwards places the act in perspective by discussing milestone pieces of legislation that immediately preceded it, which were integral to the development of the nascent US financial system. These were the Legal Tender Act of 1862, which codified the power for the federal government to issue a national currency, and the National Banking Acts of 1863 and 1864, which created the Office of the Comptroller of the Currency (OCC), which to this day charters, supervises, and regulates national banks.

Rather than traverse a chronological summary of the downfall of FST, I will enumerate a number of the underlying causes for the failure. Those causes were common to many of the US bank failures over the past 200 years.



Savings and Trust: The Rise and Betrayal of the Freedman's Bank

By Justene Hill Edwards

336 pp.; W.W. Norton, 2024

Explosive growth / One of the telltale signs of future financial institution failure is a rapid burst of growth over a relatively short period of time. According to Edwards, total FST deposits grew from $305,000 in 1866 to over $31 million in 1872. Under its enabling legislation, the FST was allowed to operate as a nationwide deposit taker. Thus, it was not limited to a single state, as would have been the case if it were chartered by one of the individual states or if it were chartered by the newly created OCC.

The FST took full advantage of this power to operate interstate branches in "such points as the interest of the Freedmen may require." Thirty-four branches were opened from 1865 to 1870, stretching down the US East Coast from New York City to Jacksonville, FL, extending along the Gulf Coast to New Orleans, then north to St. Louis. Edwards provides two visuals of this growth: a chronological list of the 34 branches and a US map of their locations.

The FST branch network proved unwieldy, contributing to the weak financial position of the institution. That prompted its trustees to close five branches, but those closures proved too little too late to stabilize the institution.

Civil rights leader Frederick Douglass took the job of president of FST in the hope of turning it around. In an unfamiliar role as a bank administrator and with the institution already in a hopeless financial position, he lasted only four months before it closed. As Edwards describes it: "After nine years of operations, the bank's exponential growth came to an abrupt stop. On July 2, 1874, the bank officially closed its doors."

About Our Reviewers:

David R. Henderson is a research fellow with the Hoover Institution and emeritus professor of economics at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, CA. He was a senior economist for health policy with President Ronald Reagan's Council of Economic Advisers. He blogs at *EconLog*.

George Leef is director of external relations for the James G. Martin Center for Academic Renewal.

Vern McKinley is the coauthor, with James Freeman, of *Borrowed Time: Two Centuries of Booms, Busts and Bailouts at Citi* (HarperCollins, 2018). He has been an intermittent contractor with the International Monetary Fund since 2008.

Ryan H. Murphy is a research associate professor at the Bridwell Institute for Economic Freedom at Southern Methodist University. He is coauthor of the current *Economic Freedom of the World Index* (Fraser Institute) and the *Human Freedom Index* (Cato Institute).

Phil R. Murray is professor of economics at Webber International University.

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

Questionable investments / The federal charter that guided FST's operations described it as a savings and trust institution—a common form of non-bank that emerged in the 19th century—"to encourage working-class populations to develop the habit of saving.... In contrast to commercial banks, which were created to generate profits for shareholders, savings banks had a benevolent, as opposed to moneymaking, mission."

Edwards explains:

> By design, savings banks were supposed to operate with less risk. These institutions did not make loans or seek to aggressively make a profit.... The Freedman's Bank mandate aligned with avoiding the unpredictability associated with operating a commercial bank.

The FST's enabling legislation indicated a low-risk business model, limiting its power to invest in "stocks, bonds, treasury notes and securities of the United States." Up to one-third of depositor funds *could* be invested in those instruments, but the remainder of the money was to be dedicated to an "available fund" to meet depositor and other payment demands, with the residual placed on deposit or in some other "available form."

Edwards critiques the FST legislation and the haste with which it was assembled and signed into law. She argues that clear guidance for operations was lacking:

> Speed would have its consequences. The swiftness with which Congress moved to get an approved bank-charter bill ready for Lincoln's signature meant that they overlooked key inconsistencies.

This language and the interpretation of it led to some questionable investments, one of the most obvious of which was in railroad bonds, a risky move at the time. The bond broker for the transaction was the Banking House of Jay Cooke, a 19th century investment bank. According to Edwards, that transaction was likely supported by Henry Cooke, a Freedman's trustee, chair of its finance committee, and business partner and sibling of Jay Cooke. She labels this a "conflict of financial interest" because Henry Cooke "benefited from the sale since, as the broker, he reaped a percentage of the bonds that he sold." Other trustees also abused their positions: "The number of trustees who received loans between 1870 and 1872 was staggering. In direct contravention of section 12 of the charter, at least six of the trustees took out loans." The collateral for the loans was less than required. In at least one case there was no collateral, and in another case no interest was levied.

Another questionable investment was the purchase of an over-the-top headquarters building as the flagship branch when FST moved from New York to Washington:

> Despite the bank's fiscal concerns, in 1869 the trustees decided to make a monumental gamble with its crumbling finances. This revolved around the bank's transition to Washington. It became clear, at least to the trustees, that they needed a new office.... The trustees decided that they were entitled to more than a simple office … [and] decided to find a proper building site for a Banking House.... The trustees agreed to put a bid of $80,000 for a building on the corner of 16½ Street and Pennsylvania Avenue.

The *New York Times* felt the need to comment on the investment:

> The board's decision to spend such a large amount of money on a building of no real necessity was not a prudent one.... The deposits of free people did not deserve to be spent on such an extravagance.

Breakdown in oversight / Another consistent thread in the history of major financial institution failures is that supervisors or other overseers often missed or were in denial of signs of deterioration. In this case, it was Congress that did not take its responsibility seriously and failed to act. Oversight of FST was clearly addressed in its enabling legislation, which required "that the books of the corporation shall, at all times during the hours of business, be open for inspection and examination to such persons as Congress shall designate or appoint." But in the case of FST:

> There was no formal examination of the bank's business. There was no regulation, no oversight. Since the bank opened for business in March 1865, Congress had not conducted a single official examination of its finances.

As a result, the depositors were without the benefit of an outside party or a supervisor at the state or federal level.

