DAVID STOCKMAN
Two parties, 30 years, $16 trillion
PAGE 5

SEN. RON WYDEN
The tip of the surveillance iceberg
PAGE 9

THE FIRE NEXT DOOR
The spreading carnage of the drug war
PAGE 17

Cato Policy Report

November/December 2012 Vol. XXXIV No. 6

Has the Fed Been a Failure?

BY GEORGE SELGIN, WILLIAM D. LASTRAPES, AND LAWRENCE H. WHITE

"No major institution in the U.S. has so poor a record of performance over so long a period, yet so high a public reputation."
—MILTON FRIEDMAN (1988)

In the aftermath of the Panic of 1907, Congress appointed a National Monetary Commission. In 1910 the Commission published a shelf-full of studies evaluating the problems of the postbellum National Banking system and exploring alternative regimes. A few years later Congress passed the Federal Reserve Act.

Today, in the aftermath of the Panic of 2007, and as the one hundredth birthday of the Federal Reserve System approaches, it seems appropriate to once again take stock of our monetary system. Has our experiment with the Federal Reserve been a success or a failure? Does the Fed's track record during its history merit celebration, or should Congress consider replacing it with something else? Is it time for a new National Monetary Commission?

We address these questions by surveying relevant research. The broad conclusions we reach based upon that research are that the full Fed period has been characterized by more, rather than fewer, symptoms of monetary and macroeconomic instability than the decades leading to the Fed's establishment; while the Fed's performance has undoubtedly improved since World War II, even its postwar performance has not clearly surpassed that of its (undoubtedly flawed) predecessor; and alternative arrangements exist that might do better than the presently constituted Fed has done.

These findings do not prove that any particular alternative to the Fed would, in fact, have delivered superior outcomes: to reach such a conclusion would require a

Continued on page 6

GEORGE SELGIN is professor of economics at the University of Georgia and a senior fellow at the Cato Institute. **WILLIAM D. LASTRAPES** is professor of economics at the University of Georgia. **LAWRENCE H. WHITE** is professor of economics at George Mason University and an adjunct scholar at the Cato Institute. A longer version of this article, with full notes and references, appears in the September 2012 issue of the *Journal of Macroeconomics*, with commentaries by Michael D. Bordo, Benjamin M. Friedman, Robert L. Hetzel, Allan H. Meltzer, and Jeffrey Miron.

JOHN ALLISON, former chairman and CEO of BB&T Corporation, has succeeded founder Edward H. Crane as president and CEO of the Cato Institute. Given his long-standing commitment to free-market ideals, Allison has described his new role as "a natural fit." **PAGES 2, 13**

BY JOHN A. ALLISON

> "What is the optimal way to achieve Cato's mission of limited government, free markets, individual liberty, and peace?"

President's Message

Thoughts on Joining the Cato Institute

Having spent 20 years as CEO of an S&P 500 company and 3 years as a professor at the Wake Forest Schools of Business, I have learned a great deal about organizational cultures. However, a think tank provides a new and exciting opportunity. In business, there is a tangible bottom line. How do you measure the performance of a think tank? What is the optimal way to achieve Cato's mission of expanding the understanding of public policies based on the principles of limited government, free markets, individual liberty, and peace?

It is appropriate to recognize that Cato is the world's leading libertarian think tank. Obviously Cato is not "broke" and therefore does not need fixing. Ed Crane, Cato's board, and all of Cato's team and Sponsors can be proud of the organization you have created.

On the other hand, I believe everything can be done better. When I retired from BB&T after 37 years and 20 years as CEO, I still had a list of 50 things we could do better. What are the greatest opportunities for Cato?

First, the strategic planning principles from business can be applied at Cato to focus our resources on where we can have both an immediate impact on policy debates, but equally important, shape the long-term discussion of fundamental policy issues. We must align our most important assets, the Cato scholars, with our agreed-upon strategic goals so their work has the maximum effect.

Second, Cato has a number of first-class departments and centers. However, there is an opportunity to take these to "world standard" performance. What do I mean by world standard? As an example, our Center for Constitutional Studies has significantly redirected the debate on the limitation on governmental action imposed by the U.S. Constitution. However, as strong as the Center is, we will achieve world standard status when the professors at the Harvard Law School find it necessary to respond to the arguments of Cato scholars and when the Supreme Court Justices feel consistently obligated to consider the Cato perspective in reaching their judicial decisions.

Third, to achieve world standard performance requires world standard scholars. We must attract more of those scholars and continue to focus on educating future scholars. Unfortunately, we are in competition with a tax-funded university system which grinds out liberal professors by the thousands. We need scholars who can hit major league curve balls delivered from those opposed to limited government. We need the kind of thinkers who can take libertarian ideals and present arguments that change the public debate.

The fourth opportunity is to provide leadership to the greater free-society movement by working with other think tanks with which we share specific common goals. The objective is to move these think tank scholars to a deeper understanding of libertarian principles and thereby to our public policy positions.

In my pre-Cato life, I met many individuals with libertarian ideas who did not realize they were libertarians and who had never heard of Cato. We need to educate and energize these potential supporters. By effectively promoting libertarian principles and the Cato "brand" we can significantly increase our audience, impact, and resources.

Regardless of the immediate political outcome, our society is engaged in a fundamental debate over the future of Western Civilization. I joined Cato because Cato is essential to defending the classical liberal/libertarian principles of "Life, Liberty, and the Pursuit of Happiness." We hold the moral high ground, not just from an economic well-being perspective but because the type of society we envision is necessary for individual self-fulfillment and true personal happiness.

We must be free to think for ourselves if we are to be productive, creative, innovative, and happy. By definition, all human progress is based on creativity (innovation). Unless someone does something better (that is, different), there can be no progress. Creativity is only possible for an independent thinker. If someone forces you to act as if 2 plus 2 is 5, you cannot think. Government regulations often force decision-makers to act inconsistently with what they know to be correct, discouraging productivity and lowering our standard of living.

Even more fundamentally, if we are to pursue our personal happiness, each of us must be allowed to live life on our own terms—while not violating the rights of others. We must be free to act in a manner consistent with our personal beliefs. Libertarian principles are essential for human happiness, in the Aristotelian ideal of a life well lived. This concept is the foundation for the unique American "sense of life" that inspired the Founding Fathers and created the most successful and benevolent society in history.

John Allison

Keynes, Klaus, and the role of government in the Cato Journal

In Memory of William A. Niskanen

The Fall 2012 issue of the *Cato Journal* is dedicated to the late William A. Niskanen, distinguished senior economist and chairman emeritus of the Cato Institute, who passed away on October 26, 2011. As Nobel laureate Vernon L. Smith once wrote, Niskanen was "a great American scholar, admirably independent, whose role I cannot imagine being adequately filled by anyone else."

The issue opens with a revised lecture Niskanen planned to give in Madrid in 2011, in which he assesses the major political and economic futures for Europe, as well as the considerations that come to bear on these alternatives. Perhaps the best general guidance, he notes, was offered by Václav Klaus. "No costly, freedom-constraining uniformity, harmonization, and centralization should be part of it," Niskanen writes, echoing the Czech president's words, "nor any obligatory 'European' ideology."

Dwight R. Lee looks at the serious problems undermining Keynesian hopes for moderating the decline, duration, and frequency of economic downturns. Because Keynesian remedies are filtered through a political process and almost entirely focused on short-term demand-side concerns, he argues, they end up being "a prescription for fiscal irresponsibility." They are, in the end, just another example of "bad economics making for good politics."

Elsewhere in the issue, Deepak Lal finds that the new development economics is "just the old 'development economics' refurbished with mathematical bells and whistles," while James A. Dorn considers first principles in order to delineate the legitimate functions of government in a free society.

Other notable contributors include David Cronin on "The New Monetary Economics," Masoud Moghaddam on "Starving the Beast Revisited," and Bruce K. Gouldey and Clifford F. Thies on "Asset Bubbles and Supply Failures: Where Are the Qualified Sellers?"

