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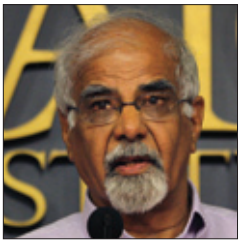

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Cato Policy Report

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Principal-Agent Theory and the Welfare State

BY MARK PENNINGTON

The recent financial Armageddon often gets blamed on shareholders failing to discipline out-of-control corporate managers. This "principal-agent" problem is seen as the cause of excessive CEO pay, as well as irresponsible risk-taking by greedy bankers and financiers. There is more than a grain of truth to these arguments, but we must not be fooled into believing that weak corporate governance lies at the heart of contemporary ills. The problems that shareholders face in overseeing irresponsible managers are nothing compared to the difficulty that voters face when reining in out-of-control politicians. If we want to deal with the fiscal crises unfolding in the United States and Europe, we must address the biggest principal-agent problem—the one at the heart of the modern welfare state.

CONTROLLING POLITICIANS: THE MOTHER OF ALL PRINCIPAL-AGENT PROBLEMS

In the 1930s, during the shift away from owner-managed capitalism, experts began studying what became known as the principal-agent problem. At the time, large numbers of relatively small investors were pooling their capital and employing professional managers to operate companies on their behalf. Unfortunately, this fragmented ownership meant it might not be worthwhile for any particular owner to spend his time and money monitoring management's actions. Because improved company performance was now shared by all the owners, each owner could hope to rely on other shareholders to monitor accountability and thereby free ride.

If most shareholders reason this way, then managers can get away with paying themselves too much, building luxury office complexes, and running up enormous travel expenses. This is the crux of the principal-agent problem.

With private industries, principal-agent relationships create inefficiencies within the market. But these distortions are limited because individual owners retain the

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MARK PENNINGTON is professor of public policy and political economy at Queen Mary, University of London, and the author of *Robust Political Economy: Classical Liberalism and the Future of Public Policy* (Edward Elgar, 2011).

At Cato University this July, SEN. RAND PAUL (R-KY) sat down to dinner with Cato founder and president EDWARD H. CRANE. In his keynote address that night on Capitol Hill, Paul spoke about the culture of spending in Washington and offered reasons to be optimistic about the country's future. PAGE 14

BY ROBERT A. LEVY

> "Individuals, like states, cannot be commandeered to carry out federal regulatory programs."

Chairman's Message

Rights, Powers, Dual Sovereignty, and Federalism

As the Supreme Court's 2010–2011 term ended, few if any pundits predicted the 9–0 decision in *Bond v. United States*—an obscure case, but with promising implications for individual liberty. Nor did court watchers anticipate that a decision of such gravity could be inspired by these bizarre facts:

Carol Bond discovered that her husband had impregnated her close friend. So Ms. Bond lathered toxic chemicals on her friend's car and mailbox, causing minor burns. If you think Bond's escapade should have been handled by local law enforcement authorities, you haven't been following the Chemical Weapons Convention, effected by a 1998 statute banning nonpeaceful use of chemicals that "cause death, temporary incapacitation or permanent harm."

Bond was indicted by the federal government but challenged the statute under the Tenth Amendment, which provides that "powers not delegated to the United States . . . are reserved to the States respectively, or to the people." She argued that a law elastic enough to cover her chemical caper represented federal encroachment on state criminal law—neither necessary nor proper to execute the president's and Senate's treaty power.

An appellate court decided, however, that Bond did not have legal standing to assert a Tenth Amendment right. After all, she sought to vindicate her personal interests, not the state's; no state was party to her lawsuit; and yet the Tenth Amendment is presumably about federal intrusion on state authority. Enter the Supreme Court, which unexpectedly transformed a tedious legal issue—standing to sue—into an energetic discourse on the meaning of federalism.

Many Americans believe federalism is synonymous with states' rights. Indeed, states do have some rights under the Constitution. For example, the Supreme Court has barred the federal government from "commandeering" the states to enforce federal gun laws and waste disposal regulations. States' rights are part of what federalism is about.

Others think of federalism as conferring state powers. That, too, is part of the story. But the Tenth Amendment confers no specific powers. It simply reserves to the states or the people all powers not granted to the national government. Whether a state can exercise a particular power depends on the state's constitution and laws—the legal pact between the state and its own citizens.

Federalism goes beyond states' rights and powers. Its essence is dual sovereignty—the Framers' ingenious system of shared authority between federal and state governments with each sovereign checking the other. The purpose of that check is to shield individuals from concentrations of power. Federalism is first and foremost a device to safeguard personal freedom. Justice Anthony Kennedy's opinion in *Bond* put it this way: Federalism "protects the liberty of all persons within a State by ensuring that laws enacted in excess of delegated governmental power cannot direct or control their actions. . . . . By denying any one government complete jurisdiction over all the concerns of public life, federalism protects the liberty of the individual from arbitrary power."

All nine members of the Court agreed: "States are not the sole intended beneficiaries of federalism. . . . An individual has a direct interest in objecting to laws that upset the constitutional balance between the National Government and the States. . . . Fidelity to the principles of federalism is not for the States alone to vindicate." Justice Kennedy also reminded us that "state sovereignty is not just an end in itself: Rather, federalism secures to citizens the liberties that derive from the diffusion of sovereign power."

So Carol Bond will have her day in court to argue that her indictment for a local crime oversteps the federal government's treaty powers. "The individual," said the Supreme Court, "can assert injury from governmental action taken in excess of the authority that federalism defines." That principle extends, of course, to other matters the Court will be considering—including various challenges to President Obama's healthcare scheme now percolating through the appellate courts.

Here is the logic: (1) The federal government is precluded from commandeering the states to carry out federal regulatory programs. (2) States and the people are treated equivalently by the Tenth Amendment. (3) All current justices acknowledge that an overriding goal of the Tenth Amendment is to secure individual rights. Therefore, (4) individuals, like states, cannot be commandeered to carry out federal regulatory programs.

Those principles may not be reconcilable with a federal mandate ordering individuals to purchase medical insurance to implement President Obama's healthcare agenda. In declaring the mandate unconstitutional, the U.S. Court of Appeals for the Eleventh Circuit pointedly noted that the Constitution's "structural limitations are often discussed in terms of federalism, [but] their ultimate goal is the protection of individual liberty." Stay tuned: The Supreme Court will have the final word, probably during its upcoming term.

Robert A Levy

Obesity, short-selling, and whistleblowers in Regulation

Public Servants or CON Artists?

Should companies have to prove to a government agency that what they offer fulfills a "public need"? In the latest issue of *Regulation*, Timothy Sandefur looks at "certificate of necessity" (CON) laws, which force businesses to do just that. Many industries—from taxicab services to moving companies to hospitals—are finding themselves subject to a host of bizarre rules that require them to get permission before opening their doors. Sandefur, a principal attorney at the Pacific Legal Foundation and author of *The Right to Earn a Living*, explores the history of these laws and reveals their frustratingly anti-competitive nature. "It is hard to imagine how any prospective business owner could ever prove that the public 'needs' a new product or service," he writes.

Michael L. Marlow and Alden F. Shiers, economists at California Polytechnic State University, ask whether government policies aimed at reducing obesity are sound. Using a simple supply-and-demand model, they find that the optimal weight varies across different individuals over time. As such, it is unlikely that public interventions—such as restrictions on soda sales, bans on HappyMeal toys, and mandates on restaurant locations—can successfully address the rise in obesity rates—given that each of these interventions is, of course, "one size fits all."

Henry I. Miller and Gregory Conko, coauthors of *The Frankenfood Myth*, investigate activism within the U.S. Department of Agriculture and discover that the regulatory process is often based on politics more than science. By the same token, law professor Jonathan H. Adler considers the REINS Act (Regulations from the Executive in Need of Scrutiny) and its attempt to reassert legislative control over regulatory policy.

Other contributors include Chinmay Jain, Pankaj K. Jain, and Thomas H. McInish on short-selling restrictions in "Everything Old Is New Again," and Jonathan L. Awner and Denise Dickins on the use of federal bounty programs in "Will There Be Whistleblowers?"