In early 1872, the board of trustees created a committee on inspections to examine FST's finances, but it was too late to halt the slide. The OCC became involved in assessing its condition while conducting its maiden formal supervisory examination in early 1873. FST was already illiquid and well on its way to insolvency.

OCC examiner Charles A. Meigs submitted his findings to the Senate Committee on Finance in February of that same year. Edwards writes, "His report painted an unflattering picture of the bank and highlighted its shady financial dealings." Meigs conducted a follow-up examination in January of 1874: "He reported that the bank held $3.12 million in assets but $3.33 million in liabilities. The bank was in dire straits."

All that scrutiny only added to the cost that was ultimately borne by depositors. "In the end," notes Edwards, "the depositors had to forgo approximately $330,000 paid to the commissioners, examiners and investigators who uncovered the reasons for the bank's demise."

Panic of 1873 / Most well-known institution failures or near failures (bailouts) in US history occurred during bank panics or financial crises, when the weaknesses

IN REVIEW

of financial institutions tend to manifest themselves. This occurred with trust institutions during the Panic of 1907, the Great Depression that brought down the Bank of United States, and the Great Recession of 2008–2009 when institutions like Lehman, Citigroup, and AIG crashed and burned.

The downfall of FST coincided with the Panic of 1873. Freedman's was affected because of its relationship with the Cooke empire, which collapsed when its investment bank filed for bankruptcy:

> Jay Cooke & Company's collapse affected the Freedman's Bank immediately. The bank's connection to the company was widely known, especially in Washington.… Henry Cooke had been borrowing extensively from freed people's deposits in the Freedman's Bank to fund the [Northern Pacific Railroad]. News of a bank run [at FST] soon trickled out.… Depositors, fearful of not having access to their funds, stormed the bank's beautifully appointed office building, demanding to withdraw their money.

Conclusion / *Savings and Trust* is well written and is an engaging read for historians, financial experts, and a general audience alike. It weaves into the narrative the role of historical figures such as Lincoln and Andrew Johnson, as well as Douglass.

One frustrating facet is that, at times, Edwards drops in rants about the "white capitalists" on the board of trustees and "capitalism" more broadly. The incompetence and abuse perpetrated by these insiders cannot be blamed on capitalism because those traits are also inherent in the actions of managers in socialist financial systems. It was a capitalist system that led to the exit of FST from the system once market forces led to a run and the previous lack of oversight by Congress became obvious.

That point aside, Edwards' book is a fascinating and well researched tale of a very sad chapter in the nation's banking history. R

Overcoming 'Certainty Traps'

REVIEW BY GEORGE LEEF

During the Black Lives Matter riots in the summer of 2020, Kyle Rittenhouse, an Illinois teenager, went to Kenosha, WI, intending to defend property owners there against the rioters. During the melee, he shot three men, two of them fatally. He was arrested and tried for murder. In November 2021, the jury, having heard the evidence, acquitted Rittenhouse of the charges, determining that he acted in self-defense.

Almost immediately, commentators decried the verdict. For example, the chancellor and the chief diversity officer of the University of California, Santa Cruz, declared that they "join in solidarity with all who are outraged by this failure of accountability." Although the jurors, who had actually seen the evidence and heard the witnesses, came away with reasonable doubt as to Rittenhouse's guilt, many people who had not been in the courtroom were *certain* the verdict was unjust.

That is but one instance of the problem University of Illinois sociologist Ilana Redstone explores in her book *The Certainty Trap*. People have the propensity to act as if they are certain of something when certainty is not justified. This is not a new problem, but it seems to be growing worse as Americans become increasingly quick to conclude the worst about anyone who disagrees with them. The book, she writes, is meant to be "a roadmap for how to reasonably work through and overcome the heated and divisive hand-to-hand political battles." It isn't a right-wing or a left-wing book; Redstone hopes to reach people across the political spectrum, encouraging them to do more thinking and less emoting, to interrogate and clarify their beliefs, and to try to comprehend why others might have come to different conclusions.

Socrates questioned his fellow Athenians, both because he truly wanted to understand what they thought and because he wanted to get them to see the limits of their knowledge while professing his own ignorance. Redstone suggests that we should strive to be more like Socrates, probing for knowledge rather than leaping to conclusions. Our certainty traps lead to intellectual sloppiness, where people stop asking questions because they're sure they have the truth in their grasp.

Our recent political disputes are full of examples of the certainty trap problem. We have bitter exchanges over gun control, with advocates denouncing opponents as indifferent to the lives lost to gun violence, while opponents condemn supporters for wanting to disarm people so they'll be at the mercy of criminals. In the COVID emergency, people who wanted stringent protocols and vaccinations claimed that anyone who disagreed with them was in favor of letting people die merely because they didn't like some reasonable and minor disruptions in their lives, while people who opposed the governmental mandates said their opponents were authoritarians who had fallen for a hoax. What was conspicuously absent was a willingness to consider arguments, objectively weigh costs and benefits, and consider ways to accommodate different sides. On these and many other issues, we have become like two warring tribes rather than rational, thinking individuals.

Beyond civility / Quite a few people have observed this problem and concluded that the solution is to promote civil discourse, encouraging people to make their writings and conversations more respectful, productive, and truthful. There's nothing wrong with that, but Redstone argues that civility is not enough. She writes:

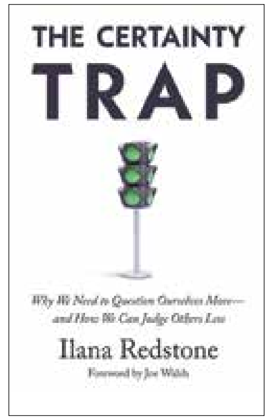
> Our problem is not simply that we have forgotten that conversations on heated topics require respect, a calm tone of voice, and active listening. To be sure, those are crucial skills to have. But the real challenge is the thinking that drives the judgments and demonization in the first place.... One way of understanding the limits of civil discourse as a remedy is that a person can be practicing all of its best norms and still be mired in certainty.

Redstone argues that we trap ourselves in feelings of certainty because we fall prey to three fallacious modes of thinking. First, there is the "settled question fallacy," which is the assumption that many controversies have already been settled and the individual knows how they've been settled. We saw that during the COVID pandemic, when officials kept telling people "The science is settled" on such questions as how to avoid the virus, how to treat it, and so on. What people should have understood is that in science (and everywhere else), knowledge is always provisional; questions are never settled but are always open to further investigation.