The Fall 2012 issue concludes with reviews of books on the grip of global finance, the argument for nuclear-weapons abolition, China's response to the recent economic downturn, and the contribution of America's "warfare state" to big government, among others. ■

All of these articles are available online at www.cato.org.

Cato News Notes

CATO WELCOMES VÁCLAV KLAUS

The Cato Institute is pleased to announce that Václav Klaus, the president of the Czech Republic, will be joining the Institute as a distinguished senior fellow after his second term ends in March. Often referred to as the "Margaret Thatcher of Central Europe," Klaus began his political career in December 1989 when he became his country's minister of finance.

As co-founder of the Civic Democratic Party, Klaus is well known for having insisted on establishing the legal and institutional framework for a stable, modern free-market economy in the Czech Republic. Thanks in large part to his efforts, today the Czech Republic is no longer behind the Iron Curtain or mired in post-Soviet socialism. We are delighted to welcome President Klaus to the Institute.

AND WE'RE FREE…FREE-FALLING

America is officially in trouble. According to the *Economic Freedom of the World: 2012 Annual Report*—co-published by the Cato Institute, the Fraser Institute, and more than 70 think tanks across the globe—economic freedom in the United States has plummeted to an all-time low. "From 1980 to 2000, the United States was generally rated the third freest economy in the world, ranking behind only Hong Kong and Singapore," the new index reports.

The country now ranks 18th—a precipitous drop from its previous leadership role. This loss of freedom is a decade-long trend—the United States ranked 8th in 2005 and 10th last year—that has accelerated in recent years. The authors calculate that the loss of economic freedom will cut long-term U.S. growth by half, to about 1.5 percent per year.

At the 11th Annual Constitution Day Conference, PAUL CLEMENT, the former U.S. Solicitor General, examined whether the Supreme Court's decision in *NFIB v. Sebelius* is "a constitutional moment."

JAMES GWARTNEY (left), director of the Stavros Center for the Advancement of Free Enterprise and Economic Education at Florida State University, presented *Economic Freedom of the World: 2012 Annual Report* at a National Press Club event moderated by Cato's IAN VÁSQUEZ. The United States plummeted to an all-time low, at 18th place, continuing a decade-long trend in the country's loss of freedom.

A little past 6 p.m. on Friday, May 18, the Internal Revenue Service (IRS) finalized its rule implementing the tax-credit provisions of Obamacare. At a hearing of the House Oversight and Government Reform Committee, MICHAEL F. CANNON (speaking), director of health policy studies at the Cato Institute, discussed why the IRS rule is inconsistent with the law. He was joined by (from left) former IRS commissioner MARK EVERSON; NINA OLSON, national taxpayer advocate of the IRS; and TIMOTHY JOST, professor of law at Washington and Lee University School of Law.

In September, HARMON KASLOW, producer of *Atlas Shrugged II*, introduced the movie during a special premiere screening in the Cato Institute's new F. A. Hayek Auditorium.

At a Cato Book Forum, *Hostile Takeover: Resisting Centralized Government's Stranglehold on America*, author MATT KIBBE, president and CEO of FreedomWorks, discussed the power of "decentralized freedom." Sen. Rand Paul (R-KY) commented.

1.

2.

3.

4.

At this year's Cato Club 200 retreat at the Biltmore Estate in Asheville, North Carolina, (1) Cato's CHRISTOPHER PREBLE and BENJAMIN FRIEDMAN conducted a foreign policy briefing for CC200 members; (2) globe-trotting senior fellows RICHARD RAHN and JOSÉ PIÑERA chatted; (3) DAVID STOCKMAN, former budget director of the Reagan administration, discussed the national debt and the GOP's downfall; and (4) Cato's DAVID BOAZ and ED CRANE enjoyed a drink with CC200 members.

Continued from page 1

counterfactual exercise too ambitious to fall within the scope of what is intended as a preliminary survey. The findings do, however, suggest that the need for a systematic exploration of alternatives to the established monetary system, involving the necessary counterfactual exercises, is no less pressing today than it was a century ago.

INFLATION

The Federal Reserve Act makes it the Fed's duty to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." These stated objectives suggest criteria by which to assess the Fed's performance, namely, the relative extent of pre- and post–Federal Reserve Act price level changes, output fluctuations and business recessions, and financial crises.

The Fed has failed conspicuously in one respect: far from achieving long run price stability, it has allowed the purchasing power of the U.S. dollar, which was hardly different on the eve of the Fed's creation from what it had been at the time of the dollar's establishment as the official U.S. monetary unit, to fall dramatically. A consumer basket selling for $100 in 1790 cost only slightly more, at $108, than its (admittedly very rough) equivalent in 1913. But thereafter the price soared, reaching $2422 in 2008. Most of the decline in the dollar's purchasing power has taken place since 1970, when the gold standard no longer placed any limits on the Fed's powers of monetary control.

The highest annual rates of inflation since the Civil War also occurred under the Fed's watch. The high rates of 1973–75 and 1978–80 are the most notorious, although authorities disagree concerning the extent to which Fed policy was to blame for them. Yet those inflation rates—in the low teens—were modest compared to annual rates recorded between 1917 and 1920, which varied from just below 15 percent to 18 percent, with annualized rates for some quarters occasionally approaching 40 percent. Significantly, both of the major post–Federal Reserve Act episodes of inflation coincided with relaxations of gold-based constraints on the Fed's money-creating abilities: the temporary gold export embargo from 1917 to 1919 and the permanent closing of the Fed's gold window in 1971.

> "Unpredictable changes in the price level have greater costs than predictable changes."

Although the costs of price level instability are hard to assess, the reduced stability of prices under the Fed's tenure has certainly not been costless. As Ben Bernanke observed several years ago, besides reducing the costs of holding money, stable prices allow people to rely on the dollar as a measure of value when making long-term contracts, engaging in long-term planning, or borrowing or lending for long period. As economist Martin Feldstein has frequently pointed out, price stability also permits tax laws, accounting rules, and the like to be expressed in dollar terms without being subject to distortions arising from fluctuations in the value of money. Feldstein himself has reckoned the recurring welfare cost of a steady inflation rate of just 2 percent—costs stemming solely from the adverse effect of inflation on the real net return to saving—at about 1 percent of gross national product.

As Bernanke's remarks suggest, unpredictable changes in the price level have greater costs than predictable changes. But here again the Fed's record has been unsatisfactory, for while inflation has become more persistent since its establishment, and especially since WWII, the future state of the price level has also become much harder to forecast. Largely for that reason, long-term (e.g., 100-year) corporate securities, which were common before 1914, have now all but disappeared.

DEFLATION

While it has failed to prevent inflation, the Fed has largely succeeded, since the Great Depression, in eliminating deflation, which was a common occurrence under the pre-Fed, post–Civil War U.S. monetary system. Between 1870 and 1896, for example, U.S. prices fell 37 percent, or at an average annual rate of 1.2 percent.

The postwar eradication of deflation would count among the Fed's achievements were deflation always a bad thing. But is it? Many economists appear to assume so. But a contrasting view, supported by a number of recent studies, holds that deflation may be either harmful or benign depending on its underlying cause. Harmful deflation—the sort that goes hand-in-hand with depression—results from a contraction in overall spending or aggregate demand for goods in a world of sticky prices.

Benign deflation, by contrast, is driven by improvements in aggregate supply—that is, by general reductions in unit production costs—which allow more goods to be produced and are therefore much more likely to be quickly and fully reflected in corresponding adjustments to actual prices. Historically, benign deflation has been the far more common type. Surveying the 20th-century experience of 17 countries, including the United States, Andrew Atkeson and Patrick Kehoe find "many more periods of deflation with reasonable growth than with depression, and many more periods of depression with inflation than with deflation."

Indeed, they conclude "that the only episode in which there is evidence of a link between deflation and depression is the Great Depression."

Taking these findings into account, the Fed's record with respect to deflation does not appear to compensate for its failure to contain inflation. It has, on the one hand, practically extinguished the benign sort of deflation, replacing it with persistent inflation that masks the true progress of productivity. On the other hand, it bears some responsibility for several of the most severe episodes of harmful deflation in U.S. history, including those of 1930–33, 1937–38, and 2008–2009.