The Summer 2011 issue features book reviews on the advantages of big-city living, the problems with philanthropy, and whether or not the U.S economy is stagnating. It wraps up with editor Peter Van Doren's survey of recent academic papers on the collapse of shadow banking, the enduring financial losses of airlines, and the economics of mergers and acquisitions—as well as a final philosophy lesson from columnist A. Barton Hinkle. ■

***Regulation* is available by subscription or online at www.cato.org/regulation.**

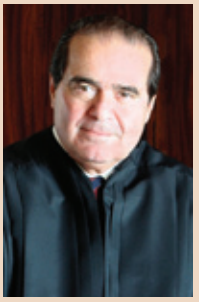
Cato News Notes

CATO'S ENDURING LEGACY


Joseph Addison

In a recent article in the *Wall Street Journal*, author John J. Miller reflected on the legacy of Cato the Younger, a Roman statesman known for his principled stand against the tyrannical rule of Julius Caesar. Using Joseph Addison's 1713 tragedy, *Cato*, as a backdrop, the article pointed out that this play was perhaps the single most important literary inspiration among the Founding Fathers. "Anyone who doubts the enduring influence of Addison's play," the article concluded, "need look no further than a big building on Massachusetts Avenue in Washington, the home of America's premier libertarian think tank: The Cato Institute."

THE DIVINE KOMEDY



The Supreme Court scored an epic victory this summer in *Brown v. Entertainment Merchants Association* by striking down California's prohibition on selling violent videogames to minors. In their decision, the judges cited Cato's amicus brief, which argued that every generation of new media—including music, movies, and even novels—has bred fear over the "seduction of the innocent" (to borrow a phrase from the 1950's panic surrounding comic books). In his majority opinion, Justice Antonin Scalia stressed that reading Dante is "unquestionably" more enlightening than playing Mortal Kombat. "But these cultural and intellectual differences are not *constitutional* ones," he wrote.

A ROSE BY ANY OTHER NAME...

***El Universo*, Ecuador's largest newspaper, recently ran a nearly blank front page featuring a single quotation from Ayn Rand's *Atlas Shrugged*. It read, in part: "When you see corruption being rewarded and honesty becoming self-sacrifice—you may know that your society is doomed." The quote—which came directly from a prior column written in the paper by elcato.org editor Gabriela Calderón—was the newspaper's response to a court decision that sentenced several of its employees to three years in prison, on top of a $40 million settlement. Their crime? They published an op-ed earlier this year that referred to Ecuadorian president Rafael Correa as a "dictator."**

Senior fellow Tom G. Palmer (above left) led this summer's class of Cato interns through a series of in-depth seminars on politics, economics, law, philosophy, and various policy issues. At one session, Cato president Edward H. Crane (right) discussed the history of the Institute and the circumstances that led him to establish a think tank. As part of our ongoing efforts to connect with a new generation of libertarian leaders, Cato also offered a week-long seminar, held jointly with the Institute for Humane Studies, for college students interested in public policy. At the inaugural session, economist Howard Baetjer (below left) of Towson University gave several lectures in which he illuminated the dismal science.

At a Capitol Hill Briefing in July, Kevin Williamson (left), deputy managing editor of *National Review*, debated Cato senior fellow Daniel J. Mitchell on whether a "grand compromise" budget deal was necessary to restore fiscal sanity in Washington. While Williamson argued against the no-tax-hike pledge, Mitchell said it was essential. "In the world of Washington," he said, "putting taxes on the table is simply akin to putting blood in the water with hungry sharks around."

At a Cato Policy Forum in June, Michael O'Hanlon, senior fellow and director of foreign policy research at the Brookings Institution, defended U.S. strategy in Afghanistan by drawing on his recent travels to the region.

Qué lee

Gabriela Calderón

La lectura es una herramienta esencial para su trabajo como investigadora del Cato Institute, editora de www.elcato.org y columnista de uno de los más grandes diarios del país

CARAS: Libro que te "enganchó" en la lectura...

Gabriela Calderón: Mi papá siempre me regalaba libros desde que aprendí a leer y recuerdo particularmente uno de los primeros que leí, era una selección de cuentos de *Las mil y una noches*. No sé si fue ese libro el que me enganchó en la lectura o el hecho de que mi papá siempre estaba leyendo y me contagió esa costumbre.

CARAS: ¿Qué lees actualmente?

G.C.: Para desconectarme de todo, *La guerra del fin del mundo* de Mario Vargas Llosa. Leí algunas reseñas que me llamaron la atención porque trata de un líder

CARAS: ¿Tu escritor predilecto?

G.C.: No escribió mucho, pero me encanta la corta obra el periodista económico Frederic Bastiat. Sus ensayos fueron lo primero que escogí leer cuando estaba terminando la universidad en Pensilvania y fueron los que inspiraron mis primeros artículos de opinión. Él logró hacer del análisis de la economía política algo entretenido.

CARAS: ¿Qué obra te ha quitado el sueño?

G.C.: Me pasó con *Un mundo para Julius* de Alfredo Bryce Echenique y *La fiesta del chivo* de Mario Vargas Llosa.

CARAS: Frase de un libro que nunca olvi-

CARAS: ¿Qué temas te llaman la atención?

G.C.: Siempre me interesó la historia de las ideas, del desarrollo económico y de la aparición y evolución de las instituciones. Por ejemplo, me encantó una colección de ensayos sobre desarrollo económico de Peter Bauer titulada *De la subsistencia al intercambio y otros ensayos* (algunos de esos ensayos están publicados en español en www.elcato.org). Además me gusta leer literatura de ficción, como *1984* de George Orwell y *La rebelión del atlas* de Ayn Rand.

CARAS: Libro que te da un poco de vergüenza admitir que te gusta...

This summer, *Caras* magazine in Ecuador featured an interview with Gabriela Calderón where she discussed her main intellectual influences as the editor of elcato.org. "There is all the difference in the world between treating people equally and attempting to make them equal," Calderón told the magazine, echoing the words of F. A. Hayek.

Cato's internship is part of a broader Young Leaders Program at the Institute, a project of student outreach that often includes a parliamentary-style debate with interns from other organizations. In July, two Cato summer interns debated libertarianism and conservatism with Heritage Foundation interns.

Are Big Business and Big Government enemies or allies? At a Cato Intern Forum in June, Tyson Slocum (left), energy program director at Public Citizen; Tim Carney (center), columnist for the *Washington Examiner*; and Rosario Palmieri, vice president at the National Association of Manufacturers, unraveled the complex web of collusion between market players and public officials.

In June, political scientist Jason Sorens discussed the new edition of "Freedom in the 50 States: An Index of Personal and Economic Freedom," coauthored with William Ruger and published by the Mercatus Center.

Continued from page 1

"exit option": they can sell shares in poor performers and buy shares in better ones, or invest their wealth in alternative structures such as owner-managed firms, cooperatives, or firms with concentrated ownership. In short, owners have a number of other choices.

Controlling politicians in the welfare state is a problem of an entirely different magnitude. Citizens can't withdraw their support from government programs without facing threats of fines or even imprisonment. When individual voters (principals) cannot reasonably "exit" relationships with politicians (their agents), they often become trapped in inefficient structures.

Holding politicians accountable in a welfare state requires considerable time and effort. Unfortunately, in a large democracy, the chance that any one voter's efforts to monitor government programs will affect the taxes they pay and the outcome that they experience is vanishingly small. Rather than being informed and active citizens, voters find it rational to be ignorant about the political issues around them and the impact policies might have. Even a civic-minded person may not find it worthwhile to become an informed voter when the chance of personally influencing outcomes at the ballot box is infinitesimal. One might hope that the press would take more of an interest in such matters; but given that their readers have only minimal interest in political affairs, the tendency of the media is to concentrate on political trivia rather than the deeper, underlying issues.

Studies in the United States and Europe confirm the existence of massive voter ignorance, irrespective of educational achievements and social class. In the United States, for example, as many as 70 percent of voters can't name either of their state's senators, and the vast majority cannot estimate rates of inflation or unemployment within 5 percent of actual levels. It is this rational ignorance of public policy that enables politicians to maintain policies that injure voters' interests. The ability to rely on a steady stream of tax revenue creates a "soft budget constraint." This, in turn, enables politicians to act opportunistically—either to their own benefit or those of special interests—rather than for the public good. In the latter case, politicians tend to opt for policies that concentrate highly visible benefits on organized groups (such as farmers) while dispersing the costs widely, across the unorganized groups who ultimately pay the price—taxpayers.

> "Controlling politicians in the welfare state is a problem of an entirely different magnitude."

The democratic process does, of course, provide cultural and institutional constraints that limit the form and character of political opportunism. In most developed democracies it is considered unacceptable for politicians to receive salaries that are comparable to the compensation packages of corporate managers in the private sector. It is worth keeping in mind, however, that political opportunism can manifest itself in other, nonfinancial ways. It may include a preference for "on the job leisure" for politicians and bureaucrats, or the use of discretionary power to advance causes close to a politician's or bureaucrat's heart. In general, this opportunism may simply emerge as a widespread indifference to the need for efficiency when spending other people's money.