Second, there is the "equal knowledge" fallacy, the tendency for a person to think that others would agree with his conclusions if only they had the same knowledge he does. For example, "green" advocates often say that skeptics would agree with their policies if only they knew as much about the environment as the advocates do. Therefore, they believe, differences of opinion must be based on ignorance. There's no call to examine the skeptics' grounds for their beliefs, nor to question the soundness of one's own views.

Third, there is the "known intent" fallacy, which entails the rejection of opinions one disagrees with by ascribing bad motives to the dissidents. For example, in arguments over racial preferences in college admissions, advocates of preferences often dismiss contrary arguments by saying that people who claim to want racial neutrality are actually trying to preserve white supremacy. No further discussion is needed because the evil intentions of the other side have been exposed.

This problem is exacerbated by the growing tendency for Americans to live in "ideological silos," meaning they only have contact with people and sources of information that align with their preexisting beliefs. As Redstone observes, people now are afraid to express any doubt about the views of their side lest they be attacked as apostates ("cancelled"), which can have serious consequences such as loss of employment or friendships.



The Certainty Trap: Why We Need to Question Ourselves More—and How We Can Judge Others Less

By Ilana Redstone

246 pp.; Pitchstone Books, 2024

People are not the only victims of certainty traps; our institutions are as well. The US government's response to COVID is a good example. In early 2021, very little was known about the disease, yet key governmental institutions began mandating how people should respond. It turns out that the governmental experts were as unsure about what to do as the rest of us, but they acted as though they were certain. Consequently, people now have far less trust in governmental health pronouncements than before. Redstone rightly states:

> A functional society depends on having a critical mass of people with a shared sense that we're all in this together. Ultimately, there will be times when the only reason to follow through with an action is because of some sense that it is important for the greater good. The way we get there is by building trust. The enemy of trust is certainty.

Educators carry some of the blame for our certainty traps. Increasingly, teachers and professors instruct students that some ideas are unquestionably right and others are unquestionably wrong. Thus, those educators spread their own certainty traps to their students. Educational institutions themselves have become prone to issuing pronouncements that leave no room for doubt. For example, college departments often make it clear they hold to certain views on controversies like the Israeli–Palestinian conflict. Anyone who disagrees should not bother to seek employment or education there. In decades gone by, Redstone points out, schools understood that they should be neutral on such issues, but today the zealots have routed the old guard. Our schools increasingly encourage certainty traps rather than careful analysis.

Avoiding the trap / Intelligent, rational humans should not fall into certainty traps, even if they've amassed a great deal of knowledge and think they've considered all possible grounds for disagreement. A reader of *Regulation*, for example, may be very confident that minimum wage laws are a harmful policy, considering all the pros and cons. Nevertheless, he or she must be willing to consider any contrary argument. Don't shut off dialogue with a minimum wage supporter because that dialogue might change your mind.

Redstone does not suggest any silver-bullet solutions to the certainty trap problem. She does make the eminently sensible point that those of us who are concerned about the nation's division into hostile warring tribes should model good argumentation, never taking the low road of impugning the motives or questioning the intelligence of people who disagree. Thoughtful people often profess to believe this, yet the certainty trap problem seems to be worsening. R

IN REVIEW

Public Choice and the New Deal

REVIEW BY GEORGE LEEF

As the United States approaches the hundredth anniversary of the New Deal, we should expect a lively debate over its effects. Advocates of our vast administrative state will retell the standard stories of how the instability of capitalism caused the Great Depression and Herbert Hoover's laissez-faire policies made things worse, as well as how Franklin D. Roosevelt's bold and innovative policies saved the country.

To respond, it would be good to have some solid scholarship on the New Deal. That is what Central Michigan University economist Robert Wright provides in *FDR's New Deal*. Wright argues that New Deal–style policymaking began under Hoover and that its expansion under Roosevelt was a terrible failure. Far from ending the Depression, Hoover and Roosevelt's interventions prolonged and deepened it. Many Americans were made worse off, especially members of minority groups with no political pull. The New Deal had such malign effects, Wright states, "because it denigrated the nation's tradition of individualism and extolled collectivism."

Collectivism, the dream of Marxists and other utopians, had never gained much traction in the United States. Most Americans resisted its idea that people should be compelled to live for the supposed good of all rather than freely pursuing their own self-interest. In fact, the architects of the New Deal sometimes admitted they sought to bring about a philosophical transformation of the nation. Wright quotes Laughlin Currie, one of FDR's "brain trusters," who said, "We used economic arguments for things we wanted to do on other grounds."

Wright writes from "a public choice perspective." Public choice theory tells scholars to analyze policies by asking how the measures were perceived to enhance the well-being of the politicians themselves, rather than assuming the politicians were focused on boosting general welfare. Throughout the book, we see that many New Deal policies were undertaken because they were likely to get key voting groups to favor the Democratic Party regardless of whether the policies benefited the country as a whole.

Before the New Deal / Wright locates the origins of the Depression in the "progressive" agenda of the early 20th century. The main culprits were the Federal Reserve System and the income tax, both of which would make the economy less resilient and more prone to political meddling. During the 1920s the economy "roared," but that was in part because of the Fed's easy money policy, leading to unsustainable booms in some sectors of the economy. When the Fed tightened in late 1928, it overreacted, leading to a severe contraction in the money supply, badly disrupting commerce. That could not have occurred without the blundering of Fed officials, who didn't know what they were doing. The monetary contraction set the stage for the inevitable recession, and the stock market crash in 1929 was, Wright observes, just "the bearer of bad news."

The United States had suffered financial panics before (as recently as 1921–22), but this was the first time a US president believed government power was the key to recovery. Instead of allowing the free market to correct the mistakes of the boom years, Hoover immediately began to intervene to fix what he thought was wrong with the economy. For example, he pressured employers to maintain wages, believing any reduction in purchasing power would aggravate conditions. All that did was yield shorter work weeks for employees who kept their jobs.