THE "GREAT MODERATION"

The beginning of Paul Volcker's second term as Fed chairman coincided with a dramatic decline in the volatility of real output that lasted through the Alan Greenspan era. Annual real gross domestic product growth, for example, was less than half as volatile from 1984 to 2007 as it was from 1959 to 1983. The inflation rate, having been reduced to lower single digits, also became considerably less volatile. Many have regarded this "Great Moderation" of inflation and real output as evidence of a substantial improvement in the Fed's conduct of monetary policy—a turn to what Alan Blinder terms "enlightened discretion."

The "enlightened discretion" view has, however, been challenged by statistical studies pointing to moderating forces other than improved monetary policy. A study by James Stock and Mark Watson attributes between 75 percent and 90 percent of the Great Moderation in U.S. output volatility to "good luck in the form of smaller economic disturbances" rather than improved monetary policy. Subsequent research has likewise tended to downplay the contribution of improved monetary policy, either by lending support to the "good luck" hypothesis or by attributing the Great Moderation to financial innovations, an enhanced "buffer stock" role for manufacturing inventories, an increase in the importance of the service sector relative to that of manufacturing, a change in the age composition of the U.S. population, and other sorts of structural change.

Recent experience has, of course, made it all too evident that prior reports of the passing of macroeconomic instability were premature. According to Todd Clarke, statistics gathered since the outbreak of the subprime crisis reveal "a partial or complete reversal of the Great Moderation in many sections of the U.S. economy." Clarke himself, in what amounts to the flip side of the Stock-Watson view, characterizes the reversal as a "period of very bad luck," asserting that "once the crisis subsides . . .improved monetary policy that occurred in years past should ensure that low volatility is the norm."

Those who believe, in contrast, that "luck" was no less important a factor in the moderation as it has been in the recent reversal, or who see the subprime crisis itself as a byproduct of irresponsible Fed policy, are unlikely to share Clarke's optimism.

> "Recent experience has made it all too evident that reports of the passing of macroeconomic instability were premature."

FREQUENCY AND DURATION OF RECESSIONS

The conventional business cycle chronology from the National Bureau of Economic Research suggests that contractions have been both substantially less frequent and shorter on average, while expansions have been substantially longer on average, since World War II, than they were prior to the Fed's establishment.

But differences in data, Christina Romer notes, result in a systematic overstatement of both the frequency and the duration of early contractions compared to modern ones.

Romer arrives at a new set of reference dates that "radically alter one's view of changes in the duration of contractions and expansions over time."

According to this new chronology, although contractions were indeed somewhat more frequent before the Fed's establishment than after World War II (though not, it bears noting, more frequent than in the full Federal Reserve sample period), they were also almost three months shorter on average, and no more severe. Recoveries were also faster, with an average time from trough to previous peak of 7.7 months, as compared to 10.6 months. Allowing for the recent, 18-month-long contraction further strengthens these conclusions.

In comparing pre– and post–Federal Reserve Act business cycles we have again tended to set aside the interwar period, as if allowing for a long interval during which the Fed had yet to discover its sea legs. Nevertheless, the Fed's interwar record, and especially its record during the Great Depression, cannot be overlooked altogether in a study purporting to assess its overall performance. And that record was, by most modern accounts, abysmal.

Some economic historians have blamed the Great Depression in the United States on the gold standard rather than on the Fed's misuse of its discretion, claiming that the Fed had to refrain from further monetary expansion in order to maintain the gold standard. But the Fed entered the Great Depression with very large holdings of excess gold reserves, and still held excess reserves at the time of the national bank holiday, when gold payments were suspended. What's more, Romer, in a paper with Chang-Tai Hsieh, draws on both statistical and narrative evidence to examine, and ultimately reject, the hypothesis that the Fed was compelled to refrain from expansionary policies out of fear that expansion would provoke a speculative attack on the dollar. Instead, Romer and Hsieh conclude, "the American Great Depression was largely the result of inept policy, not the inevitable consequence of a flawed international monetary system."

ALTERNATIVES TO THE FED, PAST AND PRESENT

Our review of the Fed's performance raises two very distinct questions: Might the United States have done better than to have established the Fed in 1914, and might it do better than to retain it today? While the first question is of interest to economic historians, the second should be of interest to policymakers.

Coming up with alternatives to the Fed today takes some imagination. Assuming that there is no political prospect of restoring a gold standard or other commodity money standard, for the dollar to retain its value some public institution must keep fiat money sufficiently scarce. In this respect at least, our finding that the Fed has failed does not, by itself, indicate that it would be practical to entirely dispense with some sort of public monetary authority. But neither does it indicate that the only avenues for improvement are marginal revisions to Fed operating pro-

cedures or additions to its powers. On the contrary, the Fed's poor record calls for seriously contemplating a genuine change of regime. In particular, it strengthens the case for pre-commitment to a policy rule that would constrain the discretionary powers that the Fed has used so ineffectively. Whether implementing such a new regime should be called "ending the Fed" is an unimportant question about labels.

But the gold standard warrants consideration as an alternative to discretionary central banking. Dismissals of the gold standard as a viable option have often been based on flawed assessments of its past performance. The instability in the U.S. financial system during the pre-Fed period was due to serious flaws in the U.S. bank regulatory system rather than to the gold standard. Indeed, the Federal Reserve Act, which retained the gold standard, was predicated on this view. Canada adhered to a gold standard during the same period, but with a differently regulated banking system it experienced no such instability.

A single nation's return to gold would not, however, reestablish a global currency area, and therefore could not be expected to make the relative price of gold as stable as it was under the classical system. To provide considerably greater stability than the present fiat-dollar regime, a revived U.S. gold standard would probably need to be part of a broader international revival.

> "The Fed cannot be credited with having reduced the frequency of banking panics or with having wielded its last-resort lending powers responsibly."

CONCLUSION

Available research does not support the view that the Federal Reserve System has lived up to its original promise. Early in its career, it presided over both the most severe inflation and the most severe (demand-induced) deflations in post–Civil War U.S. history. Since then, it has tended to err on the side of inflation, allowing the purchasing power of the U.S. dollar to deteriorate considerably. That deterioration has not been compensated for by enhanced stability of real output.

Although some early studies suggested otherwise, recent work suggests that there has been no substantial overall improvement in the volatility of real output since the end of World War II compared to before World War I. While a genuine improvement did occur during the subperiod known as the "Great Moderation," that improvement, besides having been temporary, appears to have been due mainly to factors other than improved monetary policy. Finally, the Fed cannot be credited with having reduced the frequency of banking panics or with having wielded its last-resort lending powers responsibly. In short, the Federal Reserve System, as presently constituted, is no more worthy of being regarded as the last word in monetary management than the National Currency System it replaced almost a century ago. ■

The Surveillance Iceberg: Mass Spying under the FISA Amendments Act

History teaches that government spying is naturally subject to abuse without strong oversight, yet only the tiniest fraction of electronic surveillance of Americans—the tip of a vast and rapidly growing iceberg—is meaningfully visible today. Under the controversial Foreign Intelligence Surveillance Act (FISA) Amendments Act (FAA) of 2008, set to expire at the end of the year, the National Security Agency (NSA) is empowered to vacuum up the international communications of Americans under sweeping authorizations that dispense with the need for individual warrants. Despite reports of large-scale overcollection of Americans' emails and phone calls, the NSA has brazenly refused to give Congress any estimate of how many citizens' private conversations are being captured in its vast databases. At a Cato Policy Forum held in July, Julian Sanchez, research fellow at the Institute, took a closer look behind this veil of secrecy. Sen. Ron Wyden (D-OR), who has blocked unanimous consent requests to pass a five-year extension of the FAA, offered his hopes for establishing sorely needed accountability when it comes to surveillance.