PRINCIPAL-AGENT PROBLEMS AND THE CRISIS OF THE WELFARE STATE

Consider welfare payments. Most voters favor mechanisms that provide security to people in the event of unemployment, disability, and other misfortune. At the same time, these voters have an interest in ensuring that this support is limited to genuine need—and that it functions by actually reducing poverty, rather than perpetuating it. In an ideal world welfare recipients would only claim benefits as necessary. In the real world, however, they may behave opportunistically by failing to seek employment or making illegitimate claims. Similarly, in an ideal world, politicians and bureaucrats in charge of administering welfare programs would be motivated to reduce such abuses. But in the real world they may prefer the benefits of political convenience and an easy life rather than the arduous work of rooting out fraud.

In a welfare state taxpayers don't have the option of "exiting" from such relationships. In theory they can lobby politicians to introduce more stringent checks on welfare recipients, but the incentives to do so are minimal. The costs of seeking to persuade politicians to change course are huge. And since effective welfare policies benefit all taxpayers, every voter has an incentive to let others incur these costs and to free ride on any improvements. As this tendency spreads throughout the electorate, welfare programs become increasingly divorced from considerations of efficiency and effectiveness.

Disincentives in controlling poor performance apply not only with respect to welfare recipients and public officials, but also to subsets of voters who demand further taxpayer funding. Self-interest, after all, is by no means confined to material benefits. It may also include emotional incentives where people derive benefits from public displays of support for particular causes. Thus, the pursuit of expressive benefits by "bleeding hearts" eager to display their greater concern for the poor or the disabled may perpetuate ineffective policies. If the costs of supporting failure are not concentrated on the bleeding hearts themselves, they are likely to demand a higher level of support than may be warranted. And, when the decision to reconsider support for a particular program is unlikely to affect either the future of that program or the size of one's own contribution to it, there are few incentives to consider more effective alternatives.

Experience differs across countries, but the lack of effective monitoring in welfare states must account in part for the substantial increase in those claiming various "disability" benefits within developed nations. At a time when general health levels have been

improving, more and more people are replacing work-generated income with disability benefits. In the United Kingdom, for example, between 2001 and 2011 the number of people claiming disability allowance increased from 2.2 million to 3.2 million. This represents almost a 50 percent increase during a period when population growth was no more than 2 percent. Across the Scandinavian countries, with their healthy populations and well-trained doctors, between 10 and 14 percent of the population are on disability benefits. In the Netherlands, 1 million people are dependent on disability payments in a labor market of only 7 million. Even in the United States—which has traditionally taken a more restrictive approach to disability allowances—the proportion of the population claiming benefits has been increasing at a rapid rate.

SOCIAL SECURITY AND MEDICARE

But we shouldn't place too much blame for the expansion of the welfare state on the questionable claims of some welfare recipients and the unwillingness of politicians to deal with this. By far the most significant factor in the current fiscal crisis is the massive growth in entitlement spending—namely, Social Security and Medicare—much of which is paid out to middle-class recipients. When caring for the elderly becomes the collective responsibility of taxpayers, rather than of individuals and their families, there are strong incentives for people to live at one another's expense. Under these circumstances, the most organized gain a disproportionate share of the spoils.

In the case of Social Security the problem is magnified because the "principals"— the future generations of workers who will foot the bill—do not yet exist as a political force and so cannot exert any influence over their "agents." One reason for this, of course, is that some of them are unborn or are too young to vote. Another, though, is that younger voters and potential taxpayers are less politically organized than older voters, who receive most of the benefits. Those who spend most of their time working or in school are the least likely to have sufficient incentives or time to participate in organized politics.

"In the case of Social Security the problem is magnified because the 'principals'—the future generations of workers who will foot the bill—do not yet exist as a political force and so cannot exert any influence over their 'agents.'"

Retirees, in other words, are better positioned to take advantage of their political involvement.

These asymmetric incentives for political action may best explain why groups such as AARP dominate political calculations concerning the future of Social Security, while the voices of those who bear the expense are seldom heard. The consequences of this imbalance are potentially catastrophic. According to the Congressional Budget Office, spending on Social Security and Medicare is set to reach 12 percent of GDP by 2035. Meanwhile, the CBO found that the 75- year "fiscal gap" (the amount by which the federal government would have to raise taxes to cover the discrepancy between future outlays and future revenues) could reach an astounding 8.1 percent of GDP.

REDUCING THE PRINCIPAL-AGENT PROBLEM: A RETURN TO VOLUNTARY WELFARE

If principal-agent problems are at the root of today's fiscal crises, then the way to address these problems is to shift incentives so that people take greater responsibility for their actions. Fundamentally, this requires introducing "exit" mechanisms so that personal decisions have more influence on outcomes. Although we can debate the legitimate extent of income redistribution, a move toward a more voluntary welfare system based on mutual aid, private philanthropy, and greater individual saving is needed if we are to encourage greater responsibility.

Historically, among the most important mechanisms for poverty relief were mutual-aid associations. As David Beito described in his book *From Mutual Aid to the Welfare State*, "friendly societies," credit unions, and insurance cooperatives were self-governing entities founded by the working poor and financed by small-scale contributions. These associations provided a safety net during difficult times—allowing members to draw "benefits" from a collective fund only if they first contributed. This fund could then be drawn upon should the individual or his family experience misfortune. Though membership was by no means universal, the majority of low-income people relied on voluntary collective action when they sought unemployment relief and security in old age.

Although mutual aid should constitute an important element in any alternative approach to poverty alleviation, so too should philanthropy. The historical record suggests that many services currently supplied through tax-funded welfare agencies have previously been performed by voluntary associations. Even today, in a context where government welfare provision has crowded out many forms of voluntary giving, private welfare organizations such as Habitat for Humanity and the Salvation Army have a far better record of helping to rescue lives than do most official programs.

Privatizing welfare would not eradicate principal-agent problems, but it would significantly reduce their severity. Dealing with poverty by way of mutual aid or charitable donations generates a more direct connection between contributions and results. This connection is most pronounced when giving is one-on-one: when donors can directly observe the impact of their contribution—and withdraw it without collective action. When charities are large and management is left to the organization's agents, this connection is less apparent. Even here, however, the donors' ability to move from one charity to another provides an incentive to contribute their money wise-

ly. Because donors are spending their own money rather than that of taxpayers, they have much stronger personal incentives to withdraw support from failing programs.

Mutual-aid and charitable organizations may also provide better incentives to discourage shirking and opportunism. In the case of mutual aid, for example, the decision of an individual to join and contribute to an association determines whether or not he will be eligible for subsequent benefits. The supply of funds from a mutual-aid association are conditional: they depend on the individual having made a financial contribution to the association rather than reflecting a state-guaranteed "right" to support. Because mutual-aid associations rely on a pool of economically active members, members have stronger incentives to ensure that successful measures are put in place to limit dependency and fraud. By contrast, Cato scholar Michael Cannon has reported a level of fraud in Medicare and Medicaid payments in excess of 10 percent, a level which would not be sufficiently reduced "with any plan that retains a role for government."

> "If principal-agent problems are the root of today's fiscal crises, then the way to address these problems is to shift incentives so that people take greater responsibility for their actions."

If there is a case for moving toward greater reliance on voluntary welfare for the poor, there is an even stronger argument for replacing more generalized government benefits such as Social Security. If individual retirement benefits become more directly related to personal saving decisions, then not only will there be more private saving but there will also be stronger lines of accountability between those investing money and those charged with managing it. This need not imply preference for a regime where people hand over their savings to corporate fund managers. Rather, it is to favor a regime in which people choose whether to entrust their savings to managed funds or to alternatives such as personal investment or private savings clubs and cooperatives.

If we are serious about addressing the core of the fiscal crisis, we must do two things. First, we must abandon a system in which those who claim future benefits have the ability to dismiss those who finance them. And second, we must address the fact that those who manage taxpayer dollars have every incentive to favor short-term political gain over long-term sustainability. ■

India Twenty Years after Reform

Twenty years ago this summer, India introduced major economic reforms that have led to sustained high growth, reductions in mass poverty, and an ongoing transformation of Indian society. The country is now widely considered a miracle economy, and many analysts predict that India will soon overtake China as the fastest-growing economy in the world. At a Cato Policy Forum held in June, Swaminathan S. Anklesaria Aiyar, research fellow at Cato's Center for Global Liberty and Prosperity; Surjit Bhalla, managing director at Oxus Research and Investments and one of the world's leading experts on growth and poverty; and Arvind Panagariya, the Jagdish Bhagwati Professor of Indian Political Economy at Columbia University, discussed the circumstances that led to these reforms and what the future holds for the world's largest democracy.