Roosevelt presidency / Hoover made other blunders that kept the economy from self-correcting, but Wright devotes most of the book to Roosevelt's administration. FDR believed he and his team were carrying out "bold experimentation" to revive the nation. He famously pledged himself to promoting "four freedoms"—freedom of speech, freedom of religion, freedom from want, and freedom from fear—but as Wright notes, Roosevelt's program at every step meant less freedom for Americans.

Wright explores the numerous programs enacted by Congress and decreed by FDR through executive orders, arguing that they actually made a bad situation worse. For example, Roosevelt's agricultural policy was based on the absurd idea that national prosperity would be restored by driving farm prices up to their pre-Depression levels, thereby giving farmers more purchasing power. He did this by attacking supply to increase scarcity. So, at a time when many Americans were standing in bread lines, the US government was paying farmers to destroy crops and livestock and to produce less in the future. That destroyed goods for no good reason.

Another of FDR's "fixes" for the economy was monetary. He had campaigned on a platform of maintaining sound money, evidently assuming that most voters wanted to stay with the gold standard. But once in office, he called the gold peg "an old fetish" and availed himself of powers under the National Emergency Banking Act to order people to turn over their gold coins, bullion, and gold certificates in exchange for paper

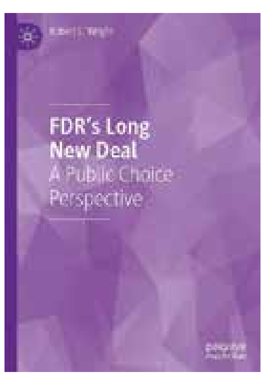
Federal Reserve notes. Not long afterward, FDR pressured Congress to pass a statute abrogating gold clauses in all public and private contracts.

Could the government do that? The drafters of the Constitution would undoubtedly have said no, but in a 5–4 ruling the Supreme Court decided that it would turn a blind eye to those federal actions. Many Americans complied with the confiscation because of the severe penalty for not doing so: a fine twice the value of the gold. This was a huge windfall for the Treasury after the dollar was devalued from $20.67 per ounce to $35 per ounce, Wright reports. Despite the monetary gyrations, the Depression continued.

What about agriculture? By 1934, payments from the government constituted two-thirds of all income for farmers. Dependence on Uncle Sam quickly established itself among our formerly independent farmers. And the Depression went on.

Another New Deal innovation was federal regulation of previously free industries. The securities industry was among them, brought under federal control with statutes enacted in 1933 and 1934. Supposedly, regulation by the Securities and Exchange Commission was necessary to restore confidence in securities markets. But Wright argues that the new regime of mandatory full disclosure "was inferior to the system that had evolved organically since the 1790s, wherein securities issuers provided high-quality information to a relatively few important investors, to whom other investors looked for signals to buy, hold, or sell." So, there was no economic improvement from securities regulation, just a lot of new jobs in Washington for bureaucrats.

Other industries that the New Deal subjected to federal regulation were airlines and trucking. Instead of free competition, government officials stepped in to set routes and rates. Those measures did not help either and were finally repealed in 1978.



FDR's Long New Deal: A Public Choice Perspective

By Robert E. Wright

339 pp.; Palgrave Macmillan, 2024

FDR usually gets credit for pushing through the repeal of Prohibition. But as Wright points out, Roosevelt's position was not because he was such a devotee of liberty that he hated governmental restrictions on what people could consume. Rather, he wanted government to receive tax revenue from the sale of alcoholic beverages. What occurred, Wright observes, was merely "to redirect the economic rents being extracted by bootleggers and organized crime to FDR's radical reform agenda."

Another aspect of the New Deal was Social Security. The idea that Americans should look to the federal government rather than their own wealth accumulation and family support in old age fit perfectly with the collectivistic views of FDR and his "brain trusters." Social Security bedevils the country to this day. As Wright states, it distorts investment "by forcing Americans, through the Social Security payroll tax, to buy the government's life annuity instead of private annuities, life insurance, real estate, business equity, or financial securities." There was no need or constitutional warrant for this new governmental program, but it helped to further undermine American individualism, just as the progressives wanted.

The New Deal set other bad precedents for the nation. FDR and his allies did all they could to stifle criticism of their experimentation. They used the government's control over radio licensing, for example, to threaten broadcasters who aired views that were unfriendly to their agenda. The federal government also got into the propaganda business by subsidizing plays that pushed the collectivist agenda.

Who benefited from the New Deal? Not the economy as a whole, which Wright shows was among the world's worst performing in the 1930s. Of course, some groups did gain, such as organized labor and a big new voting bloc of federal employees, but others lost, such as Blacks, American Indians, young people, and women.

Court packing / Wright also reviews the history of the New Deal in the courts. In some early cases, the US Supreme Court upheld blatantly authoritarian state policies (such as price setting for milk). But in 1935 and 1936, the Court drew the line at several federal statutes where Congress had unconstitutionally delegated power to the executive branch. These cases involved the National Industrial Recovery Act (which promoted cartelization of industry), the Agricultural Adjustment Act, and other New Deal laws.

FDR would not allow the Constitution to get in his way. He threatened to "pack" the Court by having Congress pass a law allowing him to nominate six new justices. Many members of his own party recoiled at the idea, but the threat convinced Justice Owen Roberts to switch sides and approve New Deal legislation from 1937 on. The old justices retired and soon the Court was filled with FDR appointees who approved even the most egregious expansions of federal control, such as in the 1942 case *Wickard v. Filburn* that enlarged the scope of Congress's power under the Commerce Clause.

Conclusion / The economy went into another tailspin in 1937, largely because of FDR's continuing economic meddling, especially the National Labor Relations Act. The voters took out their displeasure on the Democrats in the 1938 elections, and that put an end to further New Deal legislation. But the damage had been done. New Deal policies would continue to hold back economic progress through the rest of FDR's presidency. And his expansion of federal power would serve as the inspiration for much more of the same under future presidents.