JULIAN SANCHEZ: It is a truism of the information age that knowledge is power. Here at Cato, however, we always try to be cognizant of Lord Acton's famous warning about what power tends to do. Unfortunately, the history of the American intelligence community demonstrates all too clearly that, at least in government hands, data tends to corrupt—and massive databases corrupt massively.

Both our own experience and that of less free societies around the world have made it apparent that a government's ability to monitor its citizens' private communications is among its most dangerous powers. Without strong oversight, it is highly susceptible to abuse. Yet, while we recognize accountability to the public as one of the strongest checks against abuse of surveillance power, several factors have vastly increased the amount of unaccountable monitoring by intelligence agencies in recent years.

In the decades prior to the passage of the Foreign Intelligence Surveillance Act of 1978, the Federal Bureau of Investigation and other government agencies systematically and illegally spied on American antiwar activists, legislators, Supreme Court justices, political advisers, members of Congress, at least one first lady and civil rights leaders—including, perhaps most notoriously, the Rev. Martin Luther King Jr. As we now know, the FBI hoped he could be discredited or driven to suicide and replaced with what they termed "the right kind of negro leader"—one who would be covertly answerable to the Bureau itself.

None of this illegally obtained information ever saw the inside of a court, where it might be challenged. Instead, it was deployed through selective, targeted leaks of information to friendly politicians and journalists—effectively escaping any kind of real public accountability.

As these abuses came to light, thanks to the investigative work of the Church Committee in the 1970s, Congress began to realize that the corrupting power of surveillance required the counterbalancing force of oversight. This would come first and foremost from judges, but also, to the extent possible, from Congress and the public.

Much as the Cold War provided the context for surveillance abuses in the 1960s and 1970s, the attacks of September 11th set the stage for a new era of massive surveillance with minimal accountability. Many different factors have contributed to that trend. One is the fear that, without flexibility and rapid action unencumbered by judicial oversight, American intelligence agents won't be able to respond quickly enough to the threat of terror. Another is the advent of new technologies that have enabled new types of surveillance, even in ordinary criminal investigations. which don't trigger the traditional statutory reporting or warrant requirements,—surveillance of stored electronic records and emails, for instance, doesn't trigger the same reporting obligations as a traditional phone wiretap. At the same time, new technologies have greatly expanded the ability of intelligence agencies to vacuum up and sift through an ever-growing torrent of communications data.

Every year, the Administrative Office of the U.S. Courts releases a thick, data-rich report on criminal wiretaps. There's also a much shorter public report issued by the Justice Department on secret FISA surveillance. There are still, however, vast quantities of additional information-gathering about which we know almost nothing. That includes the FISA Amendments Act of 2008. The National Security Agency and the Justice Department have refused to tell even Congress how many Americans have been swept into its vast databases of information collected under this legislation. Each day, those databases are growing ever larger. We do know that in Utah a massive data storage facility is being constructed that former NSA officials have said could be effectively used to store the total volume of international data communications.

The scale of this information itself is a barrier to meaningful oversight. An audit in 2008 found that the FBI alone had over a century's worth of backlogged FISA record-

ings. The NSA has much, much more. As James Clapper, the director of national intelligence, has said, "There's only one entity in the entire universe that has visibility on all Special Access Programs—that's God." Unfortunately, what we have instead is Congress.

Given their limited access and resources, including a relatively small number of staffers with both clearance and relevant legal expertise, members of Congress have little incentive to expend energy and political capital fixing problems with secret surveillance. Even if they succeed, after all, they won't be able to put out a press release trumpeting the achievement. Especially in an election year, the attitude of many congressional overseers is exemplified by a comment made by Sen. Leverett Saltonstall (R-MA) in 1956. He said that the issue wasn't so much the reluctance of the intelligence agencies to talk to Congress, but, as he put it, "our reluctance to seek information and knowledge on subjects which I personally, as a member of Congress and as a citizen, would rather not have."

We are fortunate to have a radically different attitude represented in Congress today in the person of Sen. Ron Wyden. Please join me in welcoming today's speaker.

SEN. RON WYDEN: Let me begin with some background. If a law enforcement agency has compelling evidence that an American citizen is a serious criminal, the officers can get a warrant from a judge to tap that individual's phone. This procedure—based on probable cause—is built upon the Fourth Amendment, which the Founding Fathers considered sacred ground. It was a bedrock principle that the government could not violate the privacy of Americans with unreasonable searches and seizures. And it was a brilliant concept, simultaneously protecting individual privacy while setting up procedural mechanisms in the face of threats to public safety.

In 1978, Congress passed the Foreign Intelligence Surveillance Act, which governs wiretapping for intelligence purposes. If there is evidence that a person is a spy or a member of an international terrorist group, this legislation allowed the government to procure a warrant, even if that person had not yet committed a crime. It was based on the same concepts as probable cause, and it continues to be used today.

After September 11th, however, the Bush administration decided that it needed additional surveillance authorities beyond the FISA statute. Instead of engaging Congress, however, it manufactured a warrantless wiretapping program that operated in secret for a number of years. This, like everything else, eventually became public. There was a huge uproar, both within the halls of Congress and beyond. After a passionate national debate, Congress passed the FISA Amendments Act of 2008, replacing the warrantless wiretapping program with new government authorities to collect the phone calls and emails of those believed to be foreigners outside of the United States.


Julian Sanchez

> "At least in government hands, data tends to corrupt—and massive databases corrupt massively."

The centerpiece of that Act, and a big part of my concern, is a provision that has come to be known as Section 702. This provision, unlike the traditional FISA authorities, allows the government to collect foreign communications without individual warrants. It also contains language specifically intended to limit the government's ability to deliberately spy on law-abiding Americans. Congress put an expiration date on these new authorities, designed to foster ongoing and continuous review, and the next expiration date is in December.

The question, therefore, is whether the FISA Amendments Act should remain as it stands or whether it needs reform. For the last 18 months, Sen. Mark Udall (D-CO) and I have been asking questions. Because Section 702 was targeted at people outside our borders, it is particularly important for the public to get a rough understanding of how many people inside the United States have had their private communications collected under these authorities. If only a handful have had their phone calls and emails collected, there is probably not a substantial threat to privacy rights. But if the number is significant, then that would suggest that the privacy protections of American citizens need to be strengthened.

So we asked for an estimate. The Office of the Director of National Intelligence told the two of us in July 2011 that "it is not reasonably possible to identify the number of people located in the United States whose communications may have been reviewed'' under the Act. Obviously, this wasn't a particularly helpful response. I am prepared to accept that it might be difficult to come up with an exact count of this number, but it is hard for me to believe that it is impossible to even estimate it.

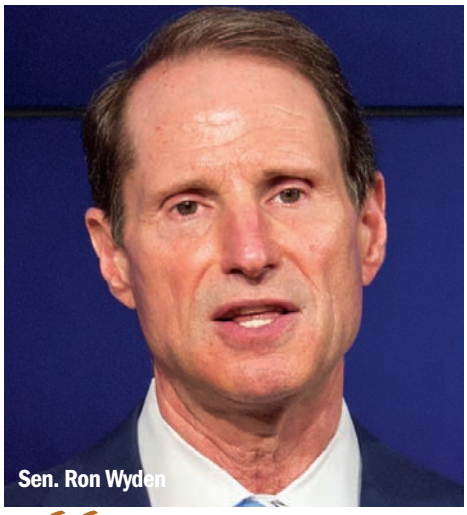
This June, in one of the more remarkable statements I've heard in my time in public service, the leadership of the NSA said that trying to come up with this estimate would in itself violate the privacy of U.S. persons. Even by Washington standards, this was far-fetched. How exactly does it violate privacy rights to give a ballpark estimate of how many people have had their communications swept up?

I am concerned, of course, that if no one has even estimated how many Americans have had their communications collected under the FISA Amendments Act, then it is

possible that this number could be quite large. Since all of the communications collected by the government under section 702 are collected without individual warrants, I believe that there should be clear rules prohibiting the government from searching through these communications in an effort to find the phone calls or emails of a particular American, unless the government has obtained a warrant or emergency authorization permitting surveillance of that American.