SWAMINATHAN AIYAR: When India became independent in 1947, the new socialist government saw free trade as a tool of British colonialism to keep the country poor. To achieve prosperity, they instead emphasized two basic principles: self-sufficiency and public-sector dominance. They created a mixed economy, rather than one based on Soviet-style planning, with licenses required for virtually all economic activity. The government placed onerous controls on what could be produced and imported—and prosperity, they believed, was best achieved when nobody had the freedom to produce or consume. The big, benevolent government was supposed to determine these things.

This planned approach gave India 3.5 percent growth, which in the 1950s was considered fabulous. Under the British, they had barely achieved 1.2 percent growth. It didn't take long, however, for Singapore, Hong Kong, and others to exceed 7 percent—and for these "neo-colonial puppets" to gradually become richer than the British master itself. India, on the other hand, remained poor.

This continued for three decades. Income-tax rates in India went to 97.5 percent—under the false hope that this would abolish poverty—yet poverty rates remained unchanged. Then, in the 1980s, a grudging switch to partial economic liberalization, combined with a public spending boom, helped accelerate growth. Much of this growth, however, was financed by unsustainable borrowing, and in 1991 India ran out of foreign exchange.

After this crisis, a number of things happened. The Soviet Union—which was the model admired by many—was on the brink of collapse. In China, Deng Xiaoping showed that the way forward was not more control, but market-friendly development. In India, Rajiv Gandhi was assassinated, and his Congress Party no longer felt the need to justify a legacy of socialist policies. Conditions were ripe for change, and under political lightweight Narasimha Rao, that change duly took place.

Yet, critics immediately said, "Ah, you guys are in very deep water." India, you see, had taken loans from the World Bank and the IMF—and many believed that similar paths taken by Latin America and Africa in the 1980s had resulted in a "lost decade" of economic growth in these regions. They predicted the same fate for India, warning that the country would become a neo-colonial slave once again.

Almost every one of the skeptics' predictions turned out to be wrong. Far from slowing down, Indian GDP took a few years to stabilize and then took off. Between 1994 and 1997, growth averaged 7.5 percent, and it became obvious that reform had succeeded. Even opposition parties—which vowed to change course—came to power and found that the policies were too successful to reverse.

Now, mind you, liberalization was a very chaotic business—there was no Margaret Thatcher or Ronald Reagan in India—and the process was often two steps forward, one step back. Yet every subsequent government followed roughly the same path. While growth slowed somewhat because of the Asian financial crisis of 1997–1999, two major droughts in the early 2000s, and the recession of 2001, India survived the recent crisis with only minor bumps before returning to 8.5 percent growth. Truly, and very unexpectedly, the lumbering elephant has finally become the Asian tiger.

What were the key achievements of these 20 years? India's per capita income shot up from $300 in 1990 to $1700 today. This not only raised employment directly, but also yielded a public revenue boom that has increased spending on welfare, education, and other programs. India's fast growth, however, did not follow the Asian-tiger model of using cheap labor. Because all of its political parties are labor parties, there was much reluctance to liberalize India's labor laws—which means it was impossible to go the labor-intensive export route. Instead, India has become best known for its brain-intensive manufacturing and service sectors—ranging from auto exports to legal services.

India has become a world leader in "frugal engineering," which means reducing prices not just by 10 or 15 percent, but by 50, 60—even 80 percent. The best known example is probably the Nano: the $2,500 car produced by Tata Motors. Bajaj Auto is about to launch a rival for $3,000 that gives 90 miles to the gallon. Many sectors—from India's telecom industry to its world-class medical services—offer products that are revolutionarily cheap compared to the alternatives.

How else is India different? Unlike some

Asian countries—which have rigged their currencies to run up large, mercantilist trade surpluses—India has liberalized its capital controls. Far from being overtaken by multinational corporations—which was once the fear—Indian companies have become multinationals in their own right. In 1991, India was viewed as a bottomless pit for foreign aid. Now it is becoming a substantial aid donor. The country has gradually liberalized its foreign-investment rules. As a result, most of the Fortune 500 companies currently do business there.

There have been many criticisms over what has not been achieved in India as well—the main one being that these reforms have bypassed the poor. However, six poor, backward states, accounting for half of India's population, have grown faster than the national average in recent years. In fact, the country could not have increased its growth rate but for the fact that its poor states almost doubled theirs. The *dalits*—the lowest Hindu caste—have seen dramatic improvements in terms of not only economic indicators, but measures of social status as well. As a whole, poverty has come down from over 45 percent in 1991 to over 32 percent today.

What about the unfinished agenda? The Fraser Institute's Economic Freedom of the World Report rates India 87th out of 141 countries. Yet the economic conditions are only part of the story. India ranks a shocking 182nd of 183 countries in enforcement of contracts, according to the World Bank. Obviously your police, your courts, your systems are not functioning if enforcement is so pathetic. So while both economic and governance problems remain, the latter lag much further behind and are therefore more critical.

SURJIT BHALLA: One important element of the Indian story that is entirely unique is the amount of ideology that pervades policymaking. Before 1991, you couldn't stand in the street without first getting permission by the government. Today, you can do that and a lot more. Yet vast numbers of the intellectuals believe that liberalization has done precious little to alleviate poverty. Basically, they say, the rich have gotten richer and the poor have gotten poorer—and they find support for this from various organizations, including the World Bank. With this in mind, there are three puzzles that make the Indian story much more flavorful.

There are three periods of GDP growth worth looking at. The first is from 1950 to 1980, when growth was around 3.5 to 4 percent per annum. The second is from 1980 to 2003, when growth was 5.5 percent per annum—both before and some time after the 1991 reforms. And the third is from 2003 onwards, when growth averaged more than 8 percent.


Swaminathan Aiyar

> "What were the key achievements of these 20 years? India's per capita income shot up from $300 in 1990 to $1700 today."

The first puzzle is: Why did the Indian growth rate suddenly accelerate from 3.5 percent to 5.5 percent in the 1980s? This is the story of the dog that did not bark. What many authors forget is that the 1970s were a disastrous decade for every part of the world, including the United States. Oil prices, for instance, quadrupled in 1973 and then doubled in 1979—and growth rates in the entire world collapsed during that period. In India, growth rates collapsed from about 4.5 percent to something like 3 percent, and the subsequent acceleration is explained by something we learned as graduate students about the reallocation of labor. Just a simple movement of labor—from low-productivity agriculture to high-productivity industry—will provide an acceleration of growth. At the time of independence, agriculture made up around 65 to 70 percent of GDP. The share of agriculture in GDP today is 17 percent. This can't continue forever, but this in my view explains what happened in the 1980s.

In the three years following major reforms in 1991, growth rates in India accelerated to 7.5 percent—but collapsed back down to 5.5 percent once again. The second puzzle, therefore, is this: Why did growth rates stay exactly the same after the mother of all reforms? Well, in 1996, after reforms had taken hold, growth had moved to 7.5 percent three years in a row—and what did our policymakers do? They panicked. "India is overheating," they said, because we'd never seen this before. So they tightened monetary policy, raising interest rates such that real interest rates were 13 percent—*real*. Savings deposit rates were 12.5 percent in 1998–1999. So that killed economic growth, which came down to 5.5 percent.

And the third puzzle: Why did growth rates accelerate from 2003 onward without seemingly any reforms? This decade has seen growth increase from 5.5 percent to 8.5 percent on a pretty sustained basis, and one argument is that a rising tide lifts all boats. World growth expanded last decade, and India went along with it. But a few years ago, the World Bank was merrily forecasting a decline in India's growth because they weren't looking at the big picture. And they were proven wrong. So, what does explain India's acceleration?

Very simply, between 1999 and 2003, active government policy brought down real interest rates by 500 basis points in the space of five years. Now in the United States, there are zillions of trades made on the expectation that there might be a 25-basis-point increase in interest rates. The funny thing is, in India, there's a *500-basis-point* decline in real rates and no one has talked about it. Between 2002–2003 and 2007–2008, investment rates

increased from 23 percent of GDP to 38 percent of GDP. Does that explain India's acceleration better than its connection to world growth? I think so. There is a saying: In China, growth occurs because of the state, but in India, growth occurs despite the state. That explains why, without any reforms whatsoever in the last six or seven years, the growth rate has sustained itself.