The big message of Wright's book is that the United States would have been far better off if it had forgone the "bold experimentation" of the New Deal. The economy would have recovered much faster from the Depression (which might never have happened at all but for bad governmental policies) if the federal government had stuck to its limited constitutional role. This book provides the reader with ample ammunition to combat the still prevalent idea that the New Deal was wise and beneficial. *R*

A Look Back at the California Electricity Crisis

REVIEW BY PHIL R. MURRAY

It may have faded from the memory of anyone who is not an energy economist, but a quarter-century ago California was seized by an electricity crisis resulting from state lawmakers' efforts to restructure its electricity market. Rolling blackouts sapped the energy of state homes and businesses (not to mention Gov. Gray Davis's political ambitions). Dueling explanations quickly emerged of what caused the morass and the related financial and corporate governance crisis that took down the electricity giant Enron. This book, by Massachusetts Institute of Technology Sloan School of Management sociologist Georg Rilinger offers a thorough explanation of what caused the morass, as well as what is necessary for market design to be successful.

In the mid-1990s, California—like many other economically booming states of the time that wanted to tap the excess generation capacity of neighboring states—restructured its electricity market, shifting from heavily regulated vertical local monopolies to what might be called a conglomeration of competitive markets. This "form of *organizational planning* [had] to strike a balance between imperatives to simplify, bound, and control the market," explains Rilinger. The tradeoffs chosen by lawmakers opened the way for the electricity crisis.

According to one story, told by "marketers" and "producers," California's market for electricity seized up because of a lack of supply. The wholesale price of electricity skyrocketed and fluctuated wildly, while the retail price was capped, meaning that price could not moderate consumption. According to another story, told by "utilities and the California government," the market malfunctioned because of "outrageous trader behavior" in pursuit of illicit profits: Electricity intermediaries deliberately misaligned supply and demand to produce large profits on the spot market. Neither story is obviously true or false. There were scheming electricity traders, but it's unclear whether they broke any laws. Regulators and politicians were influenced by marketers such as Enron. Economists disagreed over econometrics and market power. Neither of the two stories will ever prevail, writes Rilinger, because "the criteria guiding the evaluation of evidence are not clear or set in stone."

He begins to explain the crisis by asking, "What structural features of the system created opportunities and incentives for behavior that was incompatible with the reliable operation of the electricity system?" He suspects that the origin of the crisis lies in the design of the market.

Market *design* is an intellectual endeavor that aims to create or improve a market. Contrast that with the evolution of a market as a phenomenon of *spontaneous order*. Economists are not the only market designers; their ranks include engineers, computer scientists, and operations researchers. Consider this description:

> At its core, market design views markets as search algorithms that solve constrained optimization problems. This is not just a matter of the formalizations designers use to conceptualize markets. It reflects how designer markets are supposed to operate. A combination of human activity and software should realize the search algorithm and produce custom-tailored results. If market actors follow the desired calculated logic, they realize the subroutines of the larger search algorithm. In that way, market design is similar to organizational planning.

Rilinger points out that "we are now quite far away from the commonsense understanding of a market as a place where people exchange money for goods and services." Indeed, we are. Notice the prominence of algorithms in the above description. Exchange is a feature so long as it is consistent with the plans of the designers. In fact, the author equates market design to social engineering. To encourage (nudge or yoke) market participants into doing what they want them to do, designers "simplify, bound, and control."

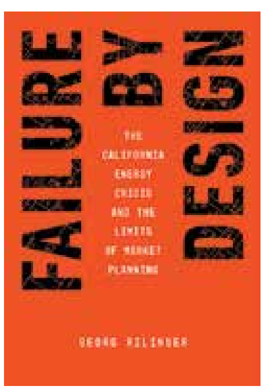
"Simplifying," the author tells us, "means reducing the behavioral options inside the market as well as the information participants need to consider." Understanding that in the context of the market for electricity is, ironically, not so simple. Rilinger tries to help:

> To give an example: the auctions required a standardized input—a step function that established how much the buyer or seller was willing to buy or sell at a given price for a given hour. This

> information had to be submitted at a particular time. After the auction closed, the software calculated the optimal combination of trades and informed buyers and sellers about sales and purchases. The algorithm incentivized all generators to bid their true marginal cost and buyers to bid their true preferences. The setup made it easy and intuitive to do what the market design required.

Simplifying the market that way worked well enough to achieve the objective of delivering electricity at a low price for a limited period of time. However, simplification was "differential" or inconsistent across the many different markets that made up the whole. Consequently, the capital expenditures that would be necessary to increase the supply of electricity in the future never materialized.

Perils of compromise / "Bounding," the author continues, "refers to an effective insulation of the market from other spheres of action." His easy-to-understand example is bullfighting: A ring bounds the matador, the picadores, and the bull. As with simplification, bounding in the context of an electricity market is hard to comprehend, but it has to do with generation companies providing electricity to California utilities either under contract or on the spot market.



Failure by Design: The California Energy Crisis and the Limits of Market Planning

By Georg Rilinger

313 pp.; University of Chicago Press, 2024

The system, in fact, consisted of many markets. The author's diagram of markets and participants shows a California Independent System Operator (CAISO) market, an imbalance market, five ancillary service markets, and a retail market. There is a distinction between "physical markets" for electricity and "financial markets." If this reviewer's understanding is correct, "access rules" allowed traders to trade in either a physical market or a financial market, but not both. "The access rules," Rilinger explains, "effectively protected an effort to simplify different market settings to different degrees." He adds that the rules "ensured that each sphere could operate on the basis of its own social and technical logic—a prime example of bounding." Traders violated the rules to reap "bandit profits," which contributed to the crisis.

Traders were able to violate rules because market designers neglected to incorporate effective enforcement. "Control," in general, "refers to ongoing efforts to identify novel behavior and either constrain it or adjust the market mechanism to accommodate it." An example of novel, objectionable behavior is "market manipulation." Rilinger and others often use that term, though they do not define it. Specific cases included turning off a generator to reduce supply and increase the price of electricity. Other cases were "games" that Enron and others played, such as being "paid to relieve artificial congestion." But the Federal Energy Regulatory Commission (FERC) regulated wholesale prices. Designers created "monitoring units," which identified misbehavior but "had no authority to sanction or penalize rule violations directly." The author puts it bluntly: "The control structure was weak, fragmented, and underprepared to react to any manipulative behavior."