Another concern is that if the government wants to search its collected communications in order to find a particular American's communications, there is currently no requirement to get a warrant. As it is currently written, in other words, Section 702 does not contain adequate protections against warrantless "backdoor" searches—even though they are the very thing that many people thought the FISA Amendments Act was intended to prevent. This loophole ought to be closed, as it would circumvent the traditional warrant requirements laid out in the Fourth Amendment.

I want to be clear: If the government has evidence that an American is engaged in terrorism, espionage, or other serious crimes, officials should be able to read that person's emails and listen to their phone calls. In fact, I believe that this is an essential part of protecting our country from terrorism. Senator Udall and I offered an amendment during the committee's markup of this bill that would have clarified the law to prohibit searching through communications collected under section 702 in an effort to find a particular American's communications. We included exceptions for searches that involved a warrant or an emergency authorization, as well as for searches for the phone calls or emails of people who consent to the search.


Sen. Ron Wyden

"Searching for Americans' phone calls and emails without a warrant is something that these agencies should not do."

This amendment was voted down. However, it was offered up to the Senate Judiciary Committee by Sen. Mike Lee (R-UT). This is at least an indication that these issues are seeing a spark of life. In fact, two particularly critical developments emerged last summer in response to my request for the intelligence community to declassify certain statements. For starters, the government admitted—for the first time—that a violation of Fourth Amendment privacy rights had taken place. In addition, the Foreign Intelligence Surveillance Court decided that the use of expanded surveillance authorities "has sometimes circumvented the spirit of the law."

It's time to step back and take a closer look at these important constitutional issues. I believe that we have an obligation as elected legislators to discuss what these agencies should or should not be doing, and it is my hope that a majority of my colleagues will agree that searching for Americans' phone calls and emails without a warrant is something that these agencies should not do. The founding fathers got it right. We need to strike a better balance between individual liberty and collective security. ■

A New York Times *bestseller from the Cato Institute's new president*

Why Pure Capitalism Is the World Economy's Only Hope

In August 2009, after completing a 20-year tenure as CEO of BB&T Corporation, John Allison let the *New York Times* in on how his company was able to weather the global financial storm. "The philosophy has clearly been a competitive advantage," he said, noting that BB&T had managed to remain profitable in turbulent times and, in doing so, outperform its peers.

This September, shortly before joining the Cato Institute as president and CEO, Allison released *The Financial Crisis and the Free Market Cure*, in which he provides "an integrated insider's perspective" on how the meltdown was caused primarily by government actions. Within its first few weeks, the book quickly became a *New York Times* bestseller. And nearly five years after the downturn began, BB&T has still not experienced a single quarterly loss.

"The financial crisis is the most important economic event in 80 years," Allison says—and, as such, a deep understanding of the circumstances that led to its onset is crucial. The book is organized around six fundamental themes, each of which helps to illuminate the causes, consequences, and cures of the financial crisis and the ensuing Great Recession.

The first theme tackles the primary cause of the crisis. "Not only did government policy create the financial environment for a significant economic correction," Allison writes, "but government policymakers unnecessarily turned a challenging economic environment into a crisis." This is not surprising, given that financial services is arguably the most highly regulated industry in the world. In fact, the claim that the financial industry was deregulated, Allison contends, is a complete myth.

The second theme is that government policy also created a bubble in residential real estate. Allison traces the roots of these policy incentives back to Lyndon Johnson's Great Society of the late 1960s. "These errors multiplied and went exponential over about a period of 10 years ending in 2007," he writes—and eventually the real estate bubble burst, as all bubbles inevitably do.

Nevertheless, Allison acknowledges that Wall Street participants made some very serious mistakes that also contributed to the crisis. However, any errors by these institutions were far less important than the policy mistakes, and almost all were the direct result of government incentives. "If the United States had separation of 'business and state' as it does separation of 'church and state,' crony capitalism could not exist," he adds.

***The Financial Crisis and the Free Market Cure*, Allison's *New York Times* bestseller, also hit #1 on the *Wall Street Journal*'s hardcover business bestseller list. The book reached #1 in several different categories of Amazon's bestseller rankings as well.**

Fourth, Allison says that almost every governmental action taken since the crisis began will reduce our standard of living in the long run, even though a few may help in the short-term. This stems from the fact that the fundamental cause of the problem has been misdiagnosed. "If your doctor treats you for cancer when you have heart disease," he writes, "the outcome will not be good."

The fifth theme is that the deeper causes of the financial crisis are not economic at all, but philosophical. The current path is "driven by a combination of altruism, pragmatism, and the related 'free lunch' mentality," Allison argues—and it's a recipe for economic disaster.

Finally, Allison makes a compelling case that the United States will be in very serious financial trouble in the next 20 to 25 years if we do not change direction soon. Analyzing everything from skyrocketing federal entitlement deficits to the failed K–12 education system, Allison warns that "the economic forces that have now been set in motion are laying the foundation for a long-term disaster."

There are, however, practical cures for the economic challenges that face the United States. Allison details those prescriptions in full, explaining that ideas ultimately determine outcomes. "The open question at this stage is not whether we have the ability to solve our problems," he concludes, "but whether we have the will to do so." ■

Visit www.amazon.com or bookstores nationwide to get your copy of *The Financial Crisis and the Free Market Cure* today.

The former CEO of BB&T sees his new role as "a natural fit"

John Allison Takes Charge of the Cato Institute

The Cato Institute is pleased to welcome John A. Allison, former chairman and CEO of BB&T Corporation, as its new president and CEO. Allison took the helm on October 1, setting his sights on continuing the Institute's effort to cultivate a freer and more prosperous society.

"As a long-time admirer of Cato's important work, I am excited about joining the Cato team in enriching the understanding of the principles of individual liberty, limited government, free markets, and peace which are the foundation of a free and prosperous society," he said.

Allison has nearly 40 years of experience in the financial services industry and recently retired as Distinguished Professor of Practice at Wake Forest University School of Business. Given his long-standing commitment to free-market ideals, he describes his new role as "a natural fit."

Allison began his career at BB&T in 1971 and rose to become chief executive in 1989, when the bank had $4.5 billion in assets. As the longest-serving CEO of a top-25 financial institution, he spearheaded the company's rapid expansion—overseeing $152 billion in assets by the time he retired in 2008.

In recognition of his outstanding career, Allison received a Lifetime Achievement Award from *American Banker* and was named one of the decade's top 100 most successful CEOs in the world by *Harvard Business Review*.

Edward H. Crane, founder and president emeritus of the Institute, welcomed Allison, whom he described as "a great champion of liberty and an outstanding choice to build on Cato's success as the foremost nonpartisan, non-aligned, independent source of libertarian perspectives on public policy."

Since 1977, Crane has guided the Institute from a three-person outfit in San Francisco to one of the major public policy research organizations on the national stage. "This is a new chapter in Cato's history, but also the end of an era," Board Chairman Robert A. Levy said, noting the significance of Crane's tenure. "From the Institute's inception, Ed Crane has played an indispensable role, co-founding, managing, and shaping it into one of the nation's leading research organizations."

Courtesy 2012 COMMIT!Forum

ABOVE: JOHN ALLISON, the new president and CEO of the Cato Institute, presented his *New York Times* bestseller, *The Financial Crisis and the Free Market Cure*, at CR Magazine's COMMIT Forum in October. BELOW: After an event at Cato, guests lined up to have their copies autographed by Allison.

Crane will remain with the organization for a transition period, and will then assume a new role as a consultant on fundraising. For his part, Allison is eager to continue the fundamental battle for a free society by restoring the principles that animated the founding generation.

"I can honestly say this is the most important point in history in my life," Allison said in a recent interview with *News & Observer*. "In Obamacare, we face a massive tax increase in the middle of a recession. It's major legislation at the time we can least afford it. And there's no plan to fix the deficits. They're the biggest in U.S. history, and that's got to have a huge impact on the economy eventually."