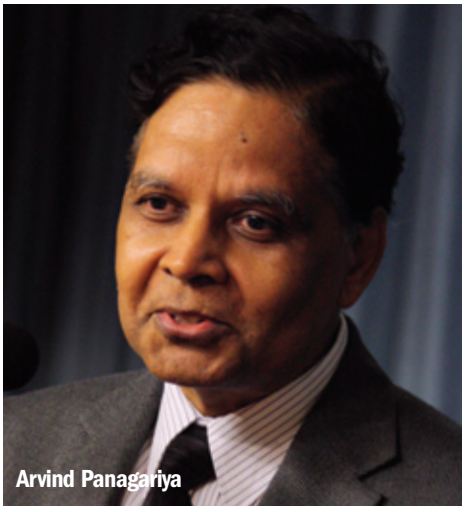
What about India's future? The biggest story emerging is that average fertility levels will reach a replacement rate of 2.1 births per woman by 2015. This will have radical implications. Women in India had a very low labor-participation rate as late as 2000, when only about 15 percent of urban women worked. The participation rate is now 34 percent, and it should eventually reach the historical developed-country norm of 55 to 60 percent. This is the huge advantage India has.

ARVIND PANAGARIYA: By all accounts, India has been growing at about 8 to 9 percent per year in the last eight years. That is the growth rate in real rupees. Yet, during that period, India's inflation rate has been much higher than that of the United States. With nominal exchange rates moving very little, what that means is that, in real terms, the rupee has appreciated. Taking this into account, the growth rate in real *dollars* has been an astonishing 13 percent over the last eight years. That is phenomenal growth.

The Indian economy today is extremely competitive. With the exception of agriculture—if you look at industry and services—the economy is very open. That's the big change that India has experienced. India is competitive. It's starting way inside the global technology frontier. Its capital and labor are both growing rapidly. And therefore I make the conservative assumption that India will grow at least 10 percent per year in real dollars over the next 10 years.

What does this imply? It implies that the Indian economy will go from $1.75 trillion today to $7 trillion by 2025, making it the third-largest economy in the world. That is going to represent a sea change, not only because the global economy will shift towards Asia, but also because we will see massive changes within India. These numbers imply a per capita income of about $5,000 in real terms, which means that poverty as we define it today will be history.

There is a second, very important change on the horizon. By 2025, the developed countries will lose about 37 million people in the 20–49 age group. China will lose about 67 million people from 20–49. Yet India will add 131 million people in this age group. If you think there are too many people like me around today, you haven't seen anything yet!


Arvind Panagariya

> "The Indian economy today is extremely competitve. With the exception of agriculture—if you look at industry and services—the economy is very open."

With such a dramatic shift, India will become a very large supplier of the global work force in the years to come.

It is also worth stepping back to consider the dark side of India's growth, which politically the country is completely oblivious to. When countries transform from poor economies to rich ones, one thing that almost always happens is that the share of agriculture in GDP declines. In India, agriculture declined from about 30 percent of GDP in 1990 to 15 percent today. Historically, when agriculture shrinks this way, industry—and manufacturing in particular—grows extremely rapidly, pulling the labor force out of agriculture in the process. This generates gainful employment, rising wages, and declining poverty.

This second step has not happened in India. The share of manufacturing in GDP has been sitting constant, and, more importantly, the share of the labor force employed in agriculture has declined very little. In fact, the absolute number of people employed in agriculture today is still rising. That is rather bad news.

Looking forward, India is facing a number of other problems. One problem is in the labor markets, where a lot of regulations are very industry unfriendly. For example, if you are an employer of 100 workers or more on a regular basis, there are virtually no circumstances under which you can layoff your employees. Even if you go bankrupt, you have to use profits from your other operations to pay the wages of that workforce. That is the kiss of death for the labor-intensive industry today. Many are pessimistic that labor-market reform will ever happen in India. But then there have been a lot of things that I never thought would happen in India that subsequently have, and therefore I remain optimistic.

There are additional problems in areas such as land acquisition and infrastructure, but perhaps the most important is the higher-education system. India is already facing skilled labor shortages, and this is likely to get much worse down the road. Indian higher education had a very good head start: the first three universities were founded in the 1850s, and the rest of their history is uninterrupted. China, by contrast, completely decimated its higher-education system under Mao during the Cultural Revolution—which they didn't start rebuilding until the early 1980s.

Now consider the figures. In 2000, China had 6 percent of its college-aged population enrolled in higher education, while India was at 10 percent. Today, China has zoomed past us to 23 percent, while we remain at 13 percent. This is the other side of the demographic dividend: it is the demographic burden. ■

Cato scholars reveal the true price of our endless battle

The Exorbitant Costs of the War on Drugs

On June 17, 1971, President Richard Nixon announced a "new, all-out offensive," citing a barrage of statistics to justify his escalation of the war on drugs. The numbers were startling. In one frequently circulated figure, Nixon informed Congress that heroin addicts stole $2 billion worth of property each year. Less publicized, however, was the fact that the total value of all property theft in 1971 was only $1.3 billion.

So began the modern chapter in our country's longest war. While seemingly minor, the president's error was the perfect prologue to the 40-year fight against narcotics. "Nixon was blaming a quarter of a million addicts for 153 percent of the property crime committed in the U.S.," author Dan Baum writes in *Smoke and Mirrors*, and "it was widely reported as holy writ." The national conversation has since become increasingly diluted with misinformation. The Cato Institute, however, has been there to counter this trend.

In June, at a forum marking the 40th anniversary of Nixon's declaration, two leading experts debated the true impact of the war. Robert DuPont, MD, president of the Institute for Behavior and Health, emphasized that current policy stems from "a completely bipartisan effort." As the country's second drug czar from 1973 to 1977, DuPont argued that drug use is a form of "chemical slavery" that confines the addict. "There's nothing less free than a person addicted to drugs," he concluded. Jeffrey Miron, senior fellow at Cato, took a different approach.

An economist at Harvard University, Miron framed the debate in terms of his area of expertise. "The prohibitionist mentality assumes that the only goal is reducing drug use," he said. But a narrow focus on this potential benefit overlooks one critical component of enforcement: the cost. In a Cato white paper last year, Miron found that legalizing drugs would reduce government expenditures by $41.3 billion annually. These dollar amounts, however, only scratch the surface of the drug war's true toll.

"What prohibition does is it creates a black market," Miron explained at the debate, "and in that market, a bunch of really unfortunate things happen."

Former Baltimore mayor KURT SCHMOKE (left) attended a Cato Debate on the 40th anniversary of President Nixon's "war on drugs." At the forum, JEFFREY A. MIRON, senior fellow at the Cato Institute, faced off against former White House drug czar Robert L. DuPont.

One such cost is an increase in crime. Without courts to turn to, drug pushers have to rely on violence to resolve disputes. As Milton Friedman wrote in Cato's 2000 book, *After Prohibition*, "only the well-financed and well-armed drug dealers can survive." In effect, they substitute guns for lawyers. Because the emphasis is placed on narcotics—an inanimate object—the "war on drugs" dehumanizes the fight. But this label is a misnomer that effectively conceals the true victims. "This war is being waged on people," Friedman continued.

The human cost can also be calculated in the erosion of civil liberties. In a 2006 Cato analysis, media fellow Radley Balko found that police were conducting as many as 40,000 no-knock raids each year. These raids involved unannounced forced entry by paramilitary units—and they were usually used to carry out narcotics warrants. "America's war on drugs has spurred a significant rise in the number of such raids, to the point where in some jurisdictions drug warrants are only served by SWAT teams," Balko wrote.

The fight has taken its toll on law enforcement as well. Drug dealers have bribed police officers and judges. "Today, corrupt officers are actually using their police powers of search and arrest to assist gangsters with their activities," writes Tim Lynch, director of the Cato Institute's Project on Criminal Justice.

The list of costs goes on. Some argue that legalization would be a surrender to pushers and cartels. It wouldn't. "It would simply be an acknowledgement that the cost of this war. . . is too high," Cato executive vice president David Boaz wrote in the *New York Times* in 1988—a piece that had a lasting impact. In short order, Baltimore mayor Kurt Schmoke called for a national debate on legalization; Rep. Pete Stark requested that his colleagues in Congress consider it as a solution; and *Nightline*, *This Week with David Brinkley*, and the *CBS Evening News* all had discussions on the issue.

Weeks before the Cato debate this summer, the Global Commission on Drug Policy released its much-anticipated report. The 19-member panel—which included former secretary general Kofi Annan, former secretary of state George Shultz, and former Fed chairman Paul Volcker—was unequivocal. "The global war on drugs has failed," they concluded, "with devastating consequences." As public opinion turns against the war, official support seems to be following suit.