Political compromise is one reason market designers created a flawed system. Several groups—including utilities, marketers, and industrial users—agreed to transform the market structure from regulated monopolies to the conglomeration of competitive markets. Disagreement emerged, however, over the nature of the transformation. One group preferred a "pool" that "would buy electricity from generators, sell it to distributors, and organize the transmission." Another group preferred a "direct-access model that allowed retail and wholesale customers to choose their supplier on the basis of bilateral contracts." The groups compromised. The first group would get the pool it wanted; to satisfy the second group, "the pool would be separated from grid management." Rilinger reports that "market designers were uniformly aghast." They warned that organizing the system based on the compromise would lead to "inefficiencies."

Market designers tried to persuade the interested parties that their compromise was unworkable. But the parties refused to listen. "In a world where everybody seemed to know how to use economic reasoning," says Rilinger, "the market designers appeared to be just one group with strange opinions." He adds, though, that "What the ideal electricity market should be and how it should work were objectively ambiguous." That seems to contradict his point that failing to heed the warnings of market designers hobbled the system from the beginning.

The second reason designers created a flawed system relates to their decision-making procedure. To complete the work on time, they chose "modularization," which Rilinger characterizes as "a radical division of labor to build the market." Now, modularization and the way it hinders the design process are among the most difficult concepts to understand in this book. Here is a rough description of the problem: Designers developing a given module, say a market, cannot imagine the effects on other markets. No one individual can oversee all modules and foresee these interaction problems. Although designers make rules to prevent bad behavior in the system, traders continue to find new ways to misbehave. Designers will not see all the modules (markets) that will be required in the system during the design phase. Even if they recognize the need for a module, they might neglect to develop it. "Modularization," the author sums up, "prevented designers from deploying strategies of simplification and bounding effectively."

Social engineering / Three kinds of designers developed the system. Each viewed markets or market behavior in unique ways. This "intellectual fragmentation" is a third reason why the system failed. Economists who designed the auction markets for electricity supply reckoned that by giving traders the right incentives in the first place, traders would do what the designers intended them to do. Markets would "self-regulate."

Economists specializing in industrial organization expected sellers to exercise market power, though not as frequently as they did. These economists recommended a "monitoring function" that would leave regulatory action to FERC. Engineers concentrated on "grid management"; they did not fathom that traders "would try to make money in any way possible." They recommended light regulation, such as requiring utilities to disclose their costs of production. The upshot of these various views of markets and market behavior is that effective measures to control behavior were not designed.

To Rilinger, market design is "a form of social engineering." Whereas some of us recoil at the thought of social engineering, the author is hopeful because "digitalization has breathed new life into projects of social engineering." He wants to give market design (or "government design") a chance so long as we understand when it will not work.

Market design will not work if decisions made in the political arena determine that something impossible must be designed. Recall that the political compromise "to separate the market from grid management" dealt a blow to the successful design of California's electricity system. Market design will not work if a large number of designers develop the system, which is what happens when the problem to be solved is a difficult one. The groups that designed California's market were apparently numerous enough that they did not communicate effectively; they did not foresee behavior that would disrupt the market. Finally, market design will not work if designers with different training or experience do not share a common view of how to develop the market. Economists and engineers did not work from the same "blueprint" to build California's market.

All this means designers should be wary of using their tools to tackle "complex allocation problems." Anyone currently involved in drafting a market solution for allocating water from the Colorado River, for instance, should be mindful that Rilinger considers water, along with electricity, clean air, and healthcare, to be such a complex allocation problem.

Market design is a technical subject involving more than markets. Thus, much of *Failure by Design* is challenging to read and understand. The layman may learn something about the basics of market design. However, the best audience is probably economists who specialize in market design and engineers who specialize in electricity transmission. According to the author, businesses including Walmart, Amazon, and Uber use the techniques of market design apparently unbeknownst to their consumers. Also, the author reveals that socialists are looking forward to "nationalizing the logistic systems" of those businesses. It will be necessary to defend market designers from government officials with socialist tendencies to preserve private property and consumer sovereignty. *R*

A Look at 'The River'

REVIEW BY RYAN H. MURPHY

Statistician and journalist Nate Silver's latest book, *On the Edge*, can be described in several ways: a "business" book, a memoir, a reflection on what may amount to temporary social mania post-COVID, and a quasi-sequel to his first (non-baseball) book, *The Signal and the Noise*.

You may have recently read about many of the topics covered in *On the Edge* on the blog *Marginal Revolution* or similar publications: tech founders, large language models, effective altruism, Sam Bankman-Fried, existential risk. If you recognize those names and phrases but are sketchy on the details, read this book right now because it will be useful. But the topics it covers may not be relevant in a few years, as *On the Edge* is very much a product of the period 2021–2024.

River and Village / In describing common economic thinking and response to risk, Silver divides people into two groups: "The River" and "The Village." Folks who make up The River combine extreme risk neutrality (or even risk-seeking behavior) with the prowess of a natural economist. (Those are not the exact words he uses, but you know such people.)

People who are part of The River fall along a spectrum of ability, from being a marginally functional member of society, to living somewhat respectably, to being among the elite. At the low end are degenerate gamblers and con artists; going "up" The River (i.e., progressively less degenerate and more professionally successful), you find successful gamblers, crypto enthusiasts, narcissistic traders on Wall Street, provocative utilitarian philosophers, and tech founders.

Opposing them in the post-COVID world is what Silver calls The Village. Members are a collection of high achieving journalists, academics, and professionals whose politics have skewed increasingly left. An earlier generation may have called them "the chattering class" or "pearl-clutchers."

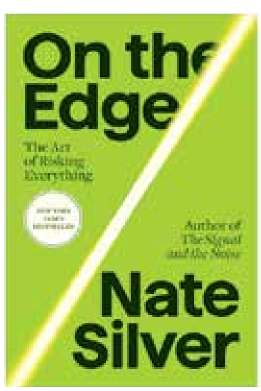
Interpreting The River / The first third of the book serves as a bridge between *The*

Signal and the Noise—Silver's statement on Bayesian reasoning and the best practices for prediction—and the topics covered in *On the Edge*. He does this via an anthropological journey through the world of professional gambling, which he had covered a bit in his earlier book.