Unless the country changes course, Allison says, the current path will lead to an unsustainable future. "There's no political leadership to fix those problems and the others we're facing right now," he concluded. "That's why Cato is important." ■

During Cato University at Capitol Hill in August, a special program for congressional staff, CHRISTOPHER PREBLE (left), vice president for defense and foreign policy studies at the Institute, explained how the Founders created a government that could "provide for the common defence," while deliberately placing constraints and checks on the government's use of military force. PETER VAN DOREN, a Cato senior fellow and editor of *Regulation* magazine, explored how unregulated insurance markets work and what failures, if any, exist in those markets.

At a Capitol Hill Briefing in September, ROBERT SAUER (at podium), president of the Jerusalem Institute for Market Studies (JIMS), discussed how U.S. aid to the Middle East fuels both an economic loss for Israel and an arms race throughout the region. He was joined by (from left) Cato's DOUG BANDOW and IAN VÁSQUEZ, and CORINNE SAUER of JIMS.

At a happy-hour event for Congressional staff in the Ken & Frayda Levy Liberty Garden on the Institute's new rooftop, two staffers chatted with Cato senior fellow DANIEL J. MITCHELL.

From President Obama's first budget message in 2009 to the Occupy Wall Street movement, there have been strong calls to ask more from the 1 percent and thereby level the playing field for the other 99 percent. At a Policy Forum in August, ALAN REYNOLDS (speaking), senior fellow at the Cato Institute, took a critical look at inequality research from the last decade and took issue in particular with the much-cited numbers by economists Thomas Piketty and Emmanuel Saez. BRIAN DOMITROVIC, chairman of the history department at Sam Houston State University, discussed his study "The Left's Dubious History of Economic Inequality."

HARVEY PITT, former chairman of the U.S. Securities and Exchange Commission, discussed the contentious issues surrounding the current regulatory framework applied to broker-dealers at a Cato Policy Forum in September.

AUGUST 14: Inequality: Sorting through the Facts

AUGUST 29: Bipartisan Medicare Dishonesty

IN AUGUST: Cato University at Capitol Hill

SEPTEMBER 10: Does the Middle East Need U.S. Aid? Implications for Israeli Security and Prosperity

SEPTEMBER 11: The IRS's Illegal Attempt to Increase Taxes and Spending under the PPACA: A Guide for the Perplexed

SEPTEMBER 12: *Shadowbosses: Government Unions Control America and Rob Taxpayers Blind*

SEPTEMBER 13: *Hostile Takeover: Resisting Centralized Government's Stranglehold on America*

SEPTEMBER 18: 11th Annual Constitution Day

SEPTEMBER 18: Release of the *2012 Economic Freedom of the World Report*

SEPTEMBER 19: Chicago: Teachers Unions' Last Stand?

SEPTEMBER 20: *Silent Spring at 50: The False Crises of Rachel Carson*

SEPTEMBER 24: *Free Market Revolution: How Ayn Rand's Ideas Can End Big Government*

SEPTEMBER 25: Should Investment Advisers Be Regulated, and If So, How?

SEPTEMBER 27-30: Cato Club 200 Retreat

SEPTEMBER 28: *Who's Counting? How Fraudsters and Bureaucrats Put Your Vote at Risk*

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 CLUB NAPLES
Naples, FL • Grey Oaks Country Club
December 12, 2012
Speakers include Michael Cannon and Louise Bennetts.

CATO INSTITUTE POLICY PERSPECTIVES 2013
Naples, FL • Waldorf-Astoria
January 30, 2013
Speakers include P. J. O'Rourke.

25TH ANNUAL BENEFACTOR SUMMIT
Scottsdale, AZ • Four Seasons Resort
February 21–24, 2013

CATO PAPERS ON PUBLIC POLICY
Washington • Cato Institute
June 6–7, 2013

Celebrating Constitution Day with a new Cato Supreme Court Review

A Term Overshadowed by Obamacare

On September 17, 1787, the delegates to the Constitutional Convention gathered in Philadelphia's Independence Hall to sign the newly drafted U.S. Constitution. Every year, to celebrate that momentous date in liberty's history, the Cato Institute hosts a daylong conference. This year marked the 11th and, as always, coincided with the release of the 2011–2012 *Cato Supreme Court Review*.

It was a term marked by a striking amount of unanimity, which, as *Review* editor-in-chief Ilya Shapiro noted, "many observers attribute to Chief Justice John Roberts's long-expressed desire for the Court to speak more with one voice."

Unfortunately, Roberts's decision in *NFIB v. Sebelius*—the case that overshadowed the rest—was little more than an exercise in "fig-leaf federalism," according to Baker & Hostetler's David Rivkin, Lee Casey, and Andrew Grossman. "Despite its strongest statement yet on the limits of Congress's power to regulate interstate commerce," Rivkin said at the conference, "the Court ultimately proved unwilling to strike down the centerpiece of a statute that a majority of the justices agreed blatantly intruded on the authority reserved to the states and the people."

In discussing *Sackett v. Environmental Protection Agency*, a case challenging the EPA's enforcement of the Clean Water Act, Jonathan Adler, of Case Western Reserve University Law School and the Volokh Conspiracy, offered a broad analysis of the overreach involved in federal environmental statutes. He focused on the EPA's routine evasion of providing adequate notice to property owners. "Progressives in particular have recognized that we need not sacrifice fundamental liberties in order to keep Americans safe from terrorist threats," Adler said, "Private landowners and corporations accused of environmental wrongs are no less worthy of due process protections than alleged terrorists."

The day sparked plenty of lively discussions. "I, like so many people before me, congratulate Cato for putting on such a wonderful event," said Tom Goldstein, cofounder of *SCOTUSblog*. Goldstein joined a panel—along with David Savage of the *Los Angeles Times* and Kannon Shanmugam of Williams & Connolly LLP—that looked ahead to the upcoming term. The Court will be deciding a number of high-profile issues over the next year, from affirmative action to the war on terror—while other cases on same-sex marriage and the constitutionality of the Voting Rights Act currently remain in the pipeline.

1.


2.


3.


4.

At the 11th Annual Constitution Day Conference, (1) former U.S. Solicitor General PAUL CLEMENT led a luncheon for Supreme Court journalists; (2) RANDY BARNETT, the Carmack Waterhouse Professor of Legal Theory at Georgetown University, discussed the lessons from Obamacare; (3) JAMES F. BLUMSTEIN, University Professor of Constitutional Law at Vanderbilt University, analyzed Obamacare's Medicaid component; and (4) a distinguished panel of experts including (from left) TOM GOLDSTEIN of *SCOTUSblog*, ILYA SHAPIRO and ROGER PILON of Cato, KANNON SHANMUGAM of Williams & Connolly LLP, and DAVID SAVAGE of the *Los Angeles Times* looked ahead to the October 2012 term.

The conference closed with the annual B. Kenneth Simon Lecture, during which a distinguished legal scholar presents a paper to be included in the next year's *Cato Supreme Court Review*. This September, the Hon. Paul Clement—the former U.S. Solicitor General—presented his thoughts on *NFIB v. Sebelius* and the burden that the challengers faced. Given the likelihood that there were four unshakable votes in favor of the law, the challengers "needed to run the table" on each of the three constitutional justifications. They needed, in other words, 15 out of 15 votes supporting their interpretations of the Commerce, Necessary and Proper, and Spending Clauses. "The good news is that they managed the quite remarkable feat of getting 14 out of 15 votes," Clement said. The bad news, of course, is that it wasn't enough to strike down the law.

In his foreword to this year's *Review*, Roger Pilon, Cato's vice president for legal affairs, writes that the concern that most animated the founding generation was "to create a government that was effective where it was authorized but limited to those authorizations." The Cato Institute takes that heritage seriously. But for the better part of a century, the Court has not. "Is there any better example of our having abandoned that inheritance of liberty through limited government than the 2,700-page monstrosity known colloquially as Obamacare?"

We've drifted far from our founding vision. "In the end, however," Pilon says, "the ultimate remedy is in the hands of the people." ■

The *2011–2012 Cato Supreme Court Review* can be purchased for $15—or the essays downloaded for free—at www.cato.org.