And while drug-reform advocates haven't yet witnessed the anticipated sea change, the tide is certainly turning. "The war on drugs is thousands of miles long," then-governor of New Mexico Gary Johnson explained at a Cato conference in 1999, "but it's only about a quarter-inch deep." ■

Scholar Profile

Chris Edwards

Chris Edwards is the director of tax policy studies at the Cato Institute and editor of www.DownsizingGovernment.org. He is an expert on federal and state tax and budget issues. Before joining Cato, Edwards was a senior economist on the congressional Joint Economic Committee, a manager with PricewaterhouseCoopers, and an economist with the Tax Foundation.

Edwards has testified before Congress on tax and budget issues numerous times, and his articles have appeared in the *Washington Post*, the *Wall Street Journal*, and many other publications. He is the author of *Downsizing the Federal Government* and coauthor of *Global Tax Revolution*, and he was a member of the Fiscal Future Commission of the National Academy of Sciences.

In 2010, Edwards launched www.DownsizingGovernment.org. The project has received widespread attention this year, gaining significant traction given that the new fiscal conservatives elected to Congress are looking for programs to cut.

Two of the biggest policy concerns in recent years have been the growth in government spending and its detrimental impact on the economy. I have always been interested in these issues. Growing up, I adopted my father's dislike of government authority, and later in college, I discovered the *Wealth of Nations, Atlas Shrugged*, and other pro-market books.

Studying the American Founders has also had a big influence on me, especially since moving from Toronto to Virginia in 1990. Today, I live in the historical land of Jefferson and Madison, yet I am surrounded in the nation's capital by economists who think that simplistic Keynesian economics justifies discarding the American heritage of individual freedom and embracing an ever-larger central government.

Years ago, I sat in an undergraduate economics class and watched the professor move lines on a chart to illustrate how the government could "manage" the economy. I remember thinking to myself, "Where the heck are the entrepreneurs here?" It always seemed obvious to me that a small number of gutsy innovators drive the economy forward, yet they were nowhere to be found in mainstream economics. It wasn't until later that I discovered Hayek and the Austrians, who had developed a school of economic thought rooted in individualism.

One of my early jobs was with a macroeconomic forecasting company, where I learned that economists build complex models with hundreds of equations, but still can't seem to forecast any better than your local weatherman. So I wasn't surprised at how far off base the Obama administration was when they claimed that the 2009 "stimulus" bill would fairly quickly push the unemployment rate to below 8 percent. When economists who think they can micromanage the economy are paired with politicians who want to, the two can form a lethal combination.

Another job experience that shaped my views was working at PricewaterhouseCoopers. There I was surrounded by some of the smartest people I'd ever met—yet they spent their time helping others comply with the convoluted tax code, rather than producing useful products for the economy. Unfortunately, Washington is full of brainy people who are paper-pushing rather than adding to GDP. With taxes, however, the solution is clear: rip out the current code and replace it with some sort of consumption-based flat tax.

Nevertheless, we won't achieve major tax reform until we get exploding federal spending under control. My research these days focuses on the failings of government spending programs. The problem is that most of the experts on these programs are the very ones who are defending them. That's why Cato is so important: it provides a crucial counterbalance in policy debates. We dig into the actual workings of government programs, reminding policymakers and the public of the many ways that spending damages the economy, harms the environment, and takes away our civil liberties. Cato's website, www.DownsizingGovernment.org, identifies hundreds of programs that should be terminated or handed over to state governments or the private sector.

In studying federal spending, I've been struck by how many programs have been failing for decades. Farm subsidies have been an appalling boondoggle since the late 1920s. Public housing has been damaging American cities since the 1930s. For over a century, federal dam building and water infrastructure projects have been economic losers, and they've been causing major environmental damage. Federal welfare programs have long harmed the social fabric of families and communities.

CHRIS EDWARDS (right) testified before the Senate Finance Committee in July, along with LAWRENCE B. LINDSEY (left), former top White House economist, and MICHAEL ETTLINGER, vice president at the Center for American Progress.

So I see my job as reminding people of the government's failures, explaining why federal solutions usually don't work, and exploring how market institutions can do a better job. The use of government power is not a free lunch. Most of the time, any benefits derived from these programs are far outweighed by the costs and collateral damage. ■

Over 150 students, faculty, and supporters attended this year's Cato University, held in one of the country's original colonial cities: Annapolis, Maryland. Historian ROBERT MCDONALD (left) of the United States Military Academy at West Point spoke about Frederick Douglass and the abolitionist movement over dinner on Wednesday night. Economist LYNNE KIESLING of Northwestern University lectured on economic issues. Other speakers during the week included Don Boudreaux, Radley Balko, Tom G. Palmer, and Sen. Rand Paul.

At an informal breakfast held at the Cato Institute in June, Sen. PAT TOOMEY (R-PA) joined Cato scholars for a wide-ranging discussion of current issues on the political agenda. Among the topics covered were out-of-control federal spending and the outlook for trade policy.

At a Cato Institute Conference held in June, three panels of experts discussed how the U.S. antidumping law undermines competitiveness at home and abroad. In one panel, DANIEL J. IKENSON (left), associate director of Cato's Herbert A. Stiefel Center for Trade Policy Studies, and MARGUERITE TROSSEVIN, former deputy chief counsel for import administration at the U.S. Department of Commerce, offered various reforms to the purely punitive aspects of the law.

At a forum for their recent book, *The Declaration of Independents: How Libertarian Politics Can Fix What's Wrong with America*, coauthors Nick Gillespie (left) and Matt Welch of Reason took the audience on a free-wheeling multimedia journey, exploring how revolutionary innovators have changed the world over the past 40 years.

In order to give our supporters real-time access to policy staff, Cato recently launched its Sponsor e-Briefing Series, an interactive online forum that typically draws an audience of over 300 Sponsors. In June, Malou Innocent (right), foreign policy analyst at Cato, joined multimedia producer Caleb Brown to discuss U.S. strategy in the Middle East and answer questions from those watching the event virtually.

JUNE 1: India Twenty Years after Reform

JUNE 2: Cato Papers on Public Policy

JUNE 8: The Korea, Colombia, and Panama FTAs: Promoting Growth and Jobs through Trade

JUNE 8: Which States Are Most Free?

JUNE 9: *Why Leaders Lie: The Truth about Lying in International Politics*

JUNE 15: Resolved: America Should Legalize Drugs

JUNE 20: Getting "No Child Left Behind" Right

JUNE 27: Cash for Care?

JUNE 28: How U.S. Antidumping Policy Undermines U.S. Competitiveness: A Pro-Reform Perspective

JUNE 29: Turning the Page in Afghanistan

JUNE 30: *The Declaration of Independents: How Libertarian Politics Can Fix What's Wrong with America*

JULY 14: Transportation Reauthorization: The Privatization Option

JULY 18: The No-Tax-Hike Pledge: Does It Help or Hurt the Fight for Smaller Government?

JULY 19: Helping Students or Ballooning College Profits: What's Federal Money Doing?

JULY 20: Immigration Reform, Yes; E-Verify, No

JULY 20: *A Better Congress: Change the Rules, Change the Results*

JULY 21: *The Ethics of Voting*

JULY 24–29: Cato University

Audio and video for all Cato events dating back to 1999, and many events before that, can be found on the Cato Institute website at www.cato.org/events. You can also find write-ups of Cato events in Ed Crane's bimonthly memo for Cato Sponsors.

Cato Calendar

CATO INSTITUTE POLICY PERSPECTIVES 2011
New York • Waldorf-Astoria • October 28, 2011

MONETARY REFORM IN THE WAKE OF CRISIS
29th Annual Monetary Conference
Washington • National Housing Center
November 16, 2011
Speakers include Rep. Ron Paul, Robert Zoellick, Allan H. Meltzer, James Grant, John A. Allison, Lawrence H. White, Roger Garrison, Richard H. Timberlake, Judy Shelton, and Jeffrey Lacker.

CATO INSTITUTE POLICY PERSPECTIVES 2011
Chicago • The Drake • November 30, 2011

24TH ANNUAL BENEFACTOR SUMMIT
Palm Beach • The Breakers
February 23–26, 2012

MILTON FRIEDMAN PRIZE PRESENTATION DINNER AND GRAND OPENING WEEKEND
Washington • May 4, 2012

CATO CLUB 200 RETREAT
Asheville, NC • Inn on Biltmore Estate
September 27–30, 2012

The Milton Friedman Prize for Advancing Liberty, named in honor of perhaps the greatest champion of liberty in the 20th century, is presented every other year to an individual who has made a significant contribution to advance human freedom. ● The 2012 prize will be presented at the Milton Friedman Prize for Advancing Liberty's Biennial Dinner, May 4, 2012, in Washington, D.C., at the Washington Hilton. ● Also, for Cato Sponsors, on Saturday, May 5, 2012: Cato Policy Day. Join us at the newly expanded Cato headquarters for presentations by senior policy staff.