In *On the Edge*, Silver chronicles how the same analytical revolution that occurred in baseball, to which he was a key contributor, swept through professional gambling a few years later, where he is a minor figure today. He tells the history of Las Vegas, broadly outlines the best techniques for playing poker, and opines on various controversies and policy issues related to gambling. Most controversially for economists, he makes the case for why many sports betting lines can be rather inefficient at reflecting the "true" odds of a team winning.

Following the chapters on professional gambling, there is a brief interlude where Silver seeks out other members of The River in various fields where one may not expect to find them. Perhaps this is the natural economist in me, but the numerous interviews of such people throughout the book bog down an already lengthy work and do not add much. Of course, a reader from The Village would likely disagree with me.

Following that interlude is the most noteworthy of the book's interviews: a series of lengthy conversations with Sam Bankman-Fried that forms the backbone of the latter portion of the book. But even here, will anyone in 2030 remember Bankman-Fried? Have you already forgotten who he is? *On the Edge* is very much a product of the time in which it was written.



On the Edge: The Art of Risking Everything
By Nate Silver
576 pp.; Penguin, 2024

If you have forgotten him, Bankman-Fried was the youthful head of an intertwined hedge fund (Alameda) and cryptocurrency exchange (FTX). Much of the latter half of the book tells of his downfall, with Silver recounting interviews prior to, during, and after it. Bankman-Fried ended up with a prison sentence of 25 years for illegally using investor deposits as funds to toy with financial markets in a manner that would make professional poker players squirm. He made trades that were, in effect, "fifty percent I destroy all my wealth and go to jail, fifty percent I double my money plus a dollar." Positive expected value, Bernoulli be damned.

The story of Bankman-Fried, both in real life and in Silver's account, seamlessly serves as a critique of the utilitarianism of Peter Singer and the "effective altruism" of William MacAskill, an outgrowth of Singer's philosophy, which got caught up with (and was substantially funded by) Bankman-Friedman in the early 2020s. Effective altruism was "supposed to be" boring philanthropic recommendations like buying mosquito nets to save the most lives per dollar spent. At its more provocative, it would tell people to work more hours at their day job rather than volunteering, so they could give more money to effective charities.

But effective altruism became associated with embarrassments like Bankman-Fried appearing on Tyler Cowen's podcast, *Conversations with Tyler*, during which Cowen got him to agree to continuously flip coins where the number of Earths doubles (and therefore utility doubles) with 51 percent probability and all life ceases to exist with 49 percent probability, because that would result in positive expected value. Silver mentions this episode in the book, and I distinctly remember listening to it while doing dishes the night it was published. I metaphorically heard a record scratch when listening to Bankman-Fried make this claim.

What makes the book especially useful is that it gives you a rough (if troubling) idea of how some of your neighbors see the world and operate in it.

What Silver is ultimately intending throughout the second part of the book is to play the public's interpreter of Bankman-Fried, Elon Musk, cryptocurrency, effective altruism, and whether artificial intelligence will one day kill us all. All these issues are ones directly related to the interests of The River, and it is the real meat of the book. Silver then offers sensible, generally middle-of-the-road conclusions on most of the issues raised. But what makes the book especially useful is that it gives you a rough (if troubling) idea of how some of your neighbors see the world and operate in it. Silver is terrific in clarifying that.

Conclusion / The concluding chapter is a somewhat surprising ode to classical liberalism and Pinkerite optimism through the lens of Deirdre McCloskey. (In fairness, Silver has shown these sentiments before, including in a *Reason* podcast months before the book was published.) Of notable interest is his call for *pluralism*—as Silver defines it, preventing any single group or ideology from dominating.

I have a speculative and Straussian reading of this oddly placed conclusion. Sports analytics and the organization *Baseball Prospectus* were where Silver first came to prominence and were the first place for The River to go mainstream and take over culture. But in the last 10 years, these organizations have become colonized by The Village, with all that entails. Perhaps with a bit more emphasis on pluralism, those organizations could have stayed in The River and continued to generate insights. *R*

IN REVIEW

Working Papers ➾ BY PETER VAN DOREN

A SUMMARY OF RECENT PAPERS THAT MAY BE OF INTEREST TO *REGULATION*'S READERS.

Income Taxes and Unrealized Capital Gains

■ **Sheffrin, Steven M., 2025, "Realization Makes an Intellectual Comeback," SSRN Working Paper no. 5057313, February.**

■ **Fox, Edward, and Zachary Liscow, 2025, "The Role of Unrealized Gains and Borrowing in the Taxation of the Rich," SSRN Working Paper no. 5104644, February.**

The *New York Times*' disclosure of nearly two decades of President Trump's tax returns in 2020 and the release of his returns by the House Ways and Means Committee in 2022 led to much discussion of his low income tax payments: $750 in 2016; $750 in 2017; and $0 in 2020.

How were such low payments possible? Discussion focused on the taxation of unrealized capital gains as well as the tax strategy colloquially described as "buy, borrow, die."

The US income tax system taxes the increased value of assets (stocks, bonds, private businesses, and real estate) only when those gains are realized—that is, when the assets are sold. But someone who has assets can borrow against their value by pledging them as collateral. The loan is not income. The borrower must pay interest on it, but he can keep rolling over the principal so the loan never need be repaid in his lifetime. Upon the death of the borrower, obligations are paid off and the value of the remaining assets to those who inherit them is "stepped-up" to market value at the time of inheritance. Thus, the capital gain from the change in value under the initial owner is only taxed through the estate tax. Hence the phrase "buy, borrow, die."

Sheffrin's article succinctly explains the intellectual debate about the taxation of capital gains over the years. Traditional theory about the ideal income tax, developed by economists Robert Haig and Henry Simons, defines income as the sum of consumption and the change in net worth. Thus, Haig–Simons calls for taxation of unrealized gains. The idea is that people with higher or increasing incomes have more ability to pay taxes.

The *actual* system of taxation has been viewed as intellectually compromised because it taxes only upon realization. Progressive legislators and President Joe Biden proposed to tax unrealized capital gains.