The inferno engulfing our neighbor and endangering us

Caught in the Crossfire of the Drug War

Since President Felipe Calderón initiated a military offensive against Mexico's powerful drug cartels in December 2006, more than 50,000 people have perished.

The Mexican military, which had largely avoided the country's pervasive corruption, is now showing signs of succumbing to the temptation of drug money. And as the increasingly brutal crackdown causes inconveniences for the drug cartels themselves, they only seem to be expanding their operations.

In his new book *The Fire Next Door: Mexico's Drug Violence and the Danger to America*, Cato senior fellow Ted Galen Carpenter forcefully argues that the current U.S.-backed strategy for trying to stem the country's drug violence has been a disaster. Officials in both governments insist on a knee-jerk adherence to comprehensive prohibition, rather than exploring alternative policy courses. Yet this failure in leadership, Carpenter demonstrates, is unsustainable.

> "Both Mexico and the United States would be wise to adopt the strategy discussed in *The Fire Next Door*."
>
> —Vicente Fox
> Former President of Mexico

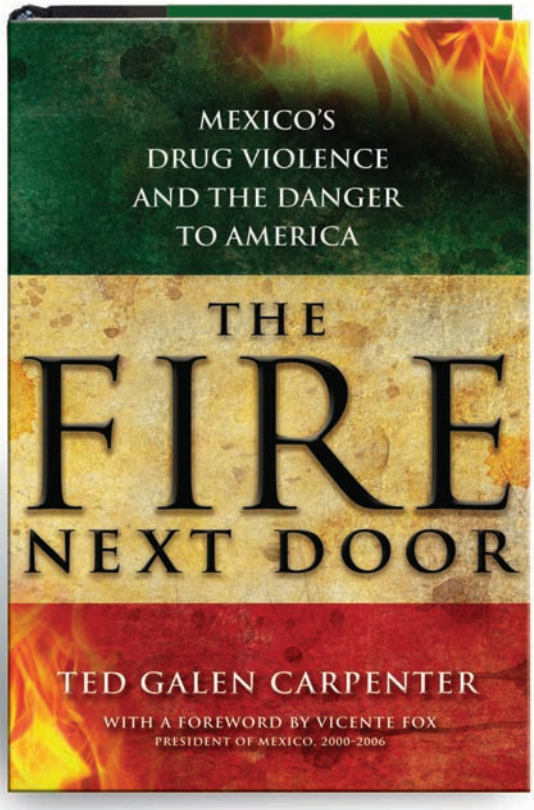
"The deteriorating security conditions in Mexico, and the risk that the frightening violence there could become a routine feature of life in American communities as the cartels begin to flex their muscles north of the border, make it urgent that leaders of both countries reconsider their approach to the crisis," he writes.

The current debate on what course of action to take centers on two contentious issues. The first is whether the carnage in Mexico is reaching the point that the country is in danger of becoming a "failed state." Carpenter points to several worrisome indicators—from sophisticated cartel operations that now target even the most prominent political figures to large numbers of middle- and upper-class families exiting the country for fear of their security. While fears of a true failed state may be overblown, "the overall trend is troubling," Carpenter writes.

The second issue is whether drug-related corruption and violence is now seeping over the border. This carries with it the risk that the turf battles between rival cartels in Mexico could become proxy wars in U.S. communities. As Carpenter shows, the cartels are clearly expanding north—threatening both American citizens and law enforcement personnel—and may even be infiltrating the U.S. military. While the implications of these trends are still controversial, Carpenter notes that one thing is clear: "The carnage associated with the black-market trade in drugs does not respect national boundaries."

The strategy behind the war on drugs has long rested on two pillars. The first is the need to shut off the flow of drugs from source countries through various eradication, suppression, and interdiction efforts. The second is to significantly reduce U.S. demand through a combination of criminal sanctions, treatment programs, and anti-drug educational programs. Both strategies, according to Carpenter, have amounted to a "futile, utopian crusade"—with an array of ugly side effects.

Prisons in the United States are now bulging with nonviolent drug offenders. The war on drugs has destroyed black families and discouraged the pursuit of legal employment. The most unsavory individuals now gain dominant positions within these communities, creating dubious role models. Meanwhile, users themselves are stigmatized, often with lifetime criminal records.



Carpenter details the mounting crisis in both countries in full and makes the case that the only effective strategy is to defund the cartels through drug legalization. As Vicente Fox, former president of Mexico, writes in the book's Foreword, "We now stand on the final frontier of the old approach to drug policy, as evidence mounts that the current strategy is not working."

As the violence flares to an alarming extent in Mexico, the only solution, Carpenter argues, is also the most radical. "U.S. leaders need to take constructive action now, before that fire consumes our neighbor's home and threatens our own," he concludes. ■

Visit www.cato.org/store or call 800-767-1241 to get your copy of *The Fire Next Door* today; $24.95 hardback.

Libertarians and the Tea Party

In 2010 the top political story was the rise of the tea party. This year, the persistence of libertarian support for Ron Paul garnered headlines. The authors of a new paper argue that these trends are "two parts to the same story—a story of the emergence of a libertarian constituency that has planted roots in the tea party." In **"Libertarian Roots of the Tea Party"** (Cato Policy Analysis no. 705), David Kirby, vice president at FreedomWorks, and Emily Ekins, a Cato research fellow and director of polling at Reason Foundation, offer the most comprehensive analysis of polling data on the tea party to date. Using comprehensive data analysis techniques, the authors find that the tea party is united on economic issues but split in half on the social issues it tends to avoid. Interestingly, from early 2008 through early 2009, libertarians—when compared with conservative tea partiers and Republicans more generally—were more than twice as angry with the Republican Party, more pessimistic about the economy and deficit, and more frustrated with their inability to affect government. "Libertarians seem to start at a higher level of agitation," they write, "leading the way for tea partiers and Republicans, who catch up over time." As such, the tea party is "upending the conventional wisdom," showing that Republican candidates must win over tea-party voters rather than placate social conservatives. It may take some years for this impulse to come to fruition. "But in the longer sweep of history, libertarian ideas are undoubtedly on the upswing," Kirby and Ekins conclude.

Regulators and Credit Ratings

Among the variety of factors that contributed to the financial crisis of 2008 was the perception that risky assets were actually reliable. This error resulted in part from a lack of competition among credit rating agencies (CRAs)—which, as the authors of a new study write, stemmed from regulatory barriers and mandated usage of these ratings. In **"Regulation, Market Structure, and the Role of Credit Rating Agencies"** (Cato Policy Analysis no. 704), Mark Calabria, director of financial regulation studies at the Cato Institute, and Emily Ekins, a Cato research fellow and director of polling at Reason Foundation, examine the origins of the credit rating agencies, highlighting the role of certain regulations in "creating regulatory dependence on designated agencies' ratings." The core of the problem is the lack of competition within the rating industry. "Entrenched market power has led to the predictable result that rating agencies would reduce the quality of their services," Calabria and Ekins write. In turn, the excessive leverage and asset regulation that resulted would not have

CATO POLICY REPORT is a bimonthly review published by the Cato Institute and sent to all contributors. It is indexed in PAIS Bulletin. Single issues are $2.00 a copy. ISSN: 0743-605X. ©2010 by the Cato Institute. • Correspondence should be addressed to *Cato Policy Report*, 1000 Massachusetts Ave., N.W., Washington, D.C. 20001. • Website: www.cato.org, call 202-842-0200, or fax 202-842-3490.

occurred "had financial regulators not embedded the use of ratings into the fabric of prudential regulation." Increased competition alone, however, will not address the dysfunction within the credit ratings industry. Policymakers should eliminate regulatory reliance on credit ratings, reducing the oligopolistic power of the CRAs and the artificial demand for these ratings. Reducing the central role of these agencies would "greatly increase the quality and quantity of monitoring of financial risk."