For accommodations, Cato has a limited number of rooms reserved at the Washington Hilton located at 1919 Connecticut Avenue, N.W., Washington, D.C. Our negotiated rate is available until April 3, 2012. Please make your reservations by calling 1-800-HILTONS and reference the group code "Cato Institute."

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For more information, please contact Lesley Albanese at 202-789-5223 or lalbanese@cato.org.

www.cato.org/friedman

Cato's Outside Publications Reach Far and Wide

More than ever, people are turning to the Cato Institute's scholars for their original insight and clear thinking. Throughout 2010, our work was cited in major newspapers across the country over 3,100 times, while Cato's policy team published nearly 800 op-eds. Likewise, www.cato.org enabled approximately 2 million downloads of our articles last year. While Cato has put considerable resources into expanding our new media capabilities, we have maintained our commitment to using traditional print as a key educational platform. Newspapers, however, capture only a fraction of our published footprint. Cato scholars write frequently for magazines, journals, and book collections. Here is a small sampling of other recent publications:

DOUG BANDOW
- "Promoting Long-Term Economic Growth: America and East Asia Working Together," *International Journal of Korean Studies*, Spring/Summer 2010.
- "What to Do About China?" *Fusion Magazine*, May 2010.

MICHAEL F. CANNON
- "Personal Medical Accounts: An Alternative to Compulsory Health Insurance," *International Federation of Pension Fund Administrators*, 2010.
- "Obamacare Can't Be Fixed, and Now Is the Time to Dismantle It," *National Review*, March 9, 2011.

TED GALEN CARPENTER
- "Estrangement: The United States and Turkey in a Multipolar Era," *Mediterranean Quarterly*, Fall 2010.
- "Plan B for Dealing with North Korea," *POLICY*, Winter 2010.

ANDREW J. COULSON
- "Comparing Public, Private, and Market Schools: The International Evidence," *Journal of School Choice*, January 2009.

JAMES A. DORN
- "Debt Dilemma," *Beijing Review*, June 2011.
- "The Rise of Government and the Decline of Morality," *Freeman*, July/August 2010.

CHRIS EDWARDS
- "Fiscal Future." Report for *National Academy of Sciences*, January 2010.
- "State and Local Fiscal Reforms," *Federal Reserve Bank of St. Louis*, April 9, 2010.

THOMAS A. FIREY
- "The Maryland Electricity Market: A Primer," *Maryland Journal*, 2011.

BENJAMIN H. FRIEDMAN
- "Managing Fear: The Politics of Homeland Security," *Political Science Quarterly*, Spring 2011.

JAGADEESH GOKHALE
- "Medicaid Crisis: A Forecast of Texas's Medicaid Expenditures Growth," *Texas Public Policy Foundation*, December 2010.

JIM HARPER
- "Privacy-Invasive Technologies and Their Origins," in *Privacy in America: Interdisciplinary Perspectives*, ed. William Aspray and Philip Doty (Lanham, MD: Scarecrow Press, 2011).

GENE HEALY
- "Libertarians and the Presidency," in *Contending Approaches to the American Presidency*, ed. Michael A. Genovese (Washington: CQ Press, 2011).

MALOU INNOCENT
- "Pakistan: Washington's Blind Spot in Afghanistan," *Foreign Service Journal*, September 2010.

ROBERT A. LEVY
- "Second Amendment Redux: Scrutiny, Incorporation, and the Heller Paradox," *Harvard Journal of Law & Public Policy*, January 14, 2010.
- "Two Cheers for Filibusters," *National Law Journal*, June 7, 2010.

JUSTIN LOGAN
- "Fixing Failed States: A Dissenting View," with Christopher Preble in *The Handbook on the Political Economy of War*, ed. Christopher J. Coyne and Rachel L. Mathers (Northampton, MA: Edward Elgar, 2011).
- "Fatal Conceit," *National Review*, August 17, 2010.

TIM LYNCH
- "The Devil's Bargain," *Reason* magazine, July 2011.

NEAL MCCLUSKEY
- "Coming Soon: The Federal Department of Standardized Minds," *Freeman*, July/August 2011 (cover story).

PATRICK J. MICHAELS
- "Global Warming Science Now Compels EPA to Reopen its Finding of Endangerment," *4th International Conference on Climate Change*, 2010.

RANDAL O'TOOLE
- "Theft as Urban Renewal: Why Idaho Should Repeal the Local Economic Development Act," report for Idaho Freedom Foundation, February 2011.
- "Public Transit in Washington," Report for *Washington Policy Center*, July 2010.

ROGER PILON
- "Health Care and the Constitution," *National Review* Online, January 14, 2010.
- "Introduction" in *American Conservative Thought in the Twentieth Century*, ed. William F. Buckley, Jr. (Piscataway, NJ: Transaction, 2011).

CHRISTOPHER A. PREBLE
- "Washington's New Bogeyman: Debunking the Fear of Failed States," with Justin Logan, *Strategic Studies Quarterly*, Summer 2010.
- "The Founders, Executive Power, and Military Intervention," *Pace Law Review*, Winter 2010.

ILYA SHAPIRO
- "A Faint-Hearted Libertarian at Best: The Sweet Mystery of Justice Anthony Kennedy," *Harvard Journal of Law & Public Policy*, Winter 2010.
- "Judicial Takings and Scalia's Shifting Sands," *Vermont Law Review*, Fall 2010.

MICHAEL D. TANNER
- "Shaping a New Conservative Agenda," in *Crisis of Conservatism? The Republican Party, the Conservative Movement, and American Politics after Bush*, ed. Joel D. Aberbach and Gillian Peele (New York: Oxford University Press, May 2011). ■

The Random Lottery of Educational Philanthropy

"The central problem confronting education systems around the world is not that we lack models of excellence," writes Andrew J. Coulson in **"The Other Lottery: Are Philanthropists Backing the Best Charter Schools?"** (Policy Analysis no. 677), "it is our inability to routinely replicate those models." Recently, philanthropists have attempted to target the best charter schools and fund their expansions. To what degree have they succeeded? Coulson, Cato's director of education policy, analyzes the academic outcomes of students in California and finds little connection to levels of philanthropic funding. "It is as if the same random lottery that determines admission to oversubscribed charter schools were being used to allocate grants," he writes. Ultimately, Coulson demonstrates that philanthropy "has not proven to be a reliable, systematic mechanism" for reproducing excellence. As in most sectors, our educational system will depend on the ability of top performers to lead the way by crowding out lower performers. But for now, "they flicker in isolation, failing to touch off a larger blaze."

Let's Abolish the Ex-Im Bank

The Obama administration recently proposed a significant increase in the operating budget of the U.S. Export-Import Bank. Established in 1934 to help finance trade with the Soviet Union, this agency is now the main federal subsidizer of American exports. But as Sallie James writes in **"Time to X Out the Ex-Im Bank"** (Trade Policy Analysis no. 47), the bank "at best recreates, and at worst misallocates, private financial behavior." By directing subsidies to favored companies, the Ex-Im Bank promotes its chosen clients and uses taxpayer dollars as collateral. James, a Cato trade policy analyst, examines the alleged justifications for the bank—finding that it fails to impact either the domestic job market or the U.S. trade balance. In the end, she recommends scaling it back dramatically as a first step toward terminating the bank in full. For now, the preservation of this Depression-era agency serves as "a valuable reminder of the folly of trusting government agencies to pick domestic winners in a complex, dynamic, globalized market."

Revisiting the Durand Line

In the face of growing disillusionment with the war in Afghanistan, two military experts have taken this opportunity to reexamine U.S. foreign policy in the region. In **"Dominoes on the Durand Line? Overcoming Strategic Myths in Afghanistan and Pakistan"** (Foreign Policy Briefing no. 92), Joshua Rovner and Austin Long explain that coalition strategy in these countries has revolved around two misguided assumptions. The first is "the seductive logic of state-building," which, they note, the U.S. has a "decidedly mixed record" with. The second assumption is that losing in Afghanistan will destabilize Pakistan, leaving its nuclear arsenal vulnerable to militant attacks. Yet the

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authors find that the case for a "spillover effect" is ultimately unconvincing. They propose replacing the current strategy with "a streamlined military approach" by combining sustained pressure on al Qaeda and diplomatic composure with Pakistan. By scaling back troops 80–90 percent, they hope to avoid "using the American military to sow liberal ideals in South and Central Asia."