Asset values may increase for two reasons: increased net cash flows and changes in interest rates. In the first, the actual cash income produced by an asset increases. In the second, the cash income remains constant but is more valuable because real interest rates decline. An increase in tax despite a constant flow of income is inconsistent with "ability to pay."

Modern financial research has provided considerable evidence that fluctuations in asset prices arise primarily from fluctuations in interest rates and not from cash flows. The large increase in the value of assets since the 1980s is the result of declines in interest rates. Thus, taxing only on realized capital gains has made an intellectual comeback.

Fox and Liscow's paper uses data to analyze the use of the "buy, borrow, die" strategy among the wealthy. The Federal Reserve's Survey of Consumer Finances oversamples the rich and reports comprehensive measures of wealth, unrealized gains, and borrowing, as well as much tax data. Aggregate borrowing by the top 1 percent wealth-holders in 2022 was only about 2.4 percent of economic income in 2022 and 1.0 percent of income for the top 0.1 percent of wealth holders. New unrealized gains were much larger: 33 percent of income for the top 1 percent and 50 percent of income for the top 0.1 percent. Hence, there's very little "buy borrow, die" going on. Instead, wealthy Americans' tax strategy appears to be "buy, save, die."

Nonpoint Source Pollution Trading

■ **Raff, Zach, et al., 2025, "The Differential Benefits of Market-Based Water Pollution Control Policy," SSRN Working Paper no. 5135170, February.**

Traditional water pollution control involves the granting of discharge permits to factories and public waste-water treatment plants that have "point sources": pipes whose discharge into lakes, rivers, and oceans can be monitored and measured. A much more difficult problem is the "nonpoint" runoff from farms, which contains phosphorous and nitrogen from fertilizer and animal manure. Those nutrients fuel algae blooms that appear in the Gulf of Mexico and elsewhere, harming aquatic life. This issue was discussed in articles in the Fall 2010 and Fall 2011 issues of *Regulation*.

In 2010, Wisconsin required many point sources to reduce their total phosphorus (TP) discharge by over 90 percent. To meet the new limits, point sources could upgrade to tertiary (filtration) treatment technology, or they could pay nonpoint sources (farms) to implement less expensive phosphorous reduction practices.

This paper concludes that technological upgrades resulted in downstream TP concentration reductions of over 29 percent, while payments to nonpoint sources reduced downstream TP concentration by 21 percent. Technological upgrades cost $34,000 per year, while payments to nonpoint sources cost just $5,900 per year. For the state, the 20-year costs of upgraded treatment would be over $7.8 million per year versus $1.4 million per year in payments to nonpoint sources.

Nordic Inequality and Policy

■ **Mogstad, Magne, et al., 2025, "Income Equality in the Nordic Countries: Myths, Facts, and Lessons," SSRN Working Paper no. 5126843, February.**

Nordic countries and their generous (relative to the United States) social welfare policies are subjected to much intellectual scrutiny. What are the benefits and costs of such policies? Should the US emulate them?

In previous Working Papers, I reviewed many papers on Nordic policies: maternity leave (Summer 2014), disability policy (Summer 2018), and education subsidies and social mobility (Summer 2021 and Fall 2023). This paper argues that Nordic equality is more the result of wage compression from national collective wage bargaining than redistribution and generous public services.

Free education does little to alter the distribution of educational achievement. The observed distributions of education and skills are relatively similar in the Nordic countries and the United States. But wage coordination in Scandinavia compresses the distribution of wages compared to the distribution of labor productivity. The wage premium for education and skills is twice as large in the US.

This paper reinforces the conclusion of the previous papers I reviewed: Universal generous daycare appears to primarily replace other forms of out-of-home care used by working mothers, resulting in little to no increase in maternal employment or earnings.

What are the lessons for the US? One theory is that the high standard of living in northern Europe is the result of free riding from the innovation that occurs in the US and high incomes paid to innovators. Thus, the US cannot mimic Nordic policy without negative consequences for us and the world. Another theory is that wage compression encourages highly productive firms to expand because labor is cheaper, meaning there would be smaller tradeoffs than what is envisioned in the "free riding" theory. A third theory is that wage compression and social insurance reduce the negative effects of trade and innovation on employment stability and thus reduce political opposition to markets.

How to test these theories? Mogstad et al. write:

> Unfortunately, empirical research to date has been limited in its ability to distinguish between the different views about what broader lessons one may draw from the Nordic model and experience. Indeed, most of what we know comes from examples, anecdotes, and cross-country comparisons, subject to the usual criticism of representativeness, omitted variables, and endogeneity.

The evidence is not adequate to guide our choices.

Medical Debt and Credit Outcomes

■ **Duarte, Victor, et al., 2025, "The Effects of Deleting Medical Debt from Consumer Credit Reports," NBER Working Paper no. 33644, April.**

Before becoming a US senator, Elizabeth Warren was a Harvard Law School professor. In the Spring 2014 Working Papers, I described her research agenda, which emphasized the disproportionate role of medical debt in personal bankruptcy: medical debt over $5,000 was found in half of the bankruptcies studied. As a senator, she proposed the creation of the Consumer Financial Protection Bureau (CFPB) to regulate consumer debt obligations in general and medical debt in particular to reduce the use of deceptive language and onerous burdens in debt contracts.

One in seven Americans carries medical debt. Some $88 billion in medical debt appeared on consumer credit reports as of 2021. The three major US credit bureaus announced in April 2023 that they were no longer including medical debt collections below $500 in credit reports. And the CFPB issued a final rule in January 2025 to eliminate all remaining medical debt collections from credit reports. The claim was that this would enhance credit access and improve loan terms for consumers burdened with medical debt.

This paper compares the effects of these policies by studying individuals with medical debts just above and below the $500 threshold. It finds no differences in credit scores, credit limits and utilization, repayment behavior, payday borrowing, or other related outcomes. So, small medical debts are not relevant for risk pricing, which is why the credit reporting firms voluntarily terminated the use of the information.

The authors then develop credit scoring models using machine learning to evaluate medical debts over and under $500. They find that larger medical debts also have little predictive value for credit outcomes. They conclude that eliminating medical debt from credit reports is unlikely to have any effect on financial outcomes. R