The Defense Budget's Excess Burden

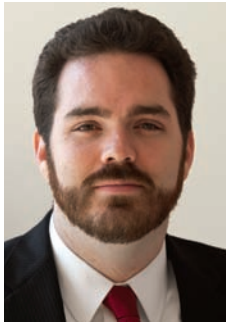
As the public debate over the future of defense spending intensifies, many are questioning whether the current structure of the U.S. military should be downsized. In **"Economic Effects of Reduction in Defense Outlays"** (Cato Policy Analysis no. 706), Benjamin Zycher, a senior fellow at the Pacific Research Institute and a visiting scholar at the American Enterprise Institute, considers the aggregate economic effects that would occur if defense outlays were reduced. Assuming spending cuts of $100 billion per year over 10 years, Zycher challenges the findings of several recent studies that conclude that such reductions will have adverse economic and employment effects. On the contrary, defense services are similar to most other goods, he writes—and therefore unemployment, as well as the other economic effects from military cuts, is "irrelevant in terms of the appropriate level of defense spending." The cuts simply shift resources among economic sectors. The resulting unemployment during this adjustment process, while "politically significant," only has temporary economic effects. Ultimately, Zycher highlights "the benefits of an economic system that reallocates resources to more productive uses as economic conditions change." He notes that the reduction in defense spending would reduce the costs of the excess burden that the tax system imposes on the economy, estimating that the cuts would reduce economic costs by $135 billion per year. "In short, the changing long-term threat environment facing the United States, at least arguably, will yield an optimal force structure smaller than that currently supported," he concludes.

The Charter School Paradox

The explosive growth of charter schools has marked an important change in the composition of primary and secondary education in the United States. Although the first one was founded just two decades ago, charters now enroll more than 1.7 million students in nearly 5,400 separate institutions. In **"The Impact of Charter Schools on Public and Private School Enrollment"** (Cato Policy Analysis no. 707), Richard Buddin, an adjunct senior economist at the RAND Corporation, examines the changes in enrollment across different types of schools, with particular emphasis on the growing charter-school sector. In analyzing district-level enrollment patterns throughout the relevant states, he finds that while most students are drawn from traditional public schools, "charters are pulling large numbers of students from the private education market" as well. This presents "a potentially devastating impact" on that market, he writes. In highly urban areas, for instance, "charter enrollments increased 14.8 percent from 2000 to 2008, while all types of private enrollments declined, "led by a 5.6 percent annual decline in Catholic school enrollments" in particular. This shift will represent a serious increase in the financial burden of taxpayers. "Charter school gains may come at a significant cost as shifts from private to public enrollment significantly increase public school costs," Buddin writes. He concludes by noting that if governments increase educational spending, tax revenues must be increased or spending in other areas reduced. In either case, this student shift represents a significant trend within the U.S. education market—one that undoubtedly requires further attention. In a companion piece to Buddin's analysis—which can be downloaded at www.cato.org/pubs/pas/Charter-School-Paradox.pdf—former policy analyst Adam Schaeffer argues that the seeming contradictions in what he calls "the charter school paradox" are simply "the unintended consequences of inadequate, public-sector-only reform."

Protectionism in Intellectual Property

The complex web of intellectual property competition today has resulted in a state of constant litigation between companies that can afford to use the courts as tools for negotiating better licensing terms. One such tool is Section 337 of the Tariff Act of 1930. According to Cato trade policy analyst K. William Watson in **"Still a Protectionist Trade Remedy"** (Cato Policy Analysis no. 708), Section 337 gives the U.S. International Trade Commission (ITC) the power to exclude imports if it finds that foreign manufacturers have engaged in "unfair methods of competition." In addition to filing a lawsuit in federal district court, U.S. patent holders can use Section 337 over the same subject matter. This tactic has become increasingly popular—the ITC has the power to render total exclusion of a product from the U.S. market—yet, as Watson argues, the mechanism has had "negative consequences for the coherence of U.S. patent law." The availability of a second venue to pursue patent lawsuits constrains the integrity and functionality of intellectual property "by establishing a dual-track system for patent enforcement." This, in turn, allows the law to serve as "a purely protectionist trade remedy mechanism." In the end, Watson writes, the only answer is full repeal of Section 337. Otherwise, the law poses substantial risk not only to the effectiveness of the patent system, but also "the ability of the United States to participate in the international trading system" and "the rights of American consumers to pick their own winners and losers in a globalized economy." ■



CATO POLICY REPORT
1000 Massachusetts Ave., N.W.
Washington, D.C. 20001

ADDRESS SERVICE REQUESTED

"To Be Governed..."

LET THE GOOD TIMES ROLL, THANKS TO THE TAXPAYERS

Washington may have the healthiest economy of any major metropolitan area in the country.

The unemployment rate was 5.7 percent in June, compared with 9.3 percent in Chicago, 9.6 percent in New York and 10.3 percent in Los Angeles. The average house price in the region is more than 10 percent above the 2009 nadir, while nationwide prices remain near a decade-long low.

And you can actually see the prosperity. . . .

Downtown Washington is full of cranes. . . .

In McLean, Va., and Potomac, Md., mansions continue to rise from the ground.

According to a Gallup poll, Washington is the country's most economically confident region.

—***New York Times,*** August 5, 2012

EXCEPT ON DRUGS, MARRIAGE, SCHOOLS...

Conservatives . . . favor investing authority in the level of government closest to the people (locales and states), which they believe is most responsive and governs best.

—**Jennifer Rubin,** ***Washington Post,*** August 27, 2012

HIGH STAKES IN THE ELECTION

The match is uneven, to be sure, but the stakes are high. Securing a second Obama victory is the only way we can be assured that our nation will not return to the dark era when it was choked in the grip of an imperial president who executed suspected terrorists with impunity and commanded lawless prison camps while drowning us in debt.

—**Zhubin Parang,** ***Tunnel Vision,*** **Spring 2012**

WASHINGTON'S UNDERSTANDING OF "SUCCESS IN THE CORPORATE WORLD"

The fortunes of Sen. Tom Harkin (D-Iowa) can also be traced to his wife's success in the corporate world. The senator's estimated wealth jumped by more than 500 percent between 2004 and 2010, from $3 million to $17 million, the *Post* analysis found.

Tom and Ruth Harkin were married in 1968, but the couple didn't begin to amass wealth until the early 2000s. Ruth Harkin worked as a prosecutor and as a lawyer for the Department of Agriculture before joining the law firm Akin Gump, where she represented companies involved in international business deals. She left to head the Overseas Private Investment Corp. before joining United Technologies as a senior vice president for international affairs and government relations.

In the early 2000s, Tom and Ruth Harkin opened mutual funds and began investing heavily in the financial markets. In disclosure forms filed with the Senate, Tom Harkin attributed much of his wealth to his wife, including her holdings in United Technologies and ConocoPhillips, where she served as a board member until recently.

—***Washington Post,*** October 7, 2012

IT'S ALMOST AS IF GOVERNMENT FUNDING MAKES PRICES RISE

[I]ncreases in the price of what the federal government buys relative to what the private sector buys will inevitably raise the cost of state involvement in the economy. Since the early 1980s the price of hospital care and higher education has risen fivefold relative to the price of cars and clothing, and more than a hundredfold relative to the price of televisions.

—**Lawrence Summers,** ***Washington Post,*** August 19, 2012

UNHEALTHY SNACKS: YOUR TAX DOLLARS AT WORK

Brian Reis, who runs a company making potato chips and other snack food about 100 miles from Cleveland . . . has received three Small Business Administration loans totaling $3.9 million since Obama took office, along with a $2 million loan during the Bush administration. In August, the agency's head, Karen Mills, toured his facility for the launch of a kit that allows people to flavor their own gourmet potato chips. Last year, Biden singled him out in a speech near Cleveland.

—***Washington Post,*** September 25, 2012

SO GIVE GOVERNMENT MORE POWER

"It's not a story of one side wants government and the other side doesn't," [Elizabeth Warren] said.

"This is a story about how government gets used. Government gets used to protect those who have already made it."

—***New Yorker,*** September 17, 2012