Hyperinflation in Higher Ed

Recent calls for oversight on the increasing amount of federal investment in for-profit universities have been warranted. But should the scrutiny be limited to just these schools? In **"Federal Higher Education Policy and the Profitable Nonprofits"** (Policy Analysis no. 678), Vance Fried, professor of entrepreneurship at Oklahoma State University, examines the real costs of so-called nonprofit colleges and finds that even they generate excess revenues. Beginning in the 1980s, federal and state governments began funneling increasingly large subsidies into these colleges, which already benefited from a patchwork of tax loopholes. "What have colleges done with their prices in response?" Fried asks. "They have aggressively raised them." In fact, profit margins are higher for nonprofit schools than their for-profit counterparts. Fried follows two distinct approaches to uncovering these little-known revenues, and navigates the maze of federal activities that has led to this massive transfer of wealth. "The net impact of federal policy," he concludes, "is that college is less affordable for everyone."

The Risks of High-Minded Homeownership

"From mid-2004 through mid-2007, over a million borrowers sat across the table from lending officers . . . accepting over a trillion dollars in loans that neither the borrower nor the lender expected to be repaid," financial experts Patric Hendershott and Kevin Villani write. How did this happen? In **"The Subprime Lending Debacle: Competitive Private Markets Are the Solution, Not the Problem"** (Policy Analysis no. 679), the authors argue that a series of "high-minded homeownership goals" set the stage for the ensuing real-estate bubble. "The result was a housing finance market heavily slanted toward making poor-quality, actuarially unsound loans—a situation that would inevitably end in a financial crisis," they write. In an ambitious survey, Hendershott and Villani trace the history of intervention in the U.S. mortgage market, focusing in particular on early social lending mandates and the distortions they caused. In the end, the authors question the conventional economic narrative that the housing finance industry will not function in the absence of regulation.

The Rise of Curbside Carriers

"The debate over President Obama's fantastically expensive high-speed rail program has obscured the resurgence of a directly competing [alternative]," Cato senior fellow Randal O'Toole observes in **"Intercity Buses: The Forgotten Mode"** (Policy Analysis no. 680). In recent years, intercity bus ridership has increased dramatically, making it America's fastest-growing transportation mode. O'Toole delves into the emerging world of curbside carriers and finds that they offer a number of distinct advantages. For starters, they are cost effective, in part because of their low overhead. As such, many companies have been able to distinguish themselves with nonstop service and onboard amenities. In addition, new-model buses are safe—"suffering almost 80 percent fewer fatalities per billion passenger miles than Amtrak"—and more environmentally friendly. O'Toole examines the recent growth of the industry, focusing on the circumstances that favored its success. "Rather than continue to subsidize a costly competitor, elected officials and regulators should get out of the way and let intercity buses flourish where they make economic sense," he writes.

India's Metamorphosis

After 1991, when India abandoned its socialist path in favor of market reforms, critics began expressing skepticism of the country's future. "Many analysts saw India as a lumbering elephant, in stark contrast to the Chinese tiger," Cato research fellow Swaminathan Aiyar writes. In **"The Elephant That Became a Tiger: 20 Years of Economic Reform in India"** (Development Policy Analysis no. 13), Aiyar reveals the shortsightedness of these expectations. Over the last decade, India has averaged 8.5 percent growth—a direct result of its economic liberalization. Aiyar explores the historical context of these reforms as well as their impact, emphasizing their benefits to the country's poor. "But the unfinished agenda," he writes, "remains large." He identifies a number of areas where significant improvement will be critical to maintaining India's growth—focusing in particular on its rampant political corruption. Despite these problems, the country is now widely considered a miracle economy. "Indeed, the real miracle," Aiyar writes, "is that India has grown so fast despite so much misgovernance."

A Regulatory Empire in Finance

A key lesson from the recent financial storm was the failure of regulators to apprehend institutional disaster. As the authors of **"Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation"** (Policy Analysis no. 681) write, "every ship in the fleet passed inspection—and then most of them were lost at sea." In an accessible analysis, financial experts Kevin Dowd, Martin Hutchinson, Simon Ashby, and Jimi Hinchliffe examine one of the main causes of the crisis: an expansive system of capital adequacy regulations known as the Basel regime. Designed to reinforce financial health, the system soon became a perpetual "work-in-progress as regulators attempted to keep up with developments in banking." In what amounts to "a serious reassessment from first principles," the authors explore the secular backdrop that led to the regime, casting doubt on the viability of financial regulations. Ultimately, they suggest a radical return to the free-banking model of a century ago. Until then, the empire of financial rules is "likely to expand much further yet." ■

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"To Be Governed..."

WITHOUT GOVERNMENT WE WOULD HAVE NO BEER

State parks, horse-racing tracks and the state Capitol are all closed because of the government shutdown here. If the budget standoff lingers, the neighborhood watering hole could be next.

More than 300 bars and liquor stores can't buy beer, wine or liquor to sell to consumers because their $20 alcohol-purchasing licenses, known as buyer's cards, have expired, a casualty of the July 1 shutdown.

—***Wall Street Journal,*** July 14, 2011

GOOD NEWS FROM THE WHITE HOUSE

This president isn't going to do anything against the Constitution, against the laws of the United States of America.

—**White House chief of staff Bill Daley on *Morning Edition,* NPR,** July 27, 2011

HOW'S THAT FLEXIBILITY WORKIN' OUT FOR YA?

A balanced-budget amendment would deprive policymakers of the flexibility they need to address national security and economic emergencies.

—**Editorial, *Washington Post,*** July 14, 2011

LIBERTARIANISM VS. PATERNALISM IN ONE LINE

We are taking away a choice that continues to let people waste their own money [on incandescent light bulbs].

—**Energy Secretary Steven Chu in the *Wall Street Journal,*** July 9, 2011

LOOKING ON THE BRIGHT SIDE

If nothing else, the crisis over the debt ceiling is reminding the country of the astonishing reach of the federal spigot, encapsulated by a figure that President Obama tossed out recently: The government sends out "70 million checks" every month. . . .

The mind-boggling number challenges a common critique of the federal government as a creaky apparatus where tax dollars are lost in the bureaucratic cracks. From the vantage point of the 70 million or 80 million checks, the government is a finely tuned machine that brings in revenue and disperses it back out across the country.

—***Washington Post,*** July 27, 2011

DARN THAT PROGRESS

There are some structural issues with our economy where a lot of businesses have learned to become much more efficient with a lot fewer workers. You see it when you go to a bank and you use an ATM, you don't go to a bank teller, or you go to the airport and you're using a kiosk instead of checking in at the gate.

—**President Obama, *Today,* NBC,** June 14, 2011

MISSING BIG-GOVERNMENT BUSH

Perhaps I should thank the current crop of Republican presidential candidates for providing me with an experience I never, ever expected: During this week's debate in New Hampshire, I had a moment of nostalgia for George W. Bush. . . .

Unlike this crowd of Republicans, Bush acknowledged that the federal government can ease injustices and get useful things done.

—**E. J. Dionne Jr., *Washington Post,*** June 16, 2011

THANK YOU, AMERICA!

The Washington metropolitan area is the only major U.S. housing market where prices increased on an annual basis in the first quarter, according to a 20-city S&P/Case Shiller home-price index released Tuesday. The region was helped by relatively stable employment, fewer foreclosures and an abundant supply of house hunters.

Other surveys indicate sales in the area are approaching boom-time levels.

—***Wall Street Journal,*** June 2, 2011

THE FATAL CONCEIT

Already, in several appearances since the [Osama bin Laden] raid, Obama has described it as a reminder that "as a nation there is nothing that we can't do," as he put it during an unrelated White House ceremony Monday. On Sunday night, during his first comments about the operation, he linked it to American values, saying the country is "once again reminded that America can do whatever we set our mind to."

—***Washington Post,*** May 7, 2011

CAN'T STOP THE GRAVY TRAIN

Some of Washington's biggest lobbying shops are pulling down good money this year, but you wouldn't know it from their public disclosures. . . .

Indeed, the passage of health care and Wall Street reform, from which K Street made a killing lobbying for two years, have now morphed into a regulatory gravy train as corporations scramble to influence the hundreds of rules that will soon govern their industries.

And because regulatory work requires specialists who understand the rule-making process and can help clients comply with, or challenge, the new rules, it is much more lucrative than traditional lobbying—paying two to three times more. . . .

And it's not just regulatory work that is booming. With the earmarks ban, lobbyists are busy working agencies and departments that are now in charge of doling out money in the form of contracts and grants.

—***National Journal,*** July 21, 